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Mr David Sullivan
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
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CANBERRA ACT 2600

Dear Mr Sullivan

Submission by MLC to the inquiry into the structure and operation of the superannuation industry

I am pleased to forward to you MLC's submission into the current inquiry by the Parliamentary Joint Committee on Corporations and Financial Services.

I commend the Committee on its initiative in examining the many issues relating to superannuation in Australia today.

MLC's submission seeks to assist Committee members and the wider Parliament with their consideration of this important element of the Australian financial services industry.

The document has brought the company's extensive industry experience and knowledge to address numerous issues raised in the Terms of Reference.

To that end, MLC has focussed its comments on three specific areas: the role of advice in superannuation, capital requirements for funds and the self managed superannuation sector.

Finally, I am available to appear before the Committee to expand upon the issues contained in MLC's submission and related industry issues for the benefit of Committee members.

I understand that the Committee is considering holding public hearings in early 2007; I look forward to providing assistance to Members and Senators.

Should you require further information on this submission please direct your initial inquiry to Dallas McInerney (t: 02 9957 8253).

Yours sincerely

Steve Tucker
Chief Executive Officer

Inquiry into the structure and operation of the superannuation industry

MLC commends the Committee's initiative in conducting this inquiry into the Australian superannuation industry and welcomes the opportunity to provide comment for the benefit of Committee members and the wider parliament.

The Company

MLC is the wealth management division of the National Australia Bank. The company provides investment funds, platforms and services that support the provision of quality financial advice to Australian investors.

Through a large network of financial advisers, MLC provides financial planning services, wealth creation (investments), wealth protection (insurance) and superannuation solutions to individual investors and corporate customers. MLC also provides corporate and institutional customers with outsourced investment, superannuation and employee benefit solutions.

MLC uses a 'manager of managers' investment approach; generally, this means the company does not directly manage investment funds. Instead, MLC's multi-manager options combine the expertise of up to 32 leading investment managers from around the world. This approach gives investors access to a combination of individually selected fund managers across each asset class, providing diversity within asset classes and across investment styles.

MLC manages more than $90 billion on behalf of individual investors and corporate customers in Australia (as at March 2006).

MLC is ranked the number one provider of retail masterfunds with 15.8% market share (source: Plan for Life Australian Retail & Wholesale Investments Market Share and Dynamics Reports as at March 2006).

MLC's submission

MLC and its subsidiaries are members of the **Financial Planning Association** (FPA) and the **Investment and Financial Services Association** (IFSA). The company has participated in the consultation process of each organisation for their respective submissions and is broadly supportive of the final documents.

This submission seeks to provide further comment in areas where MLC has specialised industry experience and considers it beneficial to the Committee.

Accordingly, this document will not respond exhaustively to each reference and will restrict its comments to three broad issues:

1. Capital requirements for publicly offered superannuation funds;
2. The role of advice in superannuation; and
3. Developments in self managed superannuation

Recent industry developments

In 2004, the Australian Government implemented wide ranging reforms to the superannuation industry; these reforms followed extensive consultation and resulted in numerous amendments to the ***Superannuation Industry (Supervision) Act 1993*** (herein referred to as the SIS Act).

The changes took effect from 1 July 2004 and were in part, recognition of the increasing importance and size of Australia's superannuation assets and the attendant need for rigorous legislative oversight. The changes included compulsory licensing for trustees, stronger operating standards and enhanced risk management requirements.

MLC makes the general observation that the current prudential framework for superannuation is both sound in principle and effective in practice; delivering security to investors and service providers.

However, MLC submits that regulators and the legislature should not regard the superannuation industry as static. Consumer demands, investment patterns and supporting technology are constantly evolving and prudential and legislative tools should respond accordingly.

1. Capital Requirements for superannuation funds

It is instructive to confirm the importance of capital requirements and the circumstances in which they prove beneficial. These include:

i) fortifying the entity and its obligations in the event of operational or governance failure;

ii) providing fund members and the wider market with evidence of the trustee's bona fides and commitment to fund members; and

iii) ensuring the trustees prudently manage the fund while ever a mandated amount of money or liability remains 'at-risk'

In its response to the Federal Government's 2001 *Safety in Superannuation Issues Paper* , Federal Treasury's Steering Working Group observed that:

> *"...it is not appropriate to distinguish between types of funds for the purposes of determining whether capital is required by Trustees or not. Rather, if there is a justification for capital for trustees of all funds, then a requirement should be applied across the board*.." [1]

The current regulatory regime distinguishes between publicly offered funds, which are subject to minimum capital requirements and funds that are not publicly offered, which are not.

