Ai Group

Submission

to the

Parliamentary Joint Committee on Corporations and Financial Services'

Inquiry into the Structure and Operation of the Superannuation Industry

September 2006

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Ai Group has a long-standing interest and participation in Australia's superannuation industry.

As a leading employer body with a close involvement in public policy, Ai Group represents businesses' views on a variety of issues impacting on superannuation.

Ai Group is the sole employer organisation shareholder of AustralianSuper Pty Ltd which is the trustee for AustralianSuper. AustralianSuper is a not for profit superannuation fund that was formed as the result of a merger between the Australian Retirement Fund (ARF) and Superannuation Trust of Australia (STA) and the amalgamation of FinSuper. Ai Group was also a shareholder of the trustees of both STA and ARF. AustralianSuper's profile includes over 1,200,000 members, 65,000 participating employers and in excess of $20 billion of funds under management.

Ai Group also participates in the management and control of CARE Super and Aust(Q) another two industry superannuation funds.

We welcome the opportunity to make this submission to the current inquiry into the structure and operation of the industry.

General Comments

The stated purpose of the present inquiry is to investigate the structure and operation of the *Superannuation Industry (Supervision) Act 1993* and the superannuation industry to ensure that it provides an efficient, effective and safe regulatory structure for the management of superannuation funds.

This inquiry was initiated very shortly after the end of the transition period for the introduction of the new licensing and registration regime administered by the Australian Prudential Regulation Authority. It also occurs after some 20 separate inquiries into superannuation in the last five years and on the threshold of major changes to the taxation of superannuation to apply from 1 July next year.

The new regime was decided upon by the Commonwealth Government only after a very thorough investigation and a broad-ranging consultative process. Ai Group does not think there has been adequate experience with the new regime which introduced substantial new prudential standards to permit a meaningful evaluation of its operation. We are of the view that this regime needs to be tested thoroughly before a proper evaluation can be made of its impacts on the structure and operation of the industry. The following comments therefore need to be read in this context.

In general, the superannuation industry appears to working very well although enhanced regulatory standards and changing legislative requirements continue to impose complexity and costs on administrators, trustees and investors in superannuation. There is a high degree of investor confidence in the current regime – something that is evident from the ongoing growth of superannuation and the remarkable level of stability evident following the introduction of superannuation choice in 2005.

1. Whether uniform capital requirements should apply to trustees.

Ai Group submits that it would be inappropriate to impose new capital adequacy requirements on trustees.

It is generally acknowledged that the need for capital adequacy rules should be assessed in the light of the full range of circumstances and regulatory arrangements impacting on asset management.

For example the International Investment Funds Association has argued that:

> Any consideration of capital requirements for asset management activities should be based on a full understanding:
>
> (a) of the reasons for such requirements;
>
> (b) of the risks involved in asset management in general and of operating investment funds in particular and of how these differ from risks within other financial services activities;
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> (c) of regulatory requirements applicable to investment funds, particularly those designed to mitigate risks, such as requirements that assets be held by third party; rules against conflicts of interest; rules preventing managers from undertaking trading activity; independent oversight of compliance with regulations; and the active involvement of regulators in establishing and monitoring regulations;
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> (d) of alternatives to capital requirements, such as insurance, investor compensation schemes, or contingency funds.[1]

This broad, contextural approach to assessment of the need for capital adequacy provisions was explicitly recognised in the Commonwealth Government's 2002 response to suggestions that additional capital adequacy requirements should apply to the Australian superannuation industry.

> The Government supports in-principle a risk sensitive framework for the holding of capital to address operational risk, but considers that the combination of requirements that each trustee be licensed by APRA, and prepare a risk management plan, will substantially address concerns relating to operational risk.
>
> Arguably the need for capital in the future may be substantially reduced as other factors come into play to address operational risk. On this basis, the Government supports the retention of the status quo for capital requirements at this time, to be revisited once the impact of the licensing and RMP reforms can be assessed.[2]

[1] International Investment Funds Association, 15th Annual Conference, 2001.
[2] Commonwealth of Australia, *Government Response to SWG Recommendations*, 28 October 2002.

With the transition period for the introduction of the new licensing and registration regime only ending on 30 June 2006, Ai Group submits that it would be premature for further regulatory arrangements to be imposed in addition to those that have only just begun to operate and for which there is insufficient experience from which to assess their impact.

More generally in line with arguments developed by the Investment & Financial Services Association (IFSA) in its submission to the Superannuation Working Group in 2002[3], Ai Group would question the suitability of capital adequacy arrangements applying to the trustees of accumulation superannuation funds. These funds are fully allocated to individual accounts and the investment arrangements are subject to disclosure arrangements. Moreover, superannuation savings are held in trusts and are generally invested in managed investments without forming part of the balance sheet of the superannuation provider.

Further, the Committee should bear in mind that capital adequacy requirements impose an opportunity cost and that these costs would be borne ultimately by superannuation investors.

If consideration were to be given to mandating reserves of some kind, full weight would need to be given to the additional compliance costs involved; the opportunity costs involved and the need to consult closely – particularly over the careful design of appropriate transitional arrangements.[4]

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

Ai Group submits that trustees should not be required to be public companies.

