Senate Select Committee on Superannuation and Financial Services

Main Inquiry
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Submission to the Senate Select Committee on Superannuation and Financial Services

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CURRENT SUPERANNUATION PRACTICES: THREE CONCERNS

The *Superannuation Industry Supervision Act 1993* does not provide sufficient safeguards for the protection of superannuation fund members. I have expressed my concerns on this matter in several published articles (please refer to appendix 1-3).

The three main weaknesses of the SIS legislation are: 1) the ability of employer sponsors to raid the surpluses of defined benefit members, particularly in the case of hybrid funds; 2) the lack of representation and protection of fund members at the trustee level; and 3) the way SIS legislation permits governing rules which act against the principles of trust law.

1) Employer-Sponsors Raiding Surpluses

I have expressed my concerns on this matter in several articles (see appendix 1-3). It is of concern that the SIS legislation does not stop employer-sponsors from using defined benefit member surpluses for their own ends. Many employer-sponsors are doing this by taking contribution holidays and relying on the surplus to meet their obligations.

A second way that employer-sponsors are doing this is by forming hybrid funds, by combining defined benefit members with accumulation fund members. They are then accessing the surplus by allowing employees (both defined benefit and accumulation members) to take reduced salaries for a corresponding amount of the defined benefit surplus.

This practice of employer-sponsors accessing defined member surpluses is often justified on the grounds that the surplus does not belong to the defined benefit members. The argument is that defined benefit members have an interest only in the amount the governing rules deems due to them, as opposed to accumulation members who have an interest in all contributions made by or for them.

Whilst defined benefit members may have a legal interest only in the amount deemed due to them by the governing rules, surely they have at least an equitable interest in the surplus for it to be used to secure their future benefits. (I will discuss this issue further in my third point, and discuss a UK precedent that holds this to be the case).

The surplus comes from amounts paid by the employer-sponsors on their behalf, and whilst the governing rules define the benefit they may receive, the contributions are nevertheless supposed to be being held on trust for them. By allowing other members, particularly those with no interest (such as accumulation members in hybrid funds) to access the surplus through salary sacrifice, the SIS legislation is allowing employer-sponsors to shirk their responsibilities, as well as reducing the financial security of defined benefit members.

Those defending the current practices would point to the fact that the trustees must have approved these arrangements. And it is acknowledged that Section 117 of the SIS Act is supposed to prevent use of members funds without both trustee approval, and recognition by an actuary that the payment is reasonable. However this reliance on the trustees is dangerous when one considers the conflict of interest present in these hybrid funds.

The SIS legislation currently requires that there be an equal number of employer-representative trustees as member representatives. Of course this doesn't take into account that those with a genuine interest in the surplus, the defined benefit members are usually a clear minority in hybrid funds.

This means that where the trustees are deciding whether to adopt a salary sacrifice measure as discussed above, the trustees are being required to make a decision that strongly benefits the employer and the accumulation members, and strongly disadvantages the defined benefit minority. How can the trustees be trusted to look out for the interests of all beneficiaries/members in this situation? More to the point, is it *possible* to genuinely represent such conflicting interests, and make a decision either way?

This leads to the second concern I wish to raise.

2) Lack of representation and protection of fund members at the trustee level

As I mentioned earlier, the SIS legislation requires that there be an equal number of employer-representative trustees and member-representative trustees. The fact that these trustees are not necessarily "elected", but rather "appointed" has been pointed out and accepted by this committee in evidence given by Mr Dan Scheiwe *(Official Committee Hansard*, Senate Select Committee on Superannuation and Financial Services. Friday 16 June, 2000 SFS 546-547)

Along with Mr Scheiwe (SFS 538), I too am concerned by the prospect of employer-sponsors being able to appoint corporate subsidiaries as trustees to the funds they contribute to.

The difficulty with leaving the interests of the members to the trustees becomes most apparent in the case of hybrid funds. As I argued above, it seems not only questionable whether in practice trustees of these funds are looking out for the interests of the minority defined benefit members, but whether this is possible.

Because the defined benefit members are usually such a minority, it seems questionable as to how one could ever structure these hybrid funds, so that the defined benefit members interests are truly protected and represented. In such a case it has to be asked how the legislation can permit them to exist.