[1] (Mercer Report, Superannuation Working Group, Treasury, 2002)

The current law requires trustees of all public offer funds to meet capital requirements in one of three ways:

- $5M net tangible assets by the trustee
- Approved guarantee of $5M
- Use of a custodian that has $5M net tangible assets

In theory, all fund members and investors are adequately protected under this regime as it gives the appearance of uniform capital requirements for all public offer funds; however, an examination of current industry practice does not support this claim.

The use of the custodian option to meet the capital requirements is wide spread and a significant amount of Australian superannuation money is ‘protected’ under this arrangement.

While imposing capital requirements on custodians can address the specific issue of securing fund assets, it clearly does not address the capacity of the fund trustee to compensate fund members for losses from fraud, maladministration (eg: unit pricing errors), technology failures and human errors on the part of the trustee.

In these circumstances, custodial arrangements – when compared to the other methods of meeting capital requirements - have the potential to compromise the ongoing viability of the fund and the investments of members.

The capital requirement option of having all fund assets held by the custodian does not provide security or consumer protection for losses resulting from operational risk, trustee malfeasance or incompetence.

Accordingly, when referenced against the reasons for having capital requirements (see above), this option is clearly inferior to the other two with respect to the levels of investor protection afforded.

MLC submits that while ever trustees are permitted to satisfy capital requirements through custodial arrangements, the prudential controls regulating Australia's superannuation investments are potentially compromised and investors put at unnecessary and inappropriate risk.

MLC requests that the Committee give consideration to removing the custodial option for trustees.

One alternative for the Committee to consider is an exemption from capital requirements for funds that invest exclusively in life policies and outsource their administrative functions to life offices - on the basis that the life office is already subject to both capital requirements (more stringent than superannuation) and APRA supervision.

For the benefit of the Committee, a discussion is provided below of a significant operational function undertaken by many superannuation funds – unit pricing.

This discussion is provided for the twin purposes of demonstrating the importance of a fund's ability to accurately price fund assets and the role that capital can have in the event of errors occurring in fund operations.

1.1 The equitable distribution of capital: unit pricing

Collective investments deliver many benefits to investors and continue to be a mainstay of the Australian financial services industry.

A collective investment is often 'unitised'. Units are priced and the sum total of all constituent units is used to calculate the quantum value of the investment; this is predominantly the case with retail superannuation funds.

Here, a fund member's holdings are expressed in the number of units held in the fund and the cumulative value of those units.

This method of fund valuation - known as *'unit pricing',* is used for the equitable apportionment of investment earnings or losses in accumulation funds. It is used to calculate the unit price for members entering the fund and members realising their investment at the point of exit.

Should a fund be overvalued, new members are penalised upon entry and exiting members benefit at the expense of remaining members.

Conversely, in the case of an undervaluation, new members acquire a larger portion of the fund at the expense of existing fund members, while exiting members experience a relative diminution of their investment. This phenomenon is often described as ***member arbitrage***.

The accuracy and method of fund asset valuation is critical to the integrity of the investment process and ultimately, investor confidence.

Unit pricing obviates the threats posed by member arbitrage; the alternative is the *crediting rate* method.

With respect to the former, APRA and ASIC issued a joint document entitled *Unit Pricing Guide to Good Practice, Joint ASIC & APRA guide* and made the following observation:

> *"...unitisation provides a more direct link to movements in asset values, investment income and transaction costs, as unit prices are calculated at, or closer to, the time unit holders acquire or dispose of products. Unit pricing avoids transferring investment returns between entering, leaving and ongoing unit holders (generations of unit holders). That is, unitisation may be perceived as providing more transparency and resulting in more equitable treatment of beneficiaries and fund members.."* [2]

[2] *Unit Pricing Guide to Good Practice, Joint ASIC & APRA guide*, November 2005

Many public offer funds do not have unit pricing as a feature and crediting rating is used, typically, these are industry funds.

There are significant risks associated with superannuation funds with substantial illiquid assets using the crediting rate method.

In the absence of unit pricing, fund members will continue to experience intra-fund arbitrage, a phenomenon that has the potential to diminish superannuation savings and confidence in superannuation generally.

Superannuation fund choice, member investment choice and recently introduced portability rules will continue to contribute to increased inter-fund membership flows, in these circumstances, the need to accurately price fund holdings increases significantly.

Unit pricing is currently the most effective method of fund valuation and has an integral role in ensuring equity and fairness remain features of Australia's superannuation system.

Unit pricing in superannuation funds ensures accurate valuations and equitable distributions for all members.

MLC submits that consideration be given to making unit pricing a requirement of all collective investment, public offer funds.

1.2. Capital and investor compensation – the NAB/MLC experience

In October 2001, several National Wealth Management companies (MLC Nominees, National Australia Financial Management and National Australia Superannuation Pty Ltd) made unit price reductions affecting several superannuation and life insurance products.

It was later shown that investors were adversely affected by these reductions and other associated historical unit pricing errors.

