Parliamentary Joint Committee on Corporations and Financial Services

Submission by Trowbridge Deloitte

29 September 2006

Trowbridge Deloitte

Committee Secretary

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

Dear Mr Sullivan,

Re: Inquiry into the structure and operation of the superannuation industry

We have pleasure in enclosing our submission for consideration in the Parliamentary Joint Committee inquiry.

Yours sincerely

Andrew Gale
Partner

Anthony Asher
Consultant

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Trowbridge Deloitte

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Introduction

Trowbridge Deloitte is the Actuarial advisory arm of Deloitte Touche Tohmatsu in Australia. A key component of the global Actuarial and Insurance Solution Group, Trowbridge Deloitte is active in both Australia and New Zealand and provides support throughout South East Asia and Japan. Our strengths are focused in Banking, Wealth Management & Life Insurance, General Insurance and Health.

A number of the questions in the Joint Committee's terms of reference intersect with work we have done. Of the most relevant, the Deloitte Super model projects the future market for superannuation assets by projecting inflows and outputs to the system. Our team has also been extensively involved in risk and capital management and current issues such as the correction of unit pricing errors. Trowbridge Deloitte is also an industry leader in the provision of wealth management distribution, platform and customer insight strategies.

We have pleasure in sharing some of the insights we have gained for the Joint Committee's consideration. We also make a number of recommendations.

In order to comply with the law as it stands, we need to make it clear that financial product advice we make is of a general nature, and is not specific to the personal needs of the Joint Committee or anyone else who reads the submission.

Summary of recommendations

We do not believe that there are any major problems with the structure of the Australian superannuation industry. Market participants operate on a fairly level and soundly regulated playing field that offers members a range of choices and is soundly regulated.

It does however appear that there is widespread agreement that the regulatory environment is too complex. In our opinion, a simpler, more principles based approach would lead to cost savings and greater innovation in meeting the needs of superannuation fund members. We make a number of suggestions to simplify the regulatory structure, enhance the information available to members, and to make trustees more accountable.

In summary:

Trustees should ensure that members bear their fair share of losses. This requires that funds have access to a minimum level of capital, and that members be informed of the trustee's approach to the allocation of losses.

Members of not-for-profit-funds, particularly, could be given more information about the business and financial position of the fund. They could also be given the right to directly elect trustees at annual general meetings.

Superannuation legislation should be simplified, mainly by removing provisions that are unnecessary given APRA's significant powers under the licensing regime.

The market conduct legislation should be replaced with more principle based legislation, but APRA should publish information in the form of industry performance tables, and ASIC should set standardized investment projection rates to encourage better planning. Various rules should be relaxed to encourage the provision of more holistic advice.

Superannuation accounting rules should specifically require reporting of amounts that could involve conflicts of interest. Defined benefit (DB) members should be given information about the effect of their salary increases on the value of their pension, and investment guarantees offered by employers should be made explicit.

Tax rules should be amended so that they do not stand in way of product innovation and the rationalization of funds and products. Rationalization should include DB arrangements. We think that this greater flexibility would facilitate the development of different ways of replacing the investment smoothing or guarantee benefits that DB members currently enjoy.

We would be happy to expand on any of the points should the Joint Committee want further input.

1 Capital requirements

This section also covers point 14 – Compensation

Terms of reference:

1 Whether uniform capital requirements should apply to trustees.

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

Companies require capital to absorb risk that is not managed or transferred to other parties. Trustees with access to significant share capital normally absorb the losses suffered by superannuation fund members, but charge the members for doing so. Losses are however currently born directly by the members of less well capitalised trustees of non-profit funds. The risks in corporate and public sector funds may be shared between employers and members.

In order to understand the advantages and disadvantages of alternative approaches, it is necessary to understand the risks. Many different approaches can be taken to classify risks. The analysis below is helpful for our purpose. The relative size of these risks can estimated by the capital requirements that the Actuarial Standards of the Life Insurance Actuarial Standards Board impose on life insurance companies in terms of the Life Insurance Act. This is because life insurers have a similar risk profile to superannuation funds.

1.1 Market risks

Market risk arises from the volatility in realisable value of the assets, or more strictly, the volatility in the difference between the realisable value of the assets and the associated liabilities. Elements of asset risks that are sometimes separately identified are asset concentration, interest rate, mis-matching and liquidity risk.

In the Actuarial Standards, resilience reserves are required for market risk. For a company that is invested in a typical balanced portfolio of assets, and guaranteed that returns would not be negative, the reserves for capital adequacy would currently be some 20% of assets. On the other hand, if the policies are investment-linked, the market risks are born by the policyholders and no reserves are required.

