THE SOCIETY OF SUPERANNUANTS

SUBMISSION TO THE PARLIAMENTARY JOINT COMMITTEE INQUIRING INTO THE STRUCTURE AND OPERATION OF THE SUPERANNUATION INDUSTRY

Introduction and Background

The Society of Superannuants is a not for profit body incorporated under the Associations Incorporation Act 1984 (NSW). The object of the Society is to assist in the protection of the rights of members of superannuation funds. The Society was formed in 2001 when a group of professional and industrial organisations - representing pilots, aircraft engineers, flight attendants, salaried doctors and ship's captains - reached a consensus, supported by legal and actuarial opinion, that the legislation governing the superannuation surcharge was flawed. The Society sought to have the superannuation surcharge abolished. Office bearers and professional consultants commenced a campaign – including appearances before the Senate Select Committee on Superannuation – aimed at the abolition of the tax.

Since the abolition of the Superannuation Surcharge, the Society has maintained a watching brief in relation to other matters where its knowledge and experience might be useful in the area of protection of the rights of members of superannuation funds. We are delighted to have the opportunity to make this submission to the Joint Committee.

We note that superannuation, in common with life insurance, is especially long term business. We cannot overstate the importance of

long term stewardship of superannuation monies. Misfeasance over a very short period can undo decades of wise and responsible stewardship and inflict heavy losses. Superannuation represents a major component of personal and family savings, to be drawn upon to replace income when employment ceases. It is therefore a business calling for the utmost good faith on the part of all who are responsible for the management and custody of those monies.

The Society is mindful that laws must be in place at all times to ensure proper stewardship, in its widest sense, of superannuation monies.

Special note. The Society notes the critical importance of the audit function in the conduct of superannuation funds. The Society expects that fund auditors will make meaningful submissions to the Committee about their role.

We turn now to comment on the terms of reference.

1. Whether uniform capital requirements should apply to trustees

The Society does not consider that uniform capital requirements should apply to trustees. Whilst the trustee of a superannuation fund is the sole responsible entity for the fund, there are numerous variables that affect the capital requirement. Leaving aside self-managed funds for which there is no capital requirement at all for the trustee, there are still many factors that vary from fund to fund. At one end of the spectrum, we have in-house funds of large corporations that are managed internally and where the employer meets the administration costs. In some cases, some or most of the direct administration cost is recovered from the fund, subject, of course, to the trustee's and the auditor's scrutiny. We do not think that there is any capital requirement in such cases.

At the other end of the spectrum, there are large commercial public funds where the trustee employs the full complement of administration staff. These operations need capital in their establishment and growth phases but the owners of the business, generally corporations of substance, usually provide it. We observe that these commercial operations have no real need of capital beyond the establishment and early growth stages. However, they provide lucrative returns for their owners as the businesses grow and the allocations to owners grow, on fixed capital invested. They could easily mutualise, but who would ever initiate such a move?

The members of these entities bear all the investment risks. Capital is meaningful in a case of major misfeasance but the capital might cover only a very small proportion of the members' losses. The shareholders' funds should be exhausted before the industry self insurance comes into play.

Industry funds are an interesting group in relation to capital requirements. It is our understanding that these funds were sponsored by trade unions and peak employer organisations. The costs of establishment and early growth could not be passed on to the members if performance was to be acceptable. Hence there was a requirement for capital. We imagine that the sponsors provided it but without studying the early history of these funds, we cannot be sure how much was provided, the form of the funding and the details of any return of funding.

Whatever the means of the industry funds getting started, they are now strong entities that have no need of capital. In effect, the members are the proprietors and bear whatever risks the business presents, including misfeasance risks that are not covered by the industry self insurance.

Qualification of trustees, audit and regulation should work together to make major misfeasance impossible. We observe that the capital of HIH Limited did not protect its insured.

There is an analogy between a mutual superannuation trustee and the very well known listed investment companies such as Argo

Investments Limited and Australian Foundation Investment Company Limited. The shareholders of these listed investment companies are the proprietors. Their position is parallel to that of the members of a mutual superannuation trust. There is no foundation capital to take a perpetual ‘rake-off’ from the earnings of these now large and highly successful companies. They are true mutuals. The investors bear all the risks in proportion to their investments. Argo has just announced a very good result including that totalling operating costs were 0.15 % of total assets at market value.