The companies entered into an enforceable undertaking with the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority and put in place comprehensive investor compensation and remedial action programmes.

Compensation was completed in April 2005 by which time the companies had paid $71.98 million in compensation to in-force and exited investors. In this instance, investors were compensated using the companies' own monies.

In the NAB/MLC experience, investors were adequately compensated and investment continuity was assured.

An important point of consideration for the Committee is whether or not a fund using a custodian to meet capital requirements would be able to make sufficient recompense to investors and guarantee the future of other investments, if it was faced with a situation similar to the NAB/MLC experience.

2. The role of advice in superannuation

MLC's subsidiaries, Godfrey Pembroke Limited, Apogee Financial Planning Limited and GWM Adviser Services Limited (trading as Garvan Financial Planning and MLC Financial Planning) are the partner of choice for approximately 1,300 self-employed and salaried advisers in Australia.

In addition, MLC holds relationships with more than 3,000 independently owned and licensed advisers who choose to utilise MLC's financial solutions to meet the needs of their clients

MLC also provides infrastructure and services to the financial planners who operate within the National Australia Bank branches. With this operational network, combined with its extensive suite of superannuation products, MLC is uniquely placed to comment upon the importance of advice in

superannuation and its place in the current legislative and prudential framework.

2.1 Superannuation, Advice and Regulatory Incongruity

At the end of the March quarter 2006, Australia's total estimated superannuation assets were valued at $905.4 billion.[3] For most Australians, their superannuation funds will become their most significant asset along with their residence.

Notwithstanding the Federal Government's recent simplification of the superannuation system[4], MLC believes all Australians can benefit from quality financial advice - particularly in a fund and investment choice environment.

Quality financial advice and planning can deliver important wealth generation and protection opportunities for Australians. A comprehensive assessment of one's needs, matched with a suitable advice plan can be vital to a person's financial security.

However, a significant and problematic incongruity exists between the superannuation industry's governing instruments and other regulation which prevents investing Australians benefiting fully from financial advice.

2.2 Recognising Advice

In recent years the Government, ASIC and the Parliament have all recognised the growing need for financial advice and its importance to the financial well being of Australians.

[3] *Statistics*, Quarterly Superannuation Performance, APRA, March 2006
[4] *A Plan to Simplify and Streamline Superannuation*, May 2006

The Hon Chris Pearce MP, Parliamentary Secretary to the Treasurer, has made the following comments:

> *"...good financial advice is what Australians need to ensure their financial future is secure and safe. Indeed, good financial advice is critical to helping Australians sort through the often complex maze of financial products and services"* [5]

And subsequently:

> *"...in the long-term, planners will achieve a net gain in new business as confidence in the market grows and the education of investors continues to improve…the professional advice you provide to your clients can and indeed does, have a profound effect on their future wellbeing.."* [6]

Similarly, ASIC has also spoken of the need for advice:

> *"…given the complexity of the tax and superannuation systems, current standards of financial literacy, and human frailties, there is considerable unmet need for quality advice."*[7]

Further, chapter 7 of the ***Corporations Act 2001***, commonly referred to as *FSR,* provides in a very detailed fashion the legislative imprimatur for the licensing and operation of financial advisory activities.

While the role of advice is properly acknowledged by the consumer regulator and the Parliament, it is not sufficiently recognised in the superannuation industry's governing statute or its derivative instruments – the ***SIS Act*** and APRA standards or circulars.

In fact, the ***SIS Act***, now 13 years old and enacted prior to the advent of fund choice, does not contain a single reference to financial advice.

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[5] FPA Launch 15 May 2006
[6] Hon Chris Pearce MP, Parliamentary Secretary to the Treasurer, IFSA Luncheon, Sydney, 6 June 2006
[7] IFSA speech, 5 October 2005, ASIC Commissioner, Professor Berna Collier

A recent example of this incongruity in action is APRA's **Superannuation Investment Circular No.II.D.1**. The FSR legislation contains the *Know-Your-Client* rule for financial planners as well as the obligation to provide appropriate recommendations after an extensive analysis of the client's needs.

The APRA circular directs trustees to have regard for individual investment strategies of members, and in turn, monitor and limit exposure to strategies such as undiversified investments.

MLC submits that the circular is potentially seeking to assign trustees a role that is neither within their proper remit nor sufficiently informed to fulfil. A direction to trustees to monitor and rebalance member accounts that are considered to be undiversified or exposed, fails to account for the role that advice has played in an individual member's investment choices.

Trustees only have a line of sight to a single superannuation fund of a member; any assessments and rebalancing conducted on the member's behalf in accordance with the circular would be done without reference to the advice the member might have received for that account.

More alarmingly, the trustees would be acting without regard for other possible assets held by the member, such as: additional superannuation accounts, direct ownership of property, shares or cash holdings.