3) Governing rules that operate against the principles of trust law

The final concern that I want to raise is that the SIS legislation permits governing rules that effectively operate against the principles of trust law.

I have discussed the various ways that employer-sponsors are accessing the surpluses of defined benefit members. Whilst some of these practices are generally accepted (eg contribution holidays) more direct attempts by employers to access these surpluses has become the subject of a considerable amount of case law in Australia, as well as the United Kingdom and New Zealand.

The question of what interest defined benefit members have in the fund surplus, as well as what duty the employer-sponsors owe to members, was considered in the recent UK case of *National Grid Co. PLC v Mayes* [2000] ICR 174. In that case an employer sought to offset existing accrued liabilities to make contributions with the fund surplus, the Court of Appeal held that this was acting against the interest of the members, and hence in breach of the employer's duty to the members.

On the issue of what duty employers owe to members, and what interest defined benefit members have in the surplus, Brooke LJ states (at para 43-44 Lexis Reference):

> "....although an employer is not to be treated as a fiduciary when he exercises powers vested in him by the provisions of a pension scheme, it needs to be remembered that he owes an implied obligation of good faith to his employees..... It is also well settled that, although the members of a pension scheme have no rights in the surplus revealed by an actuarial valuation...they have a reasonable expectation that any dealings with that surplus, whether by the employers or by the trustees of the scheme acting within the powers vested in them by the scheme, will pay a fair regard to their interests..."

Most of the cases on the topic concentrate on the governing rules, and explicitly retreat from introducing a discussion of the equity principles involved. Some discuss the unusual nature of superannuation; its peculiar combination of equity, contract and legislation. A common theme is that most jurisdictions provide the courts with insufficient clarity in the relevant legislation.

All judges in the New Zealand case of *Re UEB Industries Ltd Pension Plan* [1992] 1 NZLR 294 (a case where the trustees amended the trust deed in order to return a surplus to the employer) lament the difficult equity and policy issues the common law faces in dealing with defined benefit surpluses, in the absence of clear legislation. Thorp J states (at 309):

> "Similar considerations to those that moved Moore CJ to call for legislative action no doubt arise in New Zealand, even if in lesser degree: and as Cooke P has noted in his judgement, the United Kingdom thought fit to legislate in this area. But absent such legislation in New Zealand, it is my view..... that any amendment purporting to give the company a right to surplus (sic) would abrogate the fundamental objects of the trust, and accordingly be outside the powers of the trustees."

Whilst it is recognised that s 117 of the SIS Act is supposed to protect members' assets (in the absence of such protection in the governing rules), this section relies on the vigilance of the trustees, and presumes that the members have common interests. The case of hybrid funds show that this is not always the case, so that trustees may indeed be acting in the interests of the majority of members (ie accumulation members) and the employer, albeit to the clear disadvantage of defined benefit members.

There needs to be clear legislative protection of defined benefit fund surpluses, particularly if hybrid funds are permitted.

CONCLUSION

It is extremely disappointing that successive federal governments of both political persuasions have been so neglectful of the need to protect the retirement benefits of ordinary Australians.

I have discussed three concerns I have with the current SIS legislation. All three are effectively intertwined. The first concern; the ability of employer-sponsors to access the surpluses of defined benefit members (particularly in hybrid funds), is made possible by relying on trustees, where there is a lack of representation. This reliance on trustees to protect members is compounded by permitting governing rules that explicitly authorise unfair or inequitable returns of surpluses. My suggestions on how to overcome these inequities is to amend the legislation to provide as follows:

- Either prohibit hybrid funds, or alternatively prohibit the surplus of defined benefit members from being used for any purpose other than the best interest of *defined benefit* members. The difficulty with the latter alternative is that the legislation and trust law already requires that use of assets be for the best interest of the members, the difficulty is the strongly polarised interests of the two classes of members in hybrid funds. Making either of these changes would create the equitable result of only those beneficiaries/members with an equitable interest in trust assets receiving the benefit of them.
- This would result in a tightening on what governing rules can allow, by way of returning fund assets to members and employer-sponsors.
- As a policy issue, I would also favour explicit legislative directions about the ownership of defined benefit surpluses in certain situations (eg legislation on takeover of the employer and/or employer offers to change the status of fund membership). To my mind, an equitable starting point would be that at least one half of any surplus should belong to members in these situations.
- Finally, there should be a review of the need for employer-sponsor trustee representation. In the case of member representation, there needs to be greater substantive representation. This may be achieved (for example) through election by members, rather than appointment.