We are not aware of any arguments justifying suggestions that Australian superannuation trustees should be public companies.

Any consideration of the proposal that trustees should be public companies would need to closely examine the desirability of the purposes such a move would be intended to achieve and whether such purposes could not be achieved without requiring superannuation trustees to become public companies. Close consideration would also need to be paid to the additional costs - of both a transitional and ongoing nature - that the requirement would impose and the impacts of these costs on superannuation investors.

Further, experience indicates that in many cases trustees of highly successful and well managed superannuation funds are not public companies. These include the trustees of AustralianSuper, CARE and Aust(Q). We submit that the well-established equal representation structure of such trustees is well suited to the needs of superannuation funds and their members.

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[3] Investment & Financial Services Association, *Submission to Superannuation Working Group*, 6 February 2002.

[4] *The Australian*, "Warning on need for super reserves", 11 September 2006

3. The relevance of Australian Prudential Regulation Authority standards.

The APRA standards that have been introduced over the past two years were developed following a very rigorous examination of the superannuation industry in Australia involving a very thorough consultation process.

The new regime includes the provision that all superannuation trustees must have a prescribed licence to operate as a superannuation trustee. The stated purpose of the licensing regime is to "ensure that all superannuation trustees are competent and have adequate systems to look after the interests of superannuation fund members."[5]

- In general terms the rules require that trustees meet minimum standards of competency; have adequate resources; have a risk management plan and adequate risk management systems (including a fraud control plan); systems to manage outsourcing. In addition APRA can develop other systems that it considers appropriate to operate the proposed business.

- APRA also has powers to ensure compliance with the new licensing framework. These include the power to issue directions; disqualify trustees; vary conditions and suspend or revoke licences.

- A rigorous qualification process was applied by APRA to all applicants got the new Registerable Superannuation License applying from 1 July 2006.

- It should also be noted that corporate trustees that are not public companies (for example AustralianSuper Pty Ltd) are also subject to the additional financial licensing requirements administered by the Australian Securities and Investments Commission (ASIC).

While it is unreasonable to assume that the current standards will prove to be perfect, Ai Group believes they are certainly conducive to the efficient, effective and safe regulation of the management of superannuation funds and need to be evaluated over a reasonable period of time. .

4. The role of advice in superannuation.

Advice about superannuation serves a number of important purposes and is central to the smooth functioning of the market for superannuation products.

Regulatory arrangements need to be assessed carefully to ensure that rules relating to advice do not act as a barrier to investors receiving well-considered advice in which they can have a high level of confidence. We submit that the Committee should examine existing regulations covering advice to explore ways they can be modified to improve investors' access to appropriate advice.

A difficulty in ensuring such advice is reliable arises when advisors stand to gain in some way from an investor channelling their investment in a particular direction. In

[5] Commonwealth of Australia, *Government Response to SWG Recommendations*, 28 October 2002.

such circumstances investors should have confidence that the advisor has ensured that the investor is fully informed of any such interest. This applies most obviously when there is a direct commission paid to the advisor in the event of an investor opting for a particular course of action. Such commissions should be fully declared when advice is given.

Ai Group considers that there is a need for enhanced transparency and objectivity in the general provision of financial advice. We submit that this area should be considered by legislators and the relevant regulatory authorities as a matter of priority.

5. The meaning of member investment choice.

Generally, members of superannuation funds have choices between alternative funds and, within funds, have choices about alternative investment options.

The wide range of choices facing members provides opportunities for them to match alternative investment strategies with their own requirements and in particular with the risk/return profile they would prefer for their investment.

In response to greater choice between superannuation funds, many superannuation funds are increasing the range of investment choices available to their members.

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

Ai Group maintains that trustees have responsibilities to ensure that individual members are properly informed about the choices available to them and are similarly informed about the risks associated with alternative investment strategies.

At the same time, Ai Group believes that provided effective regulation of product disclosure statements and financial planning advice is maintained, the responsibility for exercising choice should rest in the individual and not be constrained by arbitrary limits imposed on trustees. For example, the number of investment options chosen by an individual member and the proportionate allocation between options should be the ultimate responsibility of the individual member.

As part of their more general responsibilities, Ai Group believes that trustees also have responsibilities to existing and potential members to offer a selection of investment options that will assist the fund retain existing members and attract new members. This assists in funds' objectives of realising scale economies where such economies are available.

7. The reasons for the growth in self managed superannuation funds.

Self managed superannuation funds have grown for a wide variety of reasons ranging from higher levels of financial literacy in the broader community to astute marketing by sections of the financial services industry (including the activities of financial planners).

Ai Group maintains that one reason for the growth in self managed superannuation funds that is often under-appreciated is that many individuals achieve a degree of non-pecuniary satisfaction from self management. In some cases individuals may tolerate relatively high compliance costs and the possibility of somewhat lower investment returns in order to have a greater "hands on" feeling.