1.2 Insurance risks

Insurance risks arise from charging inadequate premiums or providing inadequate reserves for future claims after the premiums have been received.

Inadequate pricing can arise from underestimating the number or size of the claims. Particularly problems arise from inadequate underwriting or unexpected inflation - especially legally driven “super-imposed” inflation. The risk can be mitigated by reinsurance – which creates a further risk that the re-insurer may fail.

The Actuarial Standards require a maximum of 50% of the insurance risk to be held as a reserve for capital adequacy. Total insurance premiums for all superannuation funds are reported as of

the order of $1 billion compared with assets of over $850 billion. The average superannuation fund would therefore require mortality and disability reserves of less than 0.1% of assets.

Superannuation funds may differ from life insurance companies because of a concentration risk: all their members may work for a single employer and be concentrated in one location. The risk of a single event causing catastrophic loss is therefore greater, but catastrophe insurance can be obtained for this. APRA has however taken an extra-ordinary cautious view of insurance:

"While APRA does not prohibit corporate funds from self-insuring death and disability benefits, approved trustees of public offer funds are not permitted to self-insure. The lack of comparative pricing, lack of adequate and specific reserving and segregation of such reserves to prevent double counting are of concern to APRA."[1]

Given that the members of superannuation funds are typically taking investment risks that can be calculated at 200 times greater than the insurance risk, APRA appears to be unnecessarily conservative on this point.

For funds that offer annuities, the risks deriving from annuitant mortality are larger and do need more capital. The need for capital can however be reduced if the risks are shared with the annuitants.

1.3 Business and operational risks

Business risks can be described as risks that expense charges are inadequate to cover actual expenses. It includes all management and operational risks that affect expenses, and competitive and economic risks that affect revenues.

Life insurance companies face capital requirements equal to their new business risks, plus 20% of their servicing expenses, plus 0.5% to 2.5% of their investment linked business – all of which might be considered as required for business risks. In comparison, the Basel II framework (2003)[2] will require banks using the "basic indicator" to set their operational risk capital requirement at 15% of their income (net of interest costs). (It can be noted that operational risk is defined variously and the banking definition is for risks that arise from failings in internal control and corporate governance.)

This suggests that the reserves required for business risks might be considered to vary between 0.5% and as much as 4% of assets.

These reserves can be compared with recent losses incurred for correction of unit pricing errors. APRA reports that "there have been several instances of unit pricing errors involving compensation of more than $10 million and affecting many thousands of investors." Recent press reports refer to enforceable undertakings from the largest organizations: AMP, CBA, MLC and ING.

The current capital requirement for trustees of $5 million is therefore relatively small.

1.4 Alternative approaches

There are a variety of ways in which trustees can allocate the losses that arise from the risks mentioned above. There seems no obvious approach that is always superior.

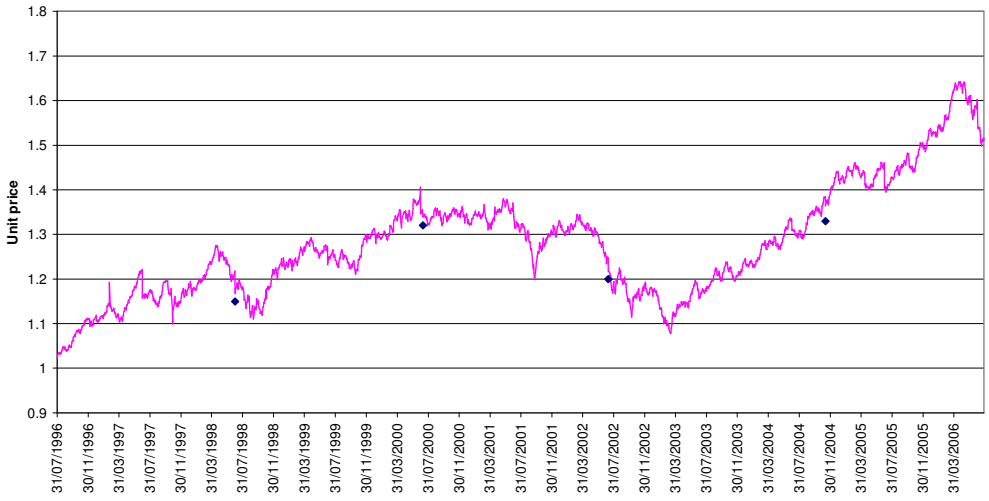
1.4.1 Debit members as losses occur

If funds have no explicit capital, then losses must be deducted from member accounts. If the members are already taking investment risks, it is a small step to also take insurance and business risks because they are so much smaller.