APPENDIX 1 – *The Bulletin*, June 27, 2000 p76

SUPER STRATEGY

Some companies use salary sacrifice provisions to legally access employees' super surpluses. **Daryl Dixon** looks at the tax implications.

The minus of a surplus

Not content merely to allow the surpluses held in defined benefit superannuation funds to slowly decrease – a slide that is the result of employers taking contribution holidays – several companies, including Shell Australia, are using salary sacrifice superannuation tax provisions to access surpluses.

Following its recent dealings with the Australian Federal Police (*B*, May 9), the Australian Taxation Office will be interested in these latest developments. The fact that the trustees of the Shell Australia Superannuation Fund have signed off on the arrangements described below indicates, however, that this approach is permitted under superannuation law.

Under normal ATO-approved salary sacrifice arrangements, employees are able to agree in advance with employers to have part of their normal wages, that would otherwise be taxable as income, paid instead as additional pre-tax employer super contributions, thus generating what is often a significant tax saving.

The new generation salary sacrifice deals, such as Shell's, involves a novel twist. Instead of paying the agreed amount of wages into superannuation, the employer retains the money for company use and the employer's super fund separately allocates a designated amount of its surplus to the relevant member.

The company is, in effect, selling off part of its accumulated surplus to fund members. In the Shell Australia case, the exchange is being offered on a dollar-for-dollar basis, allowing employees to avoid the normal 15% tax on employer contributions to funds.

This arrangement is possible because the money being allocated to members is already in Shell's super fund as accumulated surpluses. Apart from the fact that employees could be concerned that two separate legal entities are party to the one salary sacrifice arrangement, the new arrangement offers a substantial additional tax saving to members due to the way it bypasses the upfront tax.

The new arrangements, however, do not avoid the liability to the super surcharge on higher income earners because this separate tax is levied directly on the benefits accruing to individual members within the super fund.

To the extent that employees rush in to take advantage of the 15% tax saving outlined above, they in effect will be paying Shell large amounts of money to use up the fund's accumulated surplus. From the employer's situation, this is an ideal outcome because the ownership of defined benefit fund surpluses is a complex and controversial issue.

Some fund trustees, including notably those of Unisuper (*B*, January 25), are prepared to distribute surpluses free to members. In the absence of government legislation ensuring an equitable distribution of surpluses between members and employers, actual practice varies widely from fund to fund. By and large, employers attempt to retain the lion's share of the surplus.

Shell has set an annual cap of $10,000 on the amount that any employee can salary sacrifice under the new arrangements. Since salary sacrifice super offers larger tax advantages to higher income earners, such a protection against the rundown of fund reserves by wealthier members is almost essential.

The losers in this process, nevertheless, are the fund members unable to afford or unwilling to pay good money to purchase part of their super fund reserve from the employer. Given the stated desire of the federal government to simplify the superannuation system, it is even possible that future changes will provide clearer directions to all funds about the distribution of fund surpluses.

The current arrangements, for example, permit defined benefit funds to accumulate unlimited surpluses, estimated now to total more than $20bn, subject to highly concessional tax arrangements. Defined benefit funds own large holdings of shares paying fully franked dividends, meaning that their surpluses accrue annually – in many cases tax-free because of the imputation credits on the shares owned in the fund.

With the government about to start refunding surplus franking credits in cash to super funds from July 1 onwards, funds with large accumulated surpluses will be big winners. Employer sponsors of these funds are usually on contribution holidays, increasing the probability of negative tax assessments because of the absence of any 15% contributions tax liability in the fund.

To the extent that employers can reduce the amount of genuine salary sacrifice contributions to the fund, this will reduce a fund's aggregate tax liabilities. By helping employees to avoid the 15% contributions tax, defined benefit funds are thus also ensuring that the funds themselves maximise the benefits of the future refund of franking credits.