Capital is essential to enable a trustee to build the business through its establishment and growth phases. We make the point that these phases ought to be financed by share capital and not by loans unless repayment of the loans is subject to the approval of the regulator. Capital provides an incentive to make the business work properly; it is at risk if the business does not succeed.

Inevitably, any capital requirement would not be a meaningful form of security for members of a reasonably mature business because funds under trusteeship are many times a practical capital requirement.

A significant capital requirement hopefully would exclude from the business of trusteeship, persons and organizations that are not in the business for the long haul. However, we do not think that a capital requirement is the correct mechanism for sifting would-be entrants to the business. The "utmost good faith" requirement can

only be satisfied by examination of principals for overall fitness, which really means full knowledge and experience gained within the financial services industry. Examination at establishment is not sufficient. Every new appointment as a trustee must be subject to that same testing process.

We note that the entire workforce is covered by superannuation, with the exception of those self employed persons who have chosen not to arrange superannuation. We are left to wonder whether proprietary trustees spend a lot of effort and money to persuade citizens to switch providers in what is essentially a saturated market. The function of capital is very different from that of, say, a manufacturing company making durable goods, which, though durable wear out, creating a market for replacement products, better products and entirely new products. We submit that not only is the function of capital very different, so too is the need for capital.

To sum up, the Society does not believe that a uniform capital requirement is at all appropriate for trustees.

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

The Society does not think that public company status is a necessity for a trustee. This statement is a corollary to our response to Term of Reference 1.

Again putting aside self managed funds, such a requirement is not relevant to the trustees of in-house funds or industry funds or indeed, any fund that is operated on a "not for profit" basis. The Society is of the opinion that not for profit organizations are an important part of any competitive market.

We also believe that there are a number of specialist commercial funds operating off a small base of invested capital and business volume, with trustees of knowledge, experience and skill, filling a need for those who do not want a faceless trustee. These would pass the sifting examination with flying colours but would be ruled out by a requirement of public company status.

The Society acknowledges that the supervision task would be simpler and more practical if the number of players is a small number of large operators.

3. The relevance of Australian Prudential Regulation Authority standards.

The Society believes that these standards should embrace the totality of a trustee's functions and accountability and that they are absolutely relevant to every trustee of superannuation monies.

The Society believes that every trustee, including every director of a corporate trustee, ought to be required to sign a statement of duty to members, of obligation to act in accordance with the trust instrument, to ensure that all money is invested in accordance with the relevant member instructions and the fund's written policy, to ensure that all investments are properly monitored, to ensure that members are fully informed at the required times as to the details of their interests and to ensure that all payments from the trust are correct and correctly timed.

The Society notes that the auditor plays a crucial role in checking that everything that is done is done correctly, that everything that ought to be done is done and that nothing that ought not to be done is not done. The auditor's role is one of enormous responsibility, at least as great as that of the trustee. There is a danger that the trustee will rely on the auditor instead of putting its own checks and controls in place.

4. The role of advice in superannuation

The provision of advice is an essential component of the superannuation industry. Advice covers the structure of personal affairs, the structure of investments (the asset allocation), possibly the extent and structure of debt, and the choice of investments for each component of personal affairs, usually personal investments and superannuation.

Few citizens have the capacity to deal with these matters on their own. Those who have the capacity usually wish to consult with a professional and few are not beset by doubt about the wisdom of their arrangements. Risk and reward are imprecise concepts. The future is an expanding funnel of doubt and no one can be sure that their arrangements will stand the test of time. Therefore personal affairs undergo a process of continuous re-evaluation. Advice is never completed.

Analysis of personal risk tolerance is widely practiced. Personal risk tolerance, even if it could be properly measured, is a measure at a particular time of something that is variable and often not fixed in one's mind anyway.

Publication of a simple booklet by the regulator for community wide distribution, about superannuation and non-superannuation investments would also be worthwhile but not a solution. Education in schools should be expanded but it can only be part of the total education process.

5. The meaning of member investment choice

Member choice in superannuation means the right of members to choose their investment classes e.g., cash and cash equivalent, capital stable, balanced, growth, high growth subdivided by domestic and international.

Except in the case of self managed funds, where the trustee and the members are the same, there is no general right of nomination of individual investments. Te Society considers that any such right would be the 'thin end of the wedge' for member choice of individual investments with implications for the role of trustees.