It may be helpful to illustrate. The total capital reported for the investment linked statutory funds of life insurance companies is 1.5% of assets.[3] This capital ought to be somewhat more than that which the companies require for a one in four hundred year event.

The chart below shows how small even a total loss of capital would be relative to the daily movement of unit prices. The price has been artificially reduced by 1.5% at each of the points marked in blue. The effects are lost in the fluctuations of the market. While losses of this sort are not insignificant in themselves, they make little difference to the risk being taken by the members.

Typical investment performance - with 1 in 400 year losses of capital



While the percentage loss may be small, the amounts concerned can be large and it is important to ensure that all members are treated fairly. Members should be made aware that the value of their units can be reduced if there are errors in unit pricing, and that they may suffer through no fault of their own. Trustees should consider ways of ensuring that different generations of members bear their fair share of the risk. Alternative means of achieving this are set out below.

1.4.2 Accumulate reserves

While the risks are not large, they should be fairly allocated. An alternative approach is to spread the risks over time with the intention of ensuring that they are not suffered by those members unlucky enough to be present at the time of a catastrophe. Some funds do accumulate reserves for catastrophes for this reason.

There is a danger that reserves of this sort inadvertently become too big and then difficult to distribute fairly to members. This does not mean that funds should not hold specific reserves –

either in the fund or in the management company. They should be large enough to meaningfully absorb risks, but not too large to represent a temptation for misappropriation. They should be subject to a policy that sets out their purpose, including specifics of how they are to be built up and utilized.

1.4.3 Explicit capital

The reserves can alternatively be provided by normal share capital to absorb these risks. Shareholders will however typically look for a risk premium on their capital of between 5% and 10%. This means that over a period between 10 and 20 years, members of the superannuation fund will pay an amount equal to the cost of a 1 in 400 year event.

There are also alternative forms of capital that can be raised in today's sophisticated financial markets. These may be structured to absorb all or some of the risks attached to a fund. They may be more suitable for mutual organizations that do not wish to surrender control to shareholders.

1.4.4 Reinsurance and outsourcing

An alternative, which has been enforced by APRA in the licensing process, is to require trustees without adequate capital resources to outsource operations or to hold adequate indemnity insurance. This reduces the likelihood that members will have to bear any operational loss, but cannot provide complete cover. This is because insurance cover cannot cover business risks, which a trustee will have to incur in order to keep its administrative systems up to date even if it does not engage in marketing efforts to attract new members.

1.4.5 Extending compensation

Some of these risks are already covered by the Superannuation Protection Account[4]. This provides financial assistance to funds for losses that result from fraudulent conduct or theft that leads to "substantial diminution of the fund leading to difficulties in the payment of benefits." The amount and the source of the compensation are at the discretion of the Treasurer.

The cover offered by this fund could be extended to include more causes: such as negligence, or catastrophic claims or investment performance. It could also be extended by defining or interpreting "substantial diminution" to mean any catastrophic losses that exceeded a particular percentage of the fund's assets.

Such a fund could become particularly expensive to administer and would be subject to moral hazards: all stakeholders might become more lax knowing that they would be compensated. The costs would be likely to fall on well managed funds.

1.5 Equity is allocation principle

It can be helpful to see the issue in terms of equity: how can profits and losses be fairly allocated? No one can claim to have all the answers on this subject: three thousand years of legal and philosophical debate have not been able to define equity precisely. We do understand however that there is agreement that people will often be able to agree that particular outcomes are inequitable (or alternatively unjust or unfair, which mean almost the same thing.)

In our experience in the rectification of unit pricing errors particularly, we have found that it is possible to set out a few important principles.

The issues arise when trustees are required to exercise discretion, which they have to do when allocating the consequences of some unforeseen loss. One approach, sometimes used in law, is to require the discretions to conform to the "reasonable expectations" of the members. It now seems to be widely accepted that reasonable benefit expectations are created by:

- legislation and legislative practices;
- the terms of the trust deed, past and present;
- past practices of the fund;
- what has been indicated to members in the past by both employers and trustees and
- practice by other funds.[5]

We would add that expectations should be reasonable in that the benefits should be affordable, and be consistent with the objectives of the fund. We also note that Tyler and Smith[6], in a review of the social science literature on justice, show that people are often more concerned with just procedures than just outcomes.

We believe that the general law, enforced by the regulators and the courts, provides an adequate framework within which trustees can exercise their discretion, and do not see sufficient grounds for further government action in this area.

1.6 Evaluating alternatives

The alternatives each have merits and are not mutually exclusive. Table 1 below summarises the issues.