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BEST INVESTMENT RATES

Top 5 Australian equity trusts by 2-year performance		
	1-year % pa	2-year % pa
Tyndall Aust Special Sits	35.52	31.17
Hunter Hall Value Growth Trust	36.44	24.58
Col First State Fnd Leads	42.34	20.32
AXA NM Industrials Fund	10.09	17.38
JB Were Emerging Leaders Fd	34.27	16.80

Top 5 global trusts by 2-year performance		
	1-year % pa	2-year % pa
Dresdner Internet Opport	98.50	38.00
INVESCO European Growth Fund	56.39	36.43
MLC Platinum Global Fund	56.04	31.80
BT European Growth Fund	40.20	31.25
AXA NM World Growth Fund	34.48	29.57

Top bank term deposits	$10,000	
30 days	Macquarie Bank/PIBA	5.35
90 days	AMP/Colonial State Bank	5.00
180 days	Colonial State Bank	5.40
1 year	Suncorp Metway	5.50 (5.61)

Top debentures	$10,000	
1 year	Grenfell Sec/PrevCap MonBon	5.20 (5.30)
3 years	Grenfell Securities	5.60 (5.60)
5 years	Grenfell Securities	6.35 (6.35)

Top bonds		
2002	Qld Investment Bonds	6.80
2003	Qld Investment Bonds	7.10
2005	Colonial State Bank Bond	7.23
2008	None on offer	

Top 5 [illegible]	[illegible]
Arab Bank Australia Ltd	5.50 (5.65)
Colonial State Bank	5.40 (5.54)
HSBC	4.88 (5.15)
PIBA	4.50 (5.01)
Macquarie Bank Ltd	4.75 (4.84)

Top [illegible]	[illegible]
Westpac Financial Services	5.58 (5.70)
Portfolio Partners Ltd	5.44 (5.55)
Adelaide Managed Funds	5.40 (5.54)
MoneyWizard	5.37 (5.48)
Permanent Trustee	5.37 (5.48)

APPENDIX 2 – *The Bulletin*, September 5, 2000 p69

Foxes in the chicken coop

When employers dip into certain super fund surpluses, there is limited protection for members. **Daryl Dixon** explains how the regulations work and why they are inadequate.

Complaints received by *The Bulletin* about employer-sponsored defined benefit funds have revealed major defects in the protection offered by SIS legislation to fund members. Indeed, the only real control on employer-sponsors raiding fund surpluses is in the hands of member-elected trustees. It is standard practice to rely on trustees to protect the interests of members. It becomes a concern only when it is unclear whose interests the trustees are representing.

A particular concern relates to what is done with the surplus of defined benefit superannuation funds. This surplus is an asset of the fund. As such, it should be used only to ensure the security of the members' benefits. Employer-sponsors, however, have been using various means to access this surplus.

The only means of protection for members lies in the SIS legislation and general trust law. The main control on employer-sponsors seeking to access member funds is provided by section 117 of the Superannuation Industry (Supervision) Act 1993. Section 117 outlines the circumstances in which amounts can be paid out of funds to employer-sponsors.

Section 117 basically prohibits such payments, with two exceptions. The first is where a reasonable amount is paid out to the employer-sponsor to cover management or operation costs. To satisfy the second exception, all of the following conditions must be met: the payment must be authorised by the governing rules of the fund; there must have been a resolution by the trustees permitting the payment; an actuary must issue a certificate that the payment would leave the fund in a satisfactory financial position; and, finally, the trustees must give notice to the members stating that the above requirements have been met and that they consider the payment to be reasonable.

While this may seem like an exhaustive list of precautions, such precautions mean nothing if the trustees are not representing the interests of the beneficiaries. Further, concern about this is justified in light of the relatively common practice of employer-sponsors accessing member surpluses. A common way employer-sponsors do this is by taking contribution holidays, relying on the defined benefit fund surplus to fulfil their contribution obligations.

Another way employer-sponsors access the surplus is by arrangements where employees take a reduction in salary in return for a matching share of the surplus. The advantage to the employer-sponsor is obviously the saving in salary payments, while the employee avoids the 15% contributions tax (see *B*, June 27).

These two arrangements do not reveal the real weakness regarding the protection of defined benefit member interests. The genuine concern with the current regime is not whether the trustees are overlooking member interests in favour of the employer-sponsor, but rather which class of members' interests are being represented at the trustee level.