It is worthy of debate as to whether the law should proscribe any such right.

The Society suspects that relatively few members exercise their right of choice. It would be interesting to have reliable statistics from a worthwhile sample survey. The Society suspects that the compulsory offer of member choice, commendable as it sounds, has imposed significant costs on employers, often for little net advantage to employees. We believe that choice is made by employees at the employer level, not at the trustee level.

The matter of repeat offers of choice appears not to have been addressed. If it is a legal requirement to offer choice, one offer in a career does not seem to be very meaningful. Repeat offers of choice should be initiated by trustees annually as part of annual reporting

processes. We note that changes to asset allocation would usually be more important than a change of fund.

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

As we have said above, in our experience, choice is made at the employer level. As we understand it, new employees are handed a document about choice of superannuation fund as part of the induction process.

In our opinion the responsibility of the trustee is limited to ensuring that new members have signed a document confirming that choice was offered and have specified the investment option selected. The form should include provision for existing benefits to be rolled over from one or more other funds and specify the investment option to apply to the rolled over money. Application forms will include, as a matter of course, a statement that the relevant offer document has been provided.

We do not think that a trustee should be required to look behind an application to join to satisfy itself that the choice procedures were properly followed.

Advice about choice may prove quite expensive for fund members. A community education process is relevant to what members need to be told about choice and who should tell them, and about the review of selections made. The Federal Government carried out an education campaign when choice was first legislated. A sample survey of workers could yield enlightening information, including the proportion of workers who do not exercise their right of choice.

We think that very few citizens will ever change their selections. At this stage, the system has not been in place sufficiently long for trends to emerge.

We suggested earlier that trustees should initiate repeat offers of choice. These offers would be made within guidelines set out by the regulator. The responsibility of the trustee would be to make the offer and implement elections that are notified by members.

The Society believes that choice is theoretically a good thing but is not at all sure that the benefits justify the cost, which we think falls mainly on employers. Is choice a step too far - the answer is "no".

7. The reasons for the growth in self managed funds

The Society believes that the advantages of self managed funds are the ability to select individual investments and to reduce costs of investment management and administration. Whether these advantages are real or perceived is open to question.

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

The Society believes that the Superannuation Guarantee and the Superannuation Surcharge made defined benefits funds difficult to manage and difficult for member communication and member relations.

The Superannuation Guarantee leads naturally to an accumulation fund. An actuary's certificate is required to certify compliance with the Superannuation Guarantee. In some cases, minimum benefits on a defined benefits basis have been specified in an actuary's certificate. Some of these are highly technical and incomprehensible to members as well as posing problems for administration. An actuary's certificate has a time limit. Hence periodic reviews and new certificates are needed, with appropriate advice to members. Problems of compliance with minimum benefits were most serious in the period of the phasing in of the Superannuation Guarantee.

As stated in our introduction to this submission, the Superannuation Surcharge was the reason for the Society's establishment and a particular issue in that regard is notional contributions to defined benefits funds for surcharge calculations. The calculations provided much of work for actuaries but no one was satisfied with the results. Small wonder that trustees, employers and members preferred the transparency of accumulation funds. The abolition of the surcharge from 1 July 2005 might spark some renewed interest in defined benefits funds. However, they present some difficult

problems in relation to the Government's proposal, in the 2006 Budget, to abolish Reasonable Benefits Limits.

The Society notes that the Superannuation Guarantee had a levelling effect on employer supported superannuation. Many defined benefits funds were closed, or closed to new members, and accumulation superannuation on the basic Superannuation Guarantee level was substituted.

The Society also notes that most defined benefits funds were set up as a result of marketing thrusts by the life insurance industry and, to a lesser extent by superannuation consultancies. Defined benefits funds had an appeal to the managers of companies because they channel unallocated employer contributions largely in the direction of those employees whose salaries grow fastest. The granting of past service benefits for either or both of actual past service or notional past service had the same effect. (This statement is not meant to be critical of those practices that corrected to some extent prior under provision of superannuation and gave recognition for skills and experience brought from previous employment). The Superannuation Guarantee and the Superannuation Surcharge made these defined benefits funds too difficult to manage.

Salary packaging for senior employees usually specifies a superannuation component that is automatically directed to an accumulation fund of the senior employee's choice.

