



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

10 October 2006

Inquiry into the structure and operation of the superannuation industry

Australian Executor Trustees Limited and Trust Company Superannuation Services Limited welcome the opportunity to make this joint submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the structure and operation of the superannuation industry.

The key issues we highlight for the Committee are:

- the need for greater regulatory consistency between self managed superannuation funds (**SMSFs**) and small APRA funds (**SAFs**);
- the risk that failed SMSFs will become a burden on taxpayers;
- the need for increases in regulatory charges for SMSFs above the level imposed on SAFs to price for the higher risk of SMSF failure; and
- the need for members of SAFs to have more control over investments of their funds.

If you would like to discuss the issues raised in the joint submission, please contact Thomas Robertson on 02 9028 5953.

Yours faithfully

Handwritten signature of Christopher Kelaher in black ink.

Christopher Kelaher
Managing Director
Australian Executor Trustees Limited

Handwritten signature of Megan Bolton in black ink.

Megan Bolton
General Manager, Superannuation
Trust Company Superannuation Services Limited



Joint submission to

The Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into the structure and operation of the superannuation industry

Prepared by:
Australian Executor Trustees Limited; and
Trust Company Superannuation Services Limited
(the **Trustees**).

Introduction

Australian Executor Trustees Limited and Trust Company Superannuation Services Limited (together, the **Trustees**) make this joint submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the structure and operation of the superannuation industry. Australian Executor Trustees Limited is a subsidiary of the listed diversified financial services company Australian Wealth Management Limited. Trust Company Superannuation Services Limited is a subsidiary of the listed diversified financial services company Trust Company of Australia Limited.

The Trustees are registrable superannuation entity (**RSE**) licensees of small APRA funds (**SAFs**). A SAF is a superannuation fund which has four or less members, an RSE licensee as trustee and regulated by the Australian Prudential Regulation Authority (**APRA**). Together, the Trustees are trustees of over 5,200 SAFs representing more than 75% of all registrable superannuation entities regulated by the APRA. The Trustees administer \$2.7 billion of assets for SAFs of which they are trustee.

The Trustees submission addresses items 4 - 6, 9 - 10 and 14 of the inquiry's terms of reference.

Item 4 - The role of advice in superannuation

Members of SAFs generally have financial planners who provide advice on the investment strategy to be adopted and individual investments to be selected by the SAF. In a practical sense, those SAF members with financial planner support rely upon their financial planner to provide directions to the SAF trustee on their behalf. Nevertheless, the Superannuation Industry (Supervision) Act 1993 (**SIS**) does not recognise the role of financial planners, either generally or in relation to SAFs or SMSFs, as emphasised by APRA¹.

The role of financial planners in relation to superannuation funds is disregarded² by APRA, particularly in relation to the interaction between the member's investment in a superannuation fund and other investments. According to APRA, a member's other circumstances cannot be considered in determining a fund's investment strategy or selecting investments. This may be a reasonable position for public offer funds where the trustee is managing a fund for many members and there is remoteness between the trustee and fund members.

However, for SAFs, members have an expectation of greater involvement in the investments of their SAF. In many respects they see the SAF as an entity they have control over in much the same way as members of a Self Managed Superannuation Fund (**SMSF**) do. Those members with financial planners place trust and confidence in their financial planner to consider their relevant personal circumstances, including superannuation and other investments. It is a whole of financial universe approach by the financial planner and it is our submission that to do otherwise will cause the

¹ APRA, *Superannuation Circular No. II.D.1, Managing Investments and Investment Choice*, highlighted text at paragraph 47.

² *Ibid*, paragraph 48.

adviser to breach his or her contractual and statutory duties to the SAF and its members.

A conflict will therefore arise between the advice a financial planner may give to their client covering all their personal circumstances and the actions of a superannuation fund trustee in meeting APRA's expectations³ in relation to SIS. This conflict between the financial planner and trustee is more pronounced for SAFs because investments held within the SAF may form a critical aspect of the overall plan devised by the financial planner. For example, a member may hold business real property in the SAF and obtain diversification and liquidity across their total portfolio through investments outside superannuation, as recommended by the financial planner.

It appears the conflict between financial planners and trustees is less of an issue for SMSF members than SAF members.

The conflict between financial planners and trustees manifests itself in regulatory inefficiency. Members may be entitled to take action against the trustee where an investment strategy has not been properly formulated and implemented in accordance with section 52(2)(f) of SIS. The financial planner must only give advice to the member if there is a reasonable basis for the advice having regard to the member's relevant circumstances under section 945A of the Corporations Act 2001 and may be able to take action against the financial planner where the advice is not appropriate and also in breach of the planner's duties to the member. The regulatory inefficiency arises where both financial planner and trustee seek to avoid action being taken against them, so implement investment strategies that avoid adverse action but do not deliver the best investment outcome for the member. It is a fundamental fiduciary duty for a trustee to always act in the best financial interests of its members and it would appear that the APRA view expressed in the above Circular could lead a trustee to breach this fundamental duty.

