COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Structure and operation of the superannuation industry

WEDNESDAY, 7 MARCH 2007

SYDNEY

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JOINT STATUTORY COMMITTEE ON

CORPORATIONS AND FINANCIAL SERVICES

Wednesday, 7 March 2007

Members: Senator Chapman *(Chairman)*, Ms Burke *(Deputy Chair)*, Senators Brandis, Murray, Sherry and Wong and Mr Baker, Mr Bartlett, Mr Bowen and Mr McArthur

Members in attendance: Senators Chapman, Murray and Sherry

Terms of reference for the inquiry:

To inquire into and report on:

The structure and operation of the *Superannuation Industry (Supervision) Act 1993* and the superannuation industry to ensure that it provides an efficient, effective and safe regulatory structure for the management of superannuation funds, with particular reference to:

1. Whether uniform capital requirements should apply to trustees.
2. Whether all trustees should be required to be public companies.
3. The relevance of Australian Prudential Regulation Authority standards.
4. The role of advice in superannuation.
5. The meaning of member investment choice.
6. The responsibility of the trustee in a member investment choice situation.
7. The reasons for the growth in self managed superannuation funds.
8. The demise of defined benefit funds and the use of accumulation funds as the industry standard fund.
9. Cost of compliance.
10. The appropriateness of the funding arrangements for prudential regulation.
11. Whether promotional advertising should be a cost to a fund and, therefore, to its members.
12. The meaning of the concepts “not for profit” and “all profits go to members.”
13. Benchmarking Australia against international practice and experience.
14. Level of compensation in the event of theft, fraud and employer insolvency.
15. Any other relevant matters.

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Committee met at 9.02 am

CHAIRMAN (Senator Chapman)—I declare open this public hearing of the Parliamentary Joint Committee on Corporations and Financial Services inquiry into superannuation. On 30 June 2006, the committee resolved to inquire into the structure and operation of the Superannuation Industry (Supervision) Act 1993 and the superannuation industry. The committee has been examining a number of industry-wide trends and sectoral issues to ensure that it provides an efficient, effective and safe regulatory structure for the management of superannuation funds. The committee is due to report to the parliament in June this year.

I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. This gives special rights and immunities to people who appear before committees. People must be able to give evidence without prejudice to themselves. Any act which disadvantages a witness as a result of evidence given to a committee may be treated by the parliament as a contempt. It is also a contempt to give false and misleading evidence to a committee.

If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer having regard to the ground which is claimed. If the committee determines to insist on an answer, the witness may request that the answer be given in camera. Such a request for in-camera evidence may be made at any other time as well.

[9.03 am]

BRESNAHAN, Mr Jeff, Managing Director, SuperRatings Pty Ltd

CHAIRMAN—Welcome. The committee has before it your submission, which we have numbered 49. Are there any alterations or additions you wish to make to the written submission?

Mr Bresnahan—No, there are not.

CHAIRMAN—In that case, I invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Mr Bresnahan—Thank you for the opportunity of submitting on paper to the committee. We would like to place on record that, in our opinion, the industry as it stands today is probably the safest and most efficient it has ever been in the life of superannuation in Australia. There are some points we tried to make in the paper. The current delivery of advice in employer sponsored superannuation is fundamentally flawed and that needs to be investigated. The regime under which financial planners work in superannuation at the moment is unworkable and consideration should be given to a separate non-product advice category to allow easier advice delivery to members.

In terms of capital adequacy, we made the point that minimum insurance requirements should be in place for all superannuation funds in Australia. Most at risk in the superannuation industry from a trustee point of view would appear to be the professional trustee companies, as opposed to those trustee companies which act for a single entity alone.

Obviously, advice should be encouraged and every Australian should have access to an advice model. We strongly believe that advice should be an opt in scenario, not an opt out scenario. Again, I refer back to the position that in many cases Australians are paying for advice that they are not receiving; therefore, it is a bit like paying a lawyer without receiving service. We believe that, in the short term, commissions are acceptable within the industry. However, we believe that they should be phased out on mandated superannuation contributions over a two- to three-year period.

Despite the best endeavours of the regulators, we do not believe that the current delivery of statements to members adequately informs members of what they are paying in superannuation. We believe that they are quite simply a superannuation account. It is the same as a bank account and therefore should have line items for every debit and credit—for example, admin fees, insurance premiums, adviser fees and investment fees. Currently, there is a significant amount of implicit pricing within superannuation. Australians are not aware of what they are paying for that service.