Table 1: Alternatives

	Advantages	Disadvantages
Debit members	No unnecessary costs	May fall unfairly on current members
Build reserves	Spreads losses more in line with risk	Reserves more complicated to administer
Explicit Capital	Offers explicit protection	Requires greater charges
Insurance and outsourcing	Offers explicit protection	Limited coverage
Extend government protection	Offers greater protection	Moral hazards

We think that there would be some advantage in extending the situations where the Superannuation Protection Account was able to pay (by including gross negligence), but suggest that both the threshold and the percentage of the losses that are reimbursed should be set out in the legislation losses.

Of the other alternatives, we recommend that trustees be required to ensure that members are appropriately charged for business risks. This means that they should have access to capital reserves directly or by using insurance. Trustees should be free to choose their own methods of doing so, but the method and the reserves or the capital available for compensation should be clearly disclosed to members. We believe that the industry will rise to the challenge of providing alternative forms of capital to bear these risks.

2 Trustees as public companies

This section also covers point 12 - Meaning of not-for-profit.

Terms of reference:

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

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

We provide some insights from the international academic literature on the issues that seem to be of interest.

2.1 Public companies

We know of no trustees that are public companies and are not sure of the precise meaning of this point. In terms of the Corporations Act 2001, public companies must have at least 50 shareholders, hold annual general meetings (AGM) and have offices open to the public. We do see that there would be advantages if trustees held an AGM of the fund members rather than of shareholders, and believe that they should have offices that are open to the public. AGMs would present some logistical problems for members scattered around the country, but they would not be insurmountable.

We cannot however see the importance of having at least 50 shareholders and are so led to think that the underlying thrust of this point relates to whether they should have shares at all. This section of our submission therefore reports some of the international discussion of the differences between proprietary and mutual (or not-for–profit) structures.

2.2 Meaning of not-for-profit

APRA's statistical collections divide funds into four: corporate fund, public sector, industry and retail. The last category would normally be regarded as being run for commercial advantage: trustees are paid for their services and the trustees or related service providers are companies that make profits. The first three, on the other hand, are often controlled by trustees who are not remunerated for their services. They can legitimately be regarded as not-for-profit.

In the middle are funds where the trustees are remunerated but some or all of the trust companies and service providers are organizations that are run "otherwise than for profit"[7]. In the financial services sector, internationally, these organizations are referred to as mutuals and can be distinguished from proprietary companies by the fact that the capital required for the business is provided by the clients or policyholders and not outside shareholders. Policyholders and not shareholders therefore share the profits if any. A number of Australian industry funds effectively function as mutual organizations.

The table below sets out the theoretical advantages and disadvantages of both types of corporate structure.

2.3 Table 2: Alternatives

Costs and Benefits of Organizational Structures

Organizational Structure	Cost	Benefit
Mutual	As monitoring opportunities and incentives are reduced, less effective control over management is exercised.	The merging of ownership and customer interests leads to lower contracting costs to resolve conflicts between the groups.
Stock	The separation of owner and customer interests leads to higher contracting costs to resolve conflicts between the groups.	As monitoring opportunities and incentives are enhanced, more effective control over management is exercised.

Source: M J McNamara & S G Rhee (1992) Ownership Structure and Performance: The Demutualization of Life Insurers *Journal of Risk and Insurance* 59: 2: 221-238

There is some evidence that proprietary (stock) companies are more efficient, but mutuals may offer a better deal for their customers as the shareholders gain more than the benefit of the efficiencies.

McNamara and Rhee (1992) also report on views that the existence of both types of company structure – with their different advantages – increases the level of competition in a market. We agree with this assessment. Mutual organizations ought to attempt to exploit the view that all profits go to members; proprietary companies that they are more efficient and innovative.

There are however two major issues that relate to differences in structure on which we would like to comment: the role of capital and appropriate governance structures.

2.4 Governance

Appropriate governance is probably at least as important as capital and organizational structure to protect members.

2.4.1 Mutual company issues

It is widely recognized that mutuals face additional governance issues. As pointed out in Mayers et al[8], "without traded shares mutuals are not monitored in capital markets by institutional investors, other blockholders, or stock analysts." They also point out that boards of directors do not face the discipline of potential takeovers.

Monitoring power can be described in terms of "voice" and "exit". Mutual policyholders are not able to exercise the power of exit with the same ease as shareholders, and their voices are small and dispersed.

Mayers et al suggest that these factors increase the need for mutuals to have more non-executive directors. Their US research shows that the boards of mutuals tend to include more non-executives and that those that have more non-executives appear to function more efficiently. APRA's new governance standards for banks and insurers could provide an appropriate definition of independence, and requirements that boards of trustees have an appropriate renewal policy. The standards should be therefore be extended to apply to trustees as well as the other industries that are regulated.