The Trustees consider SIS and other regulatory guidance should recognise the role of financial planners in developing the investment strategy and selecting individual investments in SAFs. The Trustees make recommendations in this regard in the following sections.

Item 5 - The meaning of member investment choice

Members of SAFs have an expectation they have control over the investments of their superannuation fund. The main difference between a SAF and SMSF for a member is that the former has a professional trustee.

The expectation of SAF members having control over their investments is reinforced by their reading of SIS s58 and s52(4) which opens up the ability of members to give direction to their SAF trustee in selecting individual investments to be purchased by the SAF within their chosen investment strategy. SAF members may not appreciate their perceived control over their investments is moderated by the trustee's obligations under SIS s52(2)(f). SAF members may regard the intervention of the SAF trustee in meeting those obligations as a degree of paternalism.

³ *Ibid.*

Whilst the principle of prudent investment embodied by SIS s52(2)(f) is sound, not having regard for the role and responsibility of the SAF member in making appropriate decision for the long term and their use of professional financial planners is not optimal and potentially in breach of a trustee's obligation to always act in the best financial interests of its members..

One approach to move closer to meeting member's expectations of control over their investments would be to allow for them to elect to modify the obligation on the trustee in relation to SIS s52(2)(f). This could be on the basis of the member giving their informed consent to modifying the obligation. The principle of prudent investment could be maintained, for example, by transferring the obligation to the member. This would put SAF and SMSF members on an equal footing and meet members' expectation of control over their investments.

Such a change would not necessarily involve a radical departure from the traditional trustee law in respect of SAFs, once the "best financial interests" point is acknowledged. As SIS provides a modified codification of trustee law, such a departure is not unfeasible.

Recommendation: the Committee consider changes to enable SAF members to elect to remove impediments on members having more control over their investments.

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

APRA has set out its expectation⁴ in Superannuation Circular No. II.D.1 (**Circular**) that trustees of SAFs undertake due diligence to ensure the investment strategy of a SMSF transferring to a SAF is acceptable to the trustee, and if necessary remedy the situation within six months of appointment. The Trustees support this principle and note this suggests there is regulatory disparity between SAF trustees and SMSF trustee-members in their adherence to SIS. For example, the disposition of trustee-members towards establishing SMSFs that hold as the single fund asset one business real property, is seen as problematic by APRA⁵.

It is arguable that an RSE licensee becoming trustee of a SAF transferring from being a SMSF, it is subject to a direction in relation to the existing strategy and investments held in the fund under SIS s58.

APRA has also set out its expectation⁶ in the Circular that it requires the trustees of SAFs to exercise the same degree of care and diligence in monitoring and reviewing the investment strategies as for any other fund. The Trustees support this principle, but consider that there is a divergence between the prudential management obligations of trustees and the expectations of SAF members. Whilst not abrogating their responsibilities as RSE licensees, the Trustees consider a greater recognition of the role of SAF members in defining their investment strategy and selecting particular investments is required, particularly bearing in mind the Trustees' "best financial interests" fiduciary obligation.

⁴ *Ibid*, paragraph 83.

⁵ *Ibid*, paragraph 30 & 31.

⁶ *Ibid*, paragraph 82.

Recommendation: the Committee consider greater focus on achieving the same regulatory outcomes between APRA and Australian Tax Office regulated funds, for funds with four or less members.

Recommendation: the Committee consider measures for investment directions of SAF members, directly or through their financial planner as agent, be more closely followed without exposing RSE licensees, for example by extending the protection in SIS s55(5).

Item 9 – Cost of compliance

The role of small superannuation funds (both SAFs and SMSFs) in government retirement income policy is significant. Small superannuation funds account for 2% of all superannuation accounts in Australia but hold 23% of all superannuation assets⁷.

Through SMSFs, \$210 billion of superannuation assets are in the hands of trustee-members who are not required to demonstrate experience in reviewing a trust deed, formulating an investment strategy, managing investments, receipting income, paying disbursements, preparing accounts, lodging returns or holding assets in custody.

Managing a superannuation fund is a demanding task that requires competence, adequate resources and specialist skill. Government recognised this by passing the *Superannuation Safety Amendment Act 2004* to implement a licensing regime and ensure trustees of APRA regulated superannuation funds meet minimum requirements. No such standard exists for trustee-members of SMSFs.