Finally under this heading, the Society notes that accumulation funds are transparent and that modern information technology has made their management both practical and accurate. In previous eras accumulation funds were very difficult to administer.

9. Cost of compliance

Nil.

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

The Society notes that revenue forgoes about $7 billion per annum by allowing employer contributions as deductions from taxable income. Further subsidy occurs in the concessional taxation of investment income in the accumulation phase of funds. This subsidy will be increased if the Federal Government enacts the exemption of benefits from tax additional to the contributions tax. The Federal Government has indicated its willingness to grant that subsidy irrespective of whether it is enacted.

In the light of the subsidies that the Federal Government actually makes already and is willing to supplement, the Society is of the opinion that the Federal Government should fully fund regulation, the cost of which would be trivial in relation to the subsidies.

The Society notes that the contributions tax funds reductions in benefits taxes and pension tax rebates and should not be included as current revenue in the year of collection. The contributions tax cannot be said to be available to fund regulation.

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

In the case of a proprietary operation, advertising is a cost incurred for the benefit of the proprietors and should be paid for from the proprietor's funds. In the case of a not for profit fund, such as an industry fund, the same principle would prevent advertising.

Sensible advertising is a legitimate expenditure.

It is usual for members' periodic statements to include information of an advertising nature. Whilst we feel that such information ought to be factual, both what is said and what is not said would usually be cast to paint the enterprise in as favourable a light as possible. We do not think that regulation should control the text of material that is circulated with normal communications.

All things considered, we are of the opinion that regulation should not go beyond requiring disclosure of advertising expenditure charged against funds under trusteeship as an identifiable item in financial statements including summaries distributed to members and the prescription of penalties for misleading advertising. Such penalties should fall upon the trustees personally and not be chargeable to the members.

The industry could be invited to report perceived misleading advertising to the regulator.

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

By these terms we understand that none of the income is applied to a management fund from which payments are made to persons who are not members of the fund. This in contrast to a proprietary fund from which certain monies prescribed in the rules of the fund are set aside for the benefit of the proprietors. Of course, one must not lose sight of the fact that investors in the capital of the trustee are entitled to a fair return on the investments.

The initial operating deficits of a "not for profit fund" might be contributed by a benefactor or by means of loans to be repaid when the financial condition of the fund allowed repayment.

We are not familiar with the means by which "not for profit" funds, some of which are now very large, were established.

Mutual life insurance societies were a feature of the world life insurance scene from the birth of the industry until demutualisation took over in the 1990's. The Australian Mutual Provident Society was a mutual life insurance society that was the doyen of the Australian life insurance scene. The mutual AMP had an enviable world wide reputation as a first class operation. Mutual operations have their place in the commercial environment and are a force to be reckoned with in competition.

We are not familiar with the rules governing the appointment of directors of industry funds. We understand that employer and employee organisations have rights of nomination. We do not think that arrangements that are shown to be working well should be upset.

13. Benchmarking Australia against international practice and experience

The Society has no experience of regulatory systems in other countries. Nevertheless, we think that a study tour of the United States and the United Kingdom by a small group of regulators and two professionally qualified politicians would be worth the expense. A prior step that seems to us to be worthwhile would be to compile a booklet about regulation in Australia and seek written comments from the regulators in several other countries and details of their own regulatory systems. The booklet should identify instances of significant breach detected here and the consequences for those whose savings were put at risk and for those responsible for the breaches.

The United States appears to have a strong regulatory system in place, judging by reports of companies that have been forced to restate their accounts. However, the regulatory system has not prevented major corporate collapses.

It would be interesting to know whether routine audits are conducted in other countries by regulators, of funds and corporations where there is no prima facie breach and what such audits have returned.

It would be interesting to know also the extent to which other regulators rely on auditors as the principal defence against breach

and failure. We have sympathy with the view that audit should be a continuous process for major holders of savings of the public. Those trustees who do not engage continuous audit, should be the first targets for audit by the regulator. Continuous audit should detect deficient management and an unacceptable incidence of error before serious damage is done.

An audit manual for auditors of superannuation funds holding savings of the public is essential. We have not enquired whether such a manual exists. We are not aware whether these audits are already highly standardized or whether there is a diversity of practice.

It is the funds that hold money on behalf of the public that need to be tightly regulated.

The Society feels that self managed funds need to be regulated to prevent loss to the revenue rather than to protect the interests of the members who can be expected to look after themselves or bear the consequences.