Speckbacher (2003)[9] also discusses the problems of performance analysis within mutuals, making inter alia the point that directors and staff may accept a less than market packages for their services. We do not believe that this provides a reason to reduce the governance arrangements applicable to superannuation trustees.

Drucker (1991)[10] suggest that investors - especially if they cannot easily sell their shares - need an institutional structure to supervise management. The requirement to oversee the directors is even greater in the case of mutuals where members are even more locked in than shareholders. Drucker suggests an outside business audit covering the company's:

- mission and strategies
- marketing
- innovation
- productivity
- people development
- community relations, and
- profitability.

To this one might add risk management.

It may well be helpful to the members of non-profit superannuation funds to introduce more stringent reporting requirements that would include some of the elements of a Financial Condition Report as required for insurers. In order to limit its costs, it could well be required only every three to five years, and be limited in scope to a level where the costs do not exceed those of the annual audit.

2.4.2 Representation

The Superannuation Industry (Supervision) Act 1993 (SIS Act) requires equal member and employer representation on either the governing body or a "Policy Committee". It is not clear however that member representation is adequately accountable to its constituency in the former case, or has sufficient power in the latter case.

There would appear to be arguments for more direct election of member representatives for all funds, and the inclusion of pensioners and annuitants as members with voting rights.

2.4.3 Our suggestions

As in the previous section, we would like to see full disclosure and a variety of competitive structures. We do think that there is merit in increasing the voice of superannuation fund members by giving them more financial information, through the direct election of trustees by members and pensioners (if there are any), and by the holding of AGMs. We also think trustees should be required to have offices that are open to the public.

3 APRA Standards

This section also covers point 9 – the cost of compliance.

Terms of reference:

3 The relevance of Australian Prudential Regulation Authority standards.

9 Cost of compliance

We believe that this is the area with which the Joint Committee should be most concerned, as the changes are directly within the power of Parliament. We do believe that the time is right to initiate a significant simplification of superannuation legislation, and have made a number of more detailed suggestions in this section. Such simplification should have in mind both a reduction in costs, but also make it easier to develop innovative ways of meeting the needs of the retired population.

3.1 APRA standards

In practice, the recent licensing process has given APRA the power to impose detailed conditions on trustees to conform to guidance notes and circulars that it has issued – even if the guidance notes expressly claim to have "no legal status or legal effect whatsoever".

While we do not have extensive evidence that this practical outworking has been problematic, we have seen instances of APRA giving detailed directions on matters that could, more appropriately, be the subject of regulation.

3.2 Risk management

The risks also need managing as is required by APRA's "Superannuation guidance note SGN120.1". The guidance note sets out requirements for all trustees to have a "Risk Management Strategy" that lays out how they will "identify, monitor and manage" the relevant risks. The requirements of the guidance note are at an appropriate high level and cover the important principles required. We understand that the licensing process has been rigorous in ensuring that all trustees have appropriate risk management strategies and plans.

It is however not clear that the non-investment risks have always been communicated to members. Some trustees have made their entire risk management plans available. One would expect some reference in the product disclosure statement (PDS) as to how non-investment risks would be born.

3.3 The SIS Act and Regulations

The SIS Act and Regulations, which ought to be read with Superannuation Guarantees (Administration) Act 1992 and the Retirement Savings Account Act 1997 and their regulations, make up well over a thousand pages. They are particularly repetitive[11] and clumsy, contain a

number of alternative and counter-intuitive definitions and compare unfavourably with other Acts administered by APRA as well as some international legislation such as the Canadian Pension Benefits Standards Act, 1985.

Specific suggestions for simplification would be:

- Transfer those parts and sections administered by the ATO and ASIC to legislation that they administer.

  The current plan to simplify taxation already requires a substantial re-writing. This could be put into another Act. (The opportunity should be taken to remove part 8, which is particularly convoluted and permits "in-house assets" that the common law would prohibit.)

- The terms of reference are somewhat confusing as APRA does not legally have the power to issue standards for superannuation funds and trustees. Issuing standards not already in the SIS Act is the prerogative of Treasury[12], which must incorporate them into the SIS regulations. We suggest that APRA's powers under the licensing regime allow for a rationalization of powers, and for some of these other sections of the Act to be removed. It would be better for APRA to be able to regulate superannuation funds in the same way as it manages its other industries. APRA should therefore be allowed to issue prudential standards that should specifically cover operating risks and fiduciary standards.

- Remove the distinction between superannuation funds and approved deposit funds, pooled superannuation trusts and retirement savings accounts. This would facilitate the removal of many of the repetitive passages that make the Acts so complex.