The current dollar disclosure measures, whilst an improvement on previous measures, are still unsatisfactory to the average Australian. We made the comment that advertising is a critical part of running any business. Trustee directors who do not advertise could be detrimental to the current members of that particular fund going forward. We believe there is a significant level of

related pay transactions in the industry to the point that it is probably unacceptable and that there is too much conflict of interest because of that.

The education of Australians is obviously critical going forward. There is still a significant level of apathy among Australians with regard to superannuation. Given that it is there to fund Australians' retirement income in the future, the education level needs to be stepped up. Following on from that, the financial literacy board that the government has put in place appears to be underfunded and more should be done with regard to that. That concludes our presentation.

CHAIRMAN—At what level should insurance standards for trustees set?

Mr Bresnahan—We have not determined an appropriate level. However, we are fairly confident that some of the levels of insurance currently in place are inadequate for the fund. The levels of insurance would obviously also depend on the assets of the fund, so a stipulated percentage of assets of the fund may be required. But we believe that the capital adequacy issue would not work in its current format.

Senator SHERRY—Could the witness indicate in which areas there is insufficient insurance. Every trustee has insurance, but it is not clear to me what they are insured for and what areas—where there are gaps—they need to be insured for.

Senator MURRAY—Or underinsurance cover.

Senator SHERRY—General under level of insurance.

Mr Bresnahan—To our knowledge, there is no prerequisite insured amount, so professional indemnity, directors' and officers' liability are two key areas. If a fund had, let's say, $2½ million cover, that could be significantly inadequate in the event of a unit pricing error or in the event of a significant claim or a fraud scenario within a fund. Therefore, it falls back onto the scheme or arrangement that I believe APRA would run and then levy back on all the other funds. So each fund needs to have an adequate amount and that adequate amount might be $10 million, $20 million or $100 million worth of cover.

Senator MURRAY—Excuse my ignorance, but does APRA examine the issue of how well funds or trustees are insured?

Mr Bresnahan—I am unaware of that.

CHAIRMAN—Yesterday we were told that the 40-year projections that the industry funds sometimes put out and rely on are based on the analysis and assessments you provide. Can you provide to us the basis of those projections and the underlying assumptions that you make?

Mr Bresnahan—The methodology? The methodology is quite complex but, in short, it is based on the current fee structures of all the funds. There are two universes: one is a conglomerate of industry funds and the second is a conglomerate of commercial funds. From the average for those two groups of funds, the fees are then projected, assuming the same net earnings for both sets, and the differential at the end is simply a compound, in effect, of the differential in fees over that period.

CHAIRMAN—Have you taken into account the fact that fees are increasing?

Mr Bresnahan—Yes. All fees are updated every quarter—by us.

CHAIRMAN—What about in terms of your projections? How do you take the fee increases into account for your forward projections?

Mr Bresnahan—We take into account the fact the assets would be increasing on a yearly basis. We cannot predict what fees may change this year, next year or in 10 years time, so it is done on current fees only.

CHAIRMAN—That would militate against the accuracy of your projections in a sense, wouldn't it?

Mr Bresnahan—No, it would not, because you cannot project what fee increases or decreases may occur going forward. So it is quite clearly disclaimed that the figures are calculated with effect over the last quarter—so, to 31 December.

Senator SHERRY—Some funds have fixed money fees as well as percentage applications in some areas; others just have a total percentage. There is quite a complex approach. How do you project forward in those circumstances? Where there is a fixed money fee, would you use that same fixed money fee, increasing presumably by—what, CPI, average wages? How do you index the fee if it is a fixed money fee?

Mr Bresnahan—The fixed admin-based dollar fee would be indexed by CPI, as are a number of other variables within there. Where it is a percentage based fee, that is assumed to remain static.

Senator SHERRY—Would that be a correct assumption? Surely, if both the funds under management within a fund and the moneys within a member's account are going to grow over time—and I think that is a pretty reasonable call—the percentage would decrease over time, if you had competitive pressures working.

Mr Bresnahan—The areas that we look at which are employer sponsored superannuation divisions, particularly in the commercial sector, have a decreasing fee scale depending on the level of assets within each employer group. Our modelling takes that into account; hence we model for a small employer group, a medium employer group and a large employer group, and you will get different results based on each of those groups.