The issue of different classes of members arises in the case of "hybrid" funds. These are funds that contain both defined benefit and accumulation funds. In most cases, the number of defined benefit members is a clear minority of the total members. The result is that the member-representative trustees are usually representative of, and belong to, the accumulation fund class of members.

Consider the recent trend of employer-sponsors offering reduced salaries in return for an equal share of the surplus. Such arrangements are of most benefit to the employer-sponsor and the members of the accumulation fund, at the expense of the defined benefit members. What happens when these arrangements are being considered by the trustees who generally represent the accumulation members? In such a case will these trustees consider the interests of the minority class, or simply look out for the interests of their own class?

Considering the reliance the SIS regime places on trustees to protect the interests of fund members, allowing these hybrid funds to operate leaves defined benefit members vulnerable.

The Senate Select Committee on Superannuation and Financial Services is considering consumer protection in the superannuation industry. Defined benefit fund members can only hope that the committee will add this issue of protection of hybrid fund members to its reform agenda.

So far we have only considered the possibility of defined benefit members being exploited. In future issues, we will look at some examples of the way this is being done, and show that while the SIS regime allows the existence of hybrid funds, it might just be leaving the fox to guard the chickens.

● *www.dixon.com.au*

BEST INVESTMENT RATES

Top 5 Australian equity trusts by 2-year performance	1-year % pa	2-year % pa
Tyndall Aust Special Sits	53.51	36.92
Col First State Fut Leads	58.11	26.46
Hunter Hall Value Growth Trust	25.94	23.04
JB Were Emerging Leaders Fund	44.59	20.99
AMP Small Companies	43.90	20.97

Top 5 [illegible] by 2-year performance	1-year % pa	2-year % pa
INVESCO European Growth Fund	75.07	34.68
Dresdner Internat Opport	50.84	31.94
MLC Platinum Global Fund	44.26	29.97
BT European Growth Fund	29.75	26.76
Lowell Int Eq Growth	33.77	26.42

Top bank term deposits		$10,000
30 days	HSBC	5.90
90 days	AMP/Colonial/HSBC	6.15
180 days	Colonial State Bank	6.40
1 year	Colonial/Suncorp	6.35/6.40 (6.50)

Top debentures		$10,000
1 year	ProvCap MortDeb	6.30 (6.62)
3 years	HG&R Fin/ProvCap MortDeb	8.75 (9.11)
5 years	ProvCap MortDeb	9.00 (9.38)

Top bonds		
2002	JB Were Capital Markets	6.56
2003	Qld Investment Bonds	6.85
2005	Adelaide Bank/Colonial	6.60
2008	Territory Bonds	6.50

Top 5 banks at call	$10,000
AMP Banking	6.20 (6.44)
ING Direct	6.25 (6.43)
Arab Bank Australia Ltd	5.75 (5.96)
Colonial State Bank	5.30 (5.43)
Macquarie Bank	4.88 (5.15)

Top 5 cash management trusts *	$10,000
Adelaide Managed Funds	5.50 (5.64)
MoneyWizard	5.49 (5.60)
Permanent Trustee	5.49 (5.60)
Were Securities	5.46 (5.57)
Commonwealth/Westpac Fin Service	5.38 (5.49)

APPENDIX 3 – *The Bulletin*, October 3, 2000 p86

SUPERANNUATIO

Predatory PRACTICES

A British High Court case has highlighted some potential deficiencies of Australia's superannuation legislation, writes **Daryl Dixon.**

A leading superannuation lawyer has confirmed the dangers for all defined benefit fund members of the present Superannuation Industry Supervision legislation (*B*, June 27, September 5). Far from protecting the security of members' benefits, SIS legislation permits virtually unlimited employer access to defined benefit fund assets via hybrid fund arrangements.

In its own way as controversial as the genetic modification of food, the use of hybrid super funds involves the mixing of defined benefit and accumulation schemes. By mixing the two, the employer sponsors can legally claim back surplus benefits in the defined benefit funds via contributions holidays.

In explaining the mechanisms by which Australian employers have been raiding the surpluses of their defined benefit funds, the lawyer drew *The Bulletin's* attention to a 1999 British High Court case. In a June 1999 decision, Justice Rimer ruled that the Scientific Investment Pension Plan had behaved illegally in using the surplus of an existing defined benefit plan to fund employer contributions to a defined contribution (or accumulation) section introduced into the plan.