- Remove "member protection" that prevents administration charges exceeding investment earnings for accounts of less than $1,000[13]. These are wasteful. $1,000 represents less than a year's contributions for those on the minimum wage, so almost all of the accounts to which it applies arise because the members have not bothered to consolidate them. If the members are not sufficiently concerned to save the administration charges that they are paying on the small accounts, it seems unreasonable to require the trustees to cope with the administrative difficulties of treating them differently.

3.4 The Corporations Act and disclosure

Chapter 7 of the Corporations Act requires Financial Service Providers to give Financial Service Guides, Statements of Advice and Product Disclosure Statements. These complex and repetitive requirements have resulted in a proliferation of very lengthy documents that, although they are usually in plain English, are too long for anyone to bother to read. We imagine that many submissions to the Joint Committee will urge a change to the legislation that allows for greater flexibility and shorter and more relevant disclosure. This we support.

We also note that the proliferation of information has had the effect of making the legal wording of the contracts inaccessible to policyholders and members of superannuation funds. They are not given contracts of insurance or the governing rules of the fund. We suggest that it would be better for the legal documents to be more accessible, and for sales disclosure to focus on the critical elements of the financial instruments.

4 Advice and choice

This section covers points 4 and 5

Terms of reference:

4 The role of advice in superannuation.

5 The meaning of member investment choice.

Investment choice is available to most superannuation members. It gives them more control over their superannuation investments but can also lead to anxiety, additional costs and poor decision making. These are not arguments to remove choice, but place an onus of government and trustees to provide assistance with the choices that are made.

4.1 Current investment theory[14]

One problem is that current theory is not unanimous on how investment choice ought to be exercised. While most funds ask members to make a subjective choice of risk profile, the best theory would appear to be that the choice should depend on their other assets and liabilities, their future earning capacity, time horizons, risk appetite and the income required to maintain their current lifestyle.

Three other important facts emerge from research into the behaviour of superannuation fund members. The first is that the majority of members select the default option. The second is that a significant minority tend to make poor investment choices by trading too often and incurring additional expenses. The third is that members often do not make appropriate diversification choices.

4.2 The role of trustees

The tendency to adopt the default option places some obligation on trustees to make choices on behalf of members. The best of current theory suggests that the default option should take fewer risks for older members, but this will depend on the precise circumstances of the member (such as other investments, entitlement to pensions etc).

Trustees also have an obligation to ensure that the propensity of some members to change their investment choices often does not negatively affect other members of their fund.

They may also have some obligation to educate members about the risks of excessive trading and inappropriate diversification – which is likely to be inadequate.

APRA's Circular II.D.2 expands on the requirements of SIS regulation 4.02 that requires each choice of investment strategy to be sufficiently diversified. This is not necessary for small funds and it appears to be somewhat restrictive and unhelpful when it expressly discourages a consideration of the circumstances of the member (which it says "will necessarily be limited and always incidental.") We would suggest that this regulation be amended to allow for consideration of members' full circumstances.

4.3 The role of APRA

We would suggest that more could be done in the reporting of the expenses of investing, and of the investment consequences of exercising choice. Of particular interest are the costs of brokerage and other items that may lead to a conflict of interest and are currently not reported to trustees or members.

Our recommendation would be that superannuation accounting and reporting standards cover expenses and investment performance in more detail than currently and specifically report on payments where there may be conflict of interests. APRA should be empowered to set reporting standards that allow for published comparisons between funds. In doing so they should have reference to existing local and international standards, such as those published by IFSA.

4.4 The role of advice

The importance of people's individual circumstances makes personal advice essential, and presents a challenge for those preparing advice – and for the development of products that allow personal circumstances to be more closely matched.

That said, most Australians have relatively simple portfolios and can be given relatively generic advice that will not lead them far astray. We would therefore support the standard letter that has been submitted by many financial advisors. Simplification of the income and asset tests is essential however.

We would also urge the reintroduction of standardized projections of the retirement benefits that are likely to arise from superannuation funds. Such projections should give the projected real value of benefits at 65 (after adjusting for inflation), be based on standardized real investment returns and inflation rates and on the current expense levels of the providers concerned.

We have also recommended in 3.4 above that the regulations governing advice should be significantly simplified and allow for more flexibility, and recommend in 13.3.3 below that funds should be able to pay for advice.

5 The meaning of choice

(Covered under point 4)

6 The role of trustees and choice

(Covered under point 4)

7 Growth in self-managed funds

We have no comments on this point of the terms of reference.

8 Demise of DB funds

We have no comments on this point of the terms of reference.