Part of the regulatory process would be compliance by all funds, including self managed funds, with generally accepted accounting practices.

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

The Society commends the self insurance industry arrangements that are in place. The regulator will know how well it has worked and whether modifications are called for.

The Society would add to the foregoing events that might give rise to a call for compensation, criminal negligence by a trustee. Criminal negligence would be negligence that has been found by a court of competent jurisdiction to deserve a significant penalty. Such a finding would necessarily involve banning of the relevant individual trustees from holding an office in a body controlling a financial institution.

Theft or fraud may occur within the trustee or in a fund or corporation in which the trustee has invested money. The Society is of the opinion that members should be fully compensated for loss that results from theft or fraud within the trustee. We discuss later what full compensation might mean.

The Society is of the opinion that members ought not to be compensated for any form of failure of an investment other than the failure of an investment that has been the subject of a finding of criminal negligence on the part of the trustee. The most that members can expect to receive in respect of an investment loss (other than the special case mentioned) is whatever the trustees can recover by the processes that are available to them. There will

always be investment losses, for any one or more of a myriad of reasons. They are a normal part of doing business in investments.

A recent case involving large investment losses occurred in Japan with the prosecution and jailing of the principal officer of a listed public company called Livedor. The failure here of HIH presented the same scenario. We feel that the only compensation that any investor should be entitled to in any such case is governed by civil action against the person or persons responsible for the loss.

An example of loss that might be recoverable from the centralized insurer occurred in Australia in relatively recent times. We understand that a trustee made an unsecured loan (or an inappropriately secured loan) from a fund presented as capital secure. The business failed and the trustee was unable to recover the invested amount. The trustee might have been criminally negligent. If it were so found by the courts, a claim for compensation would appear to be sustainable.

Superannuation losses of members as a result of employer insolvency ought not to be greater than contributions that the employer has failed to remit to the trustee. Trustees should have in place steps to follow up failure of an employer to remit contributions within the prescribed time. A trustee that is shown to have failed to follow up non-payment of contributions should be subject to prosecution and to making good to the members concerned the losses suffered as a result of such failure.

In past years, administrators were reluctant to advise employees that contributions had not been remitted by the employer for fear of legal action by the employer against the administrator for damage thereby caused to the employer's business. The law should specifically protect a trustee who reports non-receipt of contributions to members.

We cannot overstate the importance of ASIC's scrutiny of offer documents and of the liability of persons who make statements for inclusion in offer documents. The approval of an offer document may well be a defence in the event of subsequent failure of the enterprise.

15. Other matters

The Society commends a strong, pro-active regulatory regime. If the regulatory system is known to be strong and pro-active, both intentional and unintentional breaches will be reduced. There will be less flouting of the law because of the higher probability of being caught. There will be less error because more care will be taken.

The Society is not sure that the Australian Taxation Office should be charged with the supervision of self managed funds. We feel that the duty of the ATO is to collect taxation revenue and apply the law in relation to that. The Australian Taxation Office is stretched to carry out those tasks and, from our observation, has not had time to be serious about its regulatory role for small superannuation funds.

Confidentiality of personal information is an important issue for the superannuation industry. So far as we are aware, breach of confidence has not been a problem that has surfaced to date, which is rather surprising considering the extent of important personal data that is held by funds and the quite large number of staff who have access to it. We are of the opinion that breach of confidentiality, by a trustee, an officer of a trustee or a contractor to a trustee should be a criminal offence carrying heavy penalty and compensation where the breach has resulted in pecuniary loss. Indemnities for trustees, staff and contractors should be made of no effect for breaches of confidentiality, by law.

The Society supports the gathering of statistics about numerous aspects of superannuation and the publication of data about the statistics that are gathered.

The Society expresses its considerable concern about the large number and amount of superannuation benefits where contact with the members has been lost. We think that further and continuous public education programmes should be undertaken to make citizens aware that it is their responsibility to check that superannuation from previous employment is not forgotten.

The industry might be invited to comment on proof of identity requirement for payments of benefits, with special consideration for the claiming of "lost" benefits.

The Society would be pleased to respond to any matters that the Committee would like to refer to it, irrespective of whether those matters are covered in this report. We would also be pleased to present ourselves for examination should the Committee so wish.

Submitted by:

THE SOCIETY OF SUPERANNUANTS