Britain has had some infamous examples of employer sponsors raiding the assets of employees in company superannuation plans. The most notorious involved the late Robert Maxwell of the Mirror group when huge amounts of employee benefits were lost.

The Scientific Investment case involved relatively small amounts of money but the principles at issue were essentially the same as being practised today by some of Australia's largest corporate super funds. The trustees of the super fund asked for a High Court ruling on several issues including whether:

- It was proper for the employer's accumulation plan liabilities to be funded out of the surplus accumulated in the defined benefit plans;
- The trustees could use remaining surplus assets in the defined plan to the benefit of other members.

The judge ruled that the surplus assets should not have been used to fund the accumulation plan contributions of the employer. In the opinion of *The Bulletin's* source, given the close ties of the Australian and the British legal systems and the fact that Australian hybrid funds are simply copycats of British arrangements, the legality of present practices is in some doubt.

The Bulletin raised this issue with several lawyers acting for defined benefit funds. They were understandably reluctant to talk about their clients' affairs but argued that the trust deed of the fund played a crucial role in the British decision. Whether members of Australian defined benefit funds would accept this argument is a moot point. The British High Court has provided a clear direction indicating that the surplus backing the benefits of defined plan members should not be used for the benefits of other persons.

The practices of the Australian hybrid funds also differ from those of their British counterparts in an important way. This involves using defined benefit fund members to fund salary sacrifice contributions of accumulation plan members.

While Australian super fund trust deeds commonly permit employer sponsors to take contribution holidays, the salary sacrifice transactions are in a completely different category. As previously outlined (*B*, June 27), these involve separate transactions between the employer and individual employees matched by corresponding allocations of fund surpluses to the members involved.

If the legality of these transactions were subject to judicial scrutiny, existing trust deeds could provide an inadequate defence for the trustees involved. The problem for the trustees is that they are responsible under SIS legislation for the protection of members' benefits and, as the Scientific Investment case demonstrates, the surplus in the defined benefit fund provides this protection for members of this plan.

An independent trustee of one major hybrid fund justified his support for using up the surpluses for the benefit of the employer on the grounds that the employer sponsor would always honour its obligations to members. As the history of the corporate sector shows only too clearly, even large companies go bankrupt or are taken over. Without specific government protection through watertight legislation, as earlier articles have revealed, members of many Australian defined benefit funds could easily become big losers from the predatory practices of their employers.

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BEST INVESTMENT RATES

Top 5 Australian equity trusts by 2-year performance		
Tyndall Aust Special Sits	24.31	29.17
Col First State Fut Leads	44.17	25.83
Hunter Hall Value Growth Trust	25.75	23.90
JB Were Emerging Leaders Fund	39.86	20.86
AMP Small Companies	36.86	20.41
[illegible]		
INVESCO European Growth Fund	86.46	34.03
MLC Platinum Global Fund	45.51	31.78
Dresdner Internat Opport	46.62	31.36
Fidelity Perp Japan Fund	34.79	30.35
Platinum International Fund	47.47	29.42

Top bank term deposits		$10,000
30 days	HSBC	5.80
90 days	AMP Banking	6.15
180 days	Colonial State Bank	6.40
1 year	Colonial/Suncorp	6.35/6.40 (6.50)
Top debentures		$10,000
1 year	ProvCap MortDeb	6.90 (6.62)
3 years	HG&R FinProvCap MortDeb	8.75 (8.11)
6 years	ProvCap MortDeb	9.00 (8.38)
Top bonds		
2002	Adelaide Bank Bonds	6.75
2003	Qld Investment Bonds	6.65
2005	Adelaide Bank Bonds	6.87
2008	Territory Bonds	6.50

Top 5 banks at call	$10,000
AMP Banking	6.25 (6.44)
ING Direct	6.25 (6.43)
St George Bank	6.25 (6.43)
Arab Bank Australia Ltd	5.75 (5.90)
Colonial State Bank	5.30 (5.43)
[illegible]	$10,000
MoneyWizard	5.63 (5.75)
Permanent Trustee	5.63 (5.75)
Adelaide Managed Funds	5.60 (5.75)
Were Securities	5.56 (5.68)
Westpac Fin Services	5.50 (5.61)