9 Cost of compliance

(Covered under point 3)

10 Appropriateness of funding

We have no comments on this point of the terms of reference.

11 Promotional advertising

(Covered under point 13)

12 Meaning of not-for-profit

(Covered under point 2)

13 Benchmarking Australia

This also covers promotional advertising (11)

Terms of reference:

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

13. Benchmarking Australia against international practice and experience.

We comment only on international expense comparisons in this section.

All companies must charge for administrative costs and for bearing risk. The charge must be at least enough to cover the expected costs and losses.

The pure economic theory is that no further charge is necessary if the risks are "idiosyncratic" and can be diversified away. In practice, there are significant costs in obtaining the necessary diversity and providers of capital will normally demand an additional return. In a free market, companies will set their prices to maximise their profits, and will make even higher profits if there is insufficient competition. Proprietary companies may well therefore charge more for administration and for bearing risks, than is strictly necessary. This is legal and can be socially - and even ethically - desirable if it encourages innovation. We believe therefore that high charges are not always a cause of concern.

13.1 International comparisons

It is not easy to make comparisons between different types of Australian superannuation funds because of the difficulty of comparing and evaluating the different services that are offered and the different costs of distribution[15]. Industry and corporate funds usually are exposed to a lower cost structure and charge lower fees than retail funds. The tables in the Appendix show that the charges incurred by both types of funds compare well with charges internationally.

The lower costs of some South American systems are achieved by limiting the number of providers in the market, who then compete as much on price as on distribution. The Swedish system is also inexpensive as it is based on a centralised distribution and administration system, with fund members having a choice of investment manager.

13.2 Distribution and advertising costs

Advertising costs are part of the general cost of distribution, which includes marketing and sales. No business can survive without marketing in some way.

Proprietary companies theoretically determine their marketing costs by judging what level will lead to the maximization of profits. Greater advertising, for instance, is expected to bring in new business that will more than cover the costs of the advertising. One necessary assumption is that

the marginal revenue from the new business will be greater than the marginal costs of administering the business.

The same considerations apply to mutual organizations. Existing members will be charged less if the marginal revenue from new business is greater than the marginal costs of administration and the cost of the advertising. Advertising that works is therefore in the interests of existing members.

As discussed in section 2.4.1, it can be argued that mutual fund management requires more oversight, but advertising should not be singled out as the only possible misuse of money.

13.3 Reducing costs

There are a number of approaches that can be taken to reduce costs in the Australian industry:

13.3.1 Rationalization

The Treasury is currently investigating facilitating the rationalization of trust vehicles and insurance product that are expensive to administer. Particular problems arise from the crystallization of capital gains taxes, but there are also problems with out-dated contractual terms that could be amended at little cost.

It is suggested that this investigation includes the rationalization of defined benefit (DB) schemes. A significant portion of the costs of corporate and public sector funds are DB arrangements, which appear to be increasingly expensive to administer. It would be unfair to force members of DB funds to give up their accrued investment guarantees, but it is unfair on employers to require them to maintain a complicated benefit structure for some employees and not others. Included in this investigation should be ways of simplifying the determination of the superannuation guarantee contribution, and the taxation of defined benefits.

13.3.2 Legislative and tax rationalization

Much of the cost of advice, which is included in the distribution costs of superannuation funds arise from the complexity of the SIS and market conduct legislation, tax, and the income and asset tests. We comment on the legislation in sections 3.2 and 3.4.

We also note that the income and asset tests affect more pensioners than those who pay tax. These tests, which are financially more onerous[16], more frequent[17] and possibly more complicated than tax, are applied to lower income, and older, pensioners less able to navigate themselves successfully than wealthier and younger tax payers. A fuller case for abolishing these tests was made in a paper to the Institute of Actuaries of Australia[18] in April this year.

13.3.3 Obstacles to competition in advice should be removed

There is currently an active debate on the alternatives of commissions and fee for advice. A strict interpretation of the common law would find commissions unacceptable as advice is potentially tainted by sales commissions from a third party. Kurland (1995)[19] however reports on the conflict and finds that it is possible for companies to manage the ethical conflicts so that clients do obtain value for money.

We would suggest that the presence of commission and fee based distribution networks is likely to lead to greater competition, and recommend that both types be facilitated. One complicating factor is that Section 154 of the SIS Act specifically provides for the payment of commission, but paying for financial advice - unless strictly limited to superannuation issues – might well contravene the sole purpose test in Section 62. It is suggested that payments from funds for the provision of financial advice should also be permitted by the SIS Act. An alternative mentioned in a number of submissions is to make such advice tax deductible, but this does not provide much assistance for low income members.