SMSFs are at greater risk of not fulfilling the government's retirement income policy objective due to:

- loss of asset value due to imprudent investment or poor record keeping;
- failure to adhere to the sole purpose requirement; and
- fraudulent access to preserved benefits through early release schemes.

Where a SMSF suffers an asset loss, this jeopardises the government's retirement income policy. It also makes the member more likely to become dependent on social welfare and future taxpayers.

Superannuation funds enjoy significant taxation concessions. With the introduction of *A Plan to Simplify and Streamline Superannuation* by the government, members of superannuation funds will be able to access superannuation monies more easily. SMSF trustee-members will effectively be able to use their SMSF as a concessionally taxed bank account, to pay their private expenses. There will be a significant temptation for trustee-members of SMSFs to use their superannuation funds for a purpose inconsistent with the government's retirement income policy.

There is a lower risk of members of SAFs suffering asset loss than SMSFs. From a regulatory perspective, the advantages of preferring RSE licensees to trustee-members of SMSFs are:

⁷ Association of Superannuation Funds of Australia, *Superannuation Statistics*, September 2006; and APRA, *Quarterly Superannuation Performance*, June 2006, p 7.

- government can prudentially supervise several thousand funds across a few RSE licensees;
- government can address issues across several funds by working with a few RSE licensees;
- the RSE licensee is a single point of contact for several funds;
- RSE licensees are responsible SAFs under their trusteeship meeting the government's retirement income policy; and
- the RSE licensee dispassionately protects the interests of members and acts to avoid the temptations SMSF trustee-members face.

There should be greater supervision of SMSFs due to the risk of them not achieving the government's retirement income policy and their members becoming dependent on social welfare. SAFs are adequately supervised and have independent professional RSE licensees as trustee.

Australians are more attracted to SMSFs than to SAFs due to lower cost and lower regulatory charges. However, SMSFs present a significant hidden compliance cost to government and taxpayers due to their greater likelihood of failure. For example, members of SAFs have benefited from having RSE licensees who, in the main, avoided allowing investment into Westpoint, compared with the potentially large exposure of SMSFs to that failed venture.

The risk to future tax payers through dependence on social welfare by trustee-members of failed SMSFs is not reflected in the cost of running an SMSF. We make a recommendation on regulatory charges in item 10 below.

Recommendation: the Committee consider the adverse impact on government retirement income policy caused by inadequate supervision of SMSFs.

Item 10 - The appropriateness of the funding arrangements for prudential regulation

The current Australian Tax Office supervisory levy for SMSFs is \$45 (with a proposed increase to \$150 from 2007/8 year) and the APRA supervisory levy for SAFs is \$500. The current levy arrangements may reflect the actual cost of regulatory supervision incurred by the respective government agencies.

SMSFs and their trustees are not subject to prudential regulation, whereas SAF licensees are prudentially supervised by APRA. The risk of loss due to collapse of a SAF licensee regulated by APRA is arguably lower than that of SMSFs that are not prudentially supervised. RSE licensees are required to hold adequate capital, have appropriate controls in place and maintain appropriate insurances to protect against financial loss. Accordingly, the risk of a SMSF member losing superannuation benefits due to collapse of the trustee, theft or fraud is greater than that of SAF members. Members who lose their superannuation benefit are more likely to become dependent on social welfare. The cost of regulatory oversight is more for SAFs than SMSFs. There is a systemic benefit in small superannuation funds having a professional trustee.

Recommendation: the Committee consider ensuring that supervisory levies for SMSFs are increased significantly above those of SAFs to reflect the greater risk of dependence on government.

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

The Trustees support the existing general arrangements for compensation in the event of theft and fraud in relation to superannuation funds under Part 23 of SIS. Those arrangements have been demonstrated to work effectively in providing support to adversely impacted members, for example SAFs under trusteeship of Commercial Nominees of Australia Limited.

There is an argument that fund members should bear the risk of collapse of their fund. This is particularly the case for SMSFs where members are trustees. For members of prudentially supervised superannuation funds the argument may hold support on the basis that the risk management systems and procedures RSE licensees have in place, together with supervision by APRA should make theft or fraud an insignificant risk. In a market with pre-acquisition and ongoing disclosure, members have a role in choosing a trustee that has adequate systems to prevent, and capacity to bear, such loss. However, the generally accepted principle that superannuation benefits should be preserved to avoid members from becoming dependent of government suggests that a self-funding arrangement should remain in place.

SAF members do raise issue with the levies imposed to fund compensation under Part 23 of SIS. Absent removal of all compensation arrangements, the Trustees do not see a practical alternative to the current arrangements. The Trustees do not see a public policy benefit in and do not support any arrangement for insurance of member benefits.

The Trustees make no comment on employer insolvency.

Recommendation: existing compensation arrangements in the event of theft and fraud be retained.