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

Ai Group believes that one of the major factors behind the demise of defined benefit funds is the inefficiencies in the allocation of risk associated with the defined benefit approach. Importantly, this includes the increasing costs and the distraction of management time imposed by the assumption of risk by trustees of defined benefit funds. In the context of an increasingly competitive global commercial environment, the opportunity costs of management time have risen and continue to rise.

9. Cost of compliance.

Compliance costs are necessarily borne by fund members, employers and taxpayers. Increasing complexity and new rules inevitably generate additional costs and give rise to the risk of reduced benefits for investors. Such impacts should be carefully considered when weighing the suitability of existing and prospective legislation, regulation and protocols.

10. The appropriateness of the funding arrangements for prudential regulation.

The current arrangements for funding prudential regulation are a mix of public funding and charges levied on regulated bodies.

While concerned with the steep increase in recent years of the charges levied on regulated bodies, Ai Group believes that some mix of government funding and such charges is generally appropriate. While it is always difficult to measure the benefits of regulation with any precision, the *intended* benefits include a greater level of financial stability; greater financial security and higher levels of confidence. If these outcomes are achieved they are of benefit both to individual superannuation investors as well as to the broader community. Superannuation investors ultimately bear the burden of charges paid by regulated bodies and the broader community finances government funding through its contribution to general taxation revenue. Thus the costs of regulation are borne in some relation to the benefits of that regulation.

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

By informing both existing and potential members of the existence and performance of a fund and of the variety of services offered by a fund, promotional advertising

helps inform existing and potential members of the full range of opportunities available to them. In so doing it empowers existing and potential members to make well-informed decisions in their own interests.

By making the existence of, and benefits associated with funds more widely known, funds are able to compete in the market and, if successful, can assist in achieving greater economies of scale. The benefits of such economies of scale flow to existing and potential members who are able to share in those benefits. Further, in the context of the contestable market for superannuation service provision, promotional advertising can assist in avoiding a loss of market share which could be associated with rising unit costs. Avoiding higher unit costs is of benefit both to existing and potential members.

In light of these points Ai Group maintains that appropriate promotional advertising should properly be a legitimate cost to funds and their members. At the same time, Ai Group supports accountability of management and transparency of reporting so that existing and potential members can be aware of the cost structure of different funds and make their investment choices accordingly.

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

The Commonwealth Government's Australian Accounting Standards Board (AASB) defines a not for profit entity as "an entity whose principal objective is not the generation of profit".[6] More generally, the distinguishing feature of a not for profit organisation is the existence of legal, ethical, behavioural or constitutional restrictions on the distribution of profits to owners or shareholders.

In Ai Group's view, an entity may reasonably be described as a "not for profit" entity if its practice is not to pay dividends to its shareholders (and not to accumulate reserves for future distribution to shareholders).

In the case of a not for profit superannuation fund with members, statements such as "run only to profit members" and "all profits go to members" provide shorthand signals to current and potential members to inform them that the fund's shareholders do not derive a profit in relation to that shareholding.

13. Benchmarking Australia against international practice and experience.

As a general principle Ai Group supports benchmarking against international practice and experience as a useful tool in informing assessment of performance. Clearly however, neither departures from, nor concordance with international practice should be used on their own to assess performance.

On the information presently available to Ai Group, we are not aware of any overseas systems where the regulatory arrangements would appear to provide greater security

[6] AASB, "Not-for-profit entity requirements in Australian Accounting Standards" November 2005

of benefits consistent with the investment options and returns and the level and allocation of overall system costs as in Australia.

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

The experience of the superannuation industry over an extended period has been one of exceptionally low levels of loss of funds due to wrongful acts and employer insolvency. We further note that, as part of its regulatory role and advisory roles, APRA maintains a close interest in the measures funds employ to secure the protection of investors against losses.

In relation to protection against employer insolvency, a very fundamental protection is provided by the fact that employers are required to pay superannuation contributions periodically (quarterly or monthly) with the rights to funds vesting in the fund member. Very onerous penalties are applied by the Australian Taxation Office when employers do not make timely payments. Protection provided by this fundamental design feature needs to be borne in mind when assessing the adequacy of protection against employer insolvency.

In Ai Group's view existing insurance arrangements provide adequate scope for the protection of investors in the event of theft and fraud. Broadly, where Trustees maintain adequate Trustee Liability or Professional Indemnity Insurance, as part of their overall risk management plan, the risk of such losses will be sufficiently mitigated.

Ai Group also draws the Committee's attention to grants of financial assistance that can be made under Part 23 of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) to superannuation funds that have suffered loss as a result of fraudulent conduct or theft. We further the *Superannuation (Financial Assistance Funding) Levy Act 1993* (the Levy Act) which provides for the imposition of levies on regulated superannuation funds and approved deposit funds to recoup the amount of grants provided under the SIS Act.

While we are not entirely convinced of the argument, Ai Group does see some points of merit suggestions that there could be a role for some form of community fund to act as a last resort in replacing all or part of superannuation benefits losses incurred by members of a regulated fund where the loss is due to theft or fraud. The structure, efficiency and cost effectiveness of any such arrangement would need considerable careful evaluation.