2.3 Advice and the sole purpose test

The sole purpose test as detailed in **APRA Circular III.A.4**, requires that a fund is established and maintained for the sole purpose of providing benefits to members upon their retirement, or to a member's beneficiaries in the event of their death.

The SIS regime and FSR could be brought into closer alignment if trustees were given sufficient discretion in applying this test with respect to the use of member's funds for accessing financial advice.

Ideally, superannuation funds should allow members to access and pay for financial advice with respect to their superannuation and other financial needs using their superannuation savings.

Importantly, this should be a fee for advice based payment, either a fixed dollar amount, or annual percentage of assets which would be agreed between the adviser and their client. The payment could be stopped by the member at any point in time if they decide they do not require ongoing advice. Further, the advice fee should be disclosed in a dollar amount on the member's annual statement.

Such an outcome would be an important accommodation of the role of advice within the SIS regime, an alignment with the requirement in the FSR Act to know-your-client and importantly, the opportunity for many Australians to access financial advice in an ***affordable*** and ***transparent*** manner.

While parts of the *SIS Act* are able to facilitate member investment choice, without a complimentary recognition of the role of advice in exercising that choice; regulation of the industry will continue run counter to consumer trends and technological innovation.

As suggested by the Government's recent public comments, MLC also believes the need for and use of financial advice will become more pervasive, particularly as superannuation evolves as the most effective retirement planning strategy for most Australians.

As Australian's continue to invest larger amounts of savings into superannuation funds, it is critically important that legislative and regulatory instruments are in concordance with sound consumer behaviours, which include the seeking of financial advice.

3. Developments in self managed superannuation

A significant and rapidly growing portion of Australia's superannuation assets are currently held in entities that are not protected by the industry's broader safe guards. Add to this the potential for consumers to receive inappropriate advice regarding their superannuation and the end result has the potential to undermine the government's objectives for long term savings via a safe superannuation system.

One such area is that of Self Managed Superannuation Funds (SMSFs) which are often established by persons outside the regulatory regime of licensing under the Corporations Act 2001. MLC acknowledges the *prima facie* attraction to the concept of SMSFs and the potential for greater control of one's own assets. However, recent developments in this sector bear closer consideration.

There are several examples of potential consumer detriment in the SMSF sector as evidenced in the recent Australian Securities and Investments Commission (ASIC) Shadow Shopping Survey on Superannuation Advice.

Recently, ASIC's Chairman has reason to make the following comments on the regulators work on illegal early access to superannuation monies:

> *"ASIC is working closely at a cross-agency level with APRA and the ATO to minimise transfers from legitimate superannuation funds to sham self-managed superannuation funds[8]"*

The Shadow Shopping report released by ASIC covered twenty two cases of advisers who were not licensed to provide advice. Eighteen of these were accountants[9].

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[8] ASIC's Super Strategies: 2006–07 An Address by Jeffrey Lucy AM, Chairman - Australian Securities and Investments Commission at The Association of Superannuation Funds of Australia 6 September 2006 Sydney, Australia

[9] Shadow shopping survey on superannuation advice - An ASIC report April 2006

The report found:

> *"In some limited circumstances, accountants can give advice on superannuation issues without needing to come within the AFS licensing regime…"In four cases the unlicensed accountant stayed within the accountant's exemption..In 16 other cases, 14 unlicensed accountants and two tax agents illegally gave advice on issues that required a licence."*

These cases included:

- advising the client about particular superannuation funds (not SMSFs), including staying with an existing fund, consolidation and asset allocation decisions within funds; and
- recommending making extra contributions to a specific super fund to access tax benefits, without warning that other factors may be relevant and the client should seek advice from a licensed adviser.

The examples expose a significant risk to some consumers accessing superannuation and, although the sample was small, it showed that almost 78% of the accountants covered in this survey gave consumers illegal advice regarding superannuation.

Numerous representations have been made arguing for a level playing field in relation to the regulated provision of financial services and in particular the apparent special treatment of accountants when providing services in relation to SMSFs.

The initial regulation which became effective in May 2003[10] provided sufficient scope for the accounting profession to deal with appropriate matters required for the efficient administration of a fund.

[10] Regulation 7.1.29(5)

The extension of that scope by a further regulation which became effective in February 2004[11] has led to confusion within the accounting profession as to where the line is drawn and, as shown in the ASIC report, an inappropriate outcome for consumers.

It is MLC's view that this latter regulation should be removed for the avoidance of doubt and to ensure consumers are protected by the appropriate licensing regime.

Finally, the Government should be urged to conduct regular reviews of the Australian Tax Office's capacity and ability to effectively regulate the growing SMSF sector of the superannuation industry.

[11] Regulation 7.1.29A