14 Compensation for theft, fraud and employer insolvency

(Covered under point 1)

Appendix

Table: Consolidated summary of charges analysis

	Reduction in yield
Mandatory Systems	
Bolivia	0.5%
Australia (industrial)	0.5%
Kazakhstan	0.6%
Colombia	0.7%
Uruguay	0.7%
Sweden	0.8% - 15%
El Salvador	0.9%
Chile	0.9%
Poland	0.8%
Hungary	0.9%
Peru	1.0%
Australia (all)	1.1%
Argentina	1.2%
Mexico	1.4%
Croatia	1.5%
Australia (master trust)	1.9%
Voluntary systems	
US TSP	0.1%
Czech Republic	0.7% - 0.9%
Italy (open funds)	1.2 - 1.7%
UK personal pensions	1.2% - 1.4%
Italy (personal policies)	1.8% - 3.1%
US mutual funds	1.8% - 2.0%

Taken from table 6 of Rob Rusconi (2004) Costs of saving for retirement: options for South Africa http://www.assa.org.za/scripts/file_build.asp?id=100000357 Sources: Anusic (2003), Andrews (2001), Chlon et al (1999), Devesa-Carpio et al (2003), Diamond (1999), Fornero et al (2004), James et al (2001), Lasagabaster (2002), Mitchell & Bateman (2003), Murthi et al (1999), Rocha & Vittas (2001), Whitehouse (2000) and my own calculations and approximations.

Comment: These statistics are difficult to obtain and understand. The Australian charges are somewhat understated largely because of the costs incurred within underlying portfolios. Most retail funds, for instance, hold their assets through life insurance policies. The costs reported by these funds to APRA do not include the charges made by the insurance companies.

It may well be that similar considerations apply in other countries. If so, the relative positions in the above table are probably correct.

[1] "Superannuation Industry overview" APRA Insight Quarter 4, 2004

[2] Basel II – The Basel Committee on Banking Supervision (2003) *The New Basel Capital Accord Third Consultative Document*

[3] From APRA's latest Half Yearly Life insurance Financial Bulletin, December 2001

[4] Part 23 of the SIS Act

[5] Adapted from Smaller S L, Drury P, George C M, O'Shea J W, Paul D R L, Poutney C V, Rathbone J C A, Simmons P R and Webb J H (1996) Ownership of the Orphan Estate, British Actuarial Journal 10: 1273-1322, Appendices 1 and 3.

[6] Tyler T R & Smith H J, 1995, Social Justice and Social Movements Institute of industrial Relations Working Paper, University of California, Berkeley, http://ideas.repec.org/p/cdl/indrel/1088.html.

[7] As envisaged by Section 18 of the Corporations Act

[8] Mayers, D. Shivdasani, A. and Smith, C.W. (1997) *Board Composition and Corporate Control: Evidence from the Insurance Industry* Journal of Business 70.1 33-62

[9] Speckbacher G (2003) The Economics of Performance Management in Nonprofit Organizations *Nonprofit Management and Leadership* 13.5 267-280

[10] Drucker P F (1991) Reckoning with the Pension Fund Revolution *Harvard Business Review* March/April: 106

[11] We note that the drafters of the Acts seem to approve repetition of provisions when they are applied to different circumstances. The counter argument is that this makes it necessary to read much more material when one wants to know the difference between each of the circumstances. It is suggested that there would be much greater clarity if identical provisions were not repeated, and that the distinctions were separately identified.

[12] In terms of section 31

[13] Defined in part 5 of the SIS regulations in terms of the general power to make regulations set out in section 31 and 32 of the SIS Act.

[14] This section is a very brief summary of Asher A (2006) Do Not Panic: choosing investments wisely presented to the 14th Australian Colloquium of Superannuation Researchers.

[15] See for instance, Asher A (2004) "Shortchanged: conflicted superstructures" UNSW Centre for Pensions and Superannuation colloquium - to be published as a chapter of Selected Papers. Can be found at http://wwwdocs.fce.unsw.edu.au/fce/Research/ResearchMicrosites/CPS/Asher.pdf

[16] They reduce superannuation saving by 49% = (1-15% contribution tax)*(1-40% clawback of benefit)-1

[17] Changes in income must be reported within 14 days to Centrelink

[18] "Means Tests: an evaluation of the justice of imposing high rates of claw-back on those of modest means" http://www.actuaries.asn.au/IAA/upload/public/fsf06_paper_asher_means%20tests.pdf

[19] Kurland N B (1995) Ethics, incentives, and conflicts of interest: A practical solution *Journal of Business Ethics* 14.6: 465 - 475