CHAIRMAN—You say in your submission that promotional advertising is in members' best interests if it is 'professional and transparent'. How do you define 'professional and transparent'?

Mr Bresnahan—Most funds have a dollar based fee or a percentage based fee. Those fees must take into account all expenditure of that particular operation. So, it is a business; it has revenue of X and it has expenditure of Y. Historically there were examples where the expenditure was larger than the income. These days that has largely been corrected within the industry so that the administration fees coming in do exceed the expenditure going out. The

marketing costs within that are in some cases clearly disclosed in the audited financial statements of the fund and in other cases wrapped up under operational costs. But again we believe that is fair and reasonable, given that they are audited financial statements and they are available to every member of that particular fund.

Senator SHERRY—Just on that: I can read some fund's annual report to members and then I will go to get the audited statements, which are only included in the annual report in a very abbreviated form. Given advertising is a contentious public issue—and, for that matter, trustee remuneration and those sorts of issues—shouldn't there be a requirement that advertising, which should be clearly defined, and trustees' and executives' remuneration within a fund should be clearly declared in the annual report?

Mr Bresnahan—Not necessarily in the annual report. I would support complete transparency through audited financial statements. The issue in the industry at the moment is that each accounting firm has a different interpretation of what needs to be disclosed in the audited financial statements, so you will find that in some cases, as I mentioned, all trustee office costs will come up under one heading of 'Operational costs'. In other funds there will be line items for marketing, directors' fees, administration costs and all those sorts of things. There is no consistency between financial statements of funds within the industry. I think that is probably worth revisiting if you want to see full transparency.

Senator SHERRY—I accept your suggestion about how you deal with that. My other concern, though, is that according to most surveys, while people look at their statement, the annual report goes in the rubbish bin. So I do not know how many actually then go to the detailed accounts. I suspect the number is minuscule. I am probably about the only junkie around who reads them, I suspect, apart from you and a few others.

CHAIRMAN—I read them.

Senator SHERRY—The 'insiders', let's say.

Mr Bresnahan—If you can get them.

Senator SHERRY—That is an interesting point. We should be able to get them; in some funds you cannot. In the context of having 300-odd licensed funds, why can't we get the annual report and the fund statements for all those funds? At this stage you cannot get them.

CHAIRMAN—I would reinforce that. I have had people saying they cannot get hold of the annual report when they have requested it.

Mr Bresnahan—My understanding is that a member is entitled to get access to the audited financial statements upon request. Some funds are putting a fee in there as a block. It might be a nominal fee, but still it is a block to discourage that sort of practice. Whilst we get the majority of audited statements, there are other instances where we are flatly refused. The other case, which is quite interesting, is that in a number of funds the financials are run back through statutory funds, which have a different reporting requirement than a stand-alone trust. Where that occurs, there is no breakdown whatsoever. I think the income and expenditures sheet is four lines long—it is income and expenditure and that is all—which is completely unfair relative to other

funds, which need to have complete and standard Australian-accepted financial statements. That issue has not been addressed. It has been raised by us on a number of occasions but has not gained any attraction.

Senator MURRAY—Raised by you with whom?

Mr Bresnahan—Just in general at conferences and those sorts of things, not directly with any of the regulators. But we have raised it in papers that we have written before, so we believe that each trust needs to have its own set of financials even if it is a subset of the same trust. So, where you have different products sitting underneath the one trust deed, generally they are brought into one set of financial accounts. If you are a member of one product you cannot see the differentiation of your product versus another product at the financial level. We think that is incorrect as well.

Senator SHERRY—You obviously try to access information on, presumably, all of the approximately 300 funds we have. For how many can you not get sufficient information?

Mr Bresnahan—I would not be able to give you an accurate statistic for that, but our response rate across the board is around 70 to 80 per cent.

Senator SHERRY—When you say ‘response’, do you actually approach them if there is not something publicly available?

Mr Bresnahan—We ask every fund every year for a complete request. They are asked to answer about 900 questions together with annual reports, audited financial statements and PDS documents—probably every document they possess. Every fund is asked every year, irrespective of whether they have told us that are not going to provide it.

Senator SHERRY—What is the reason that the 20 per cent refuse?

Mr Bresnahan—There are varying reasons. Some may have something to hide. We do not know.

Senator MURRAY—Are we staying on the topic of accounting, reporting and all that sort of thing?

CHAIRMAN—Do you have questions?

Senator MURRAY—First, I would like to refer the committee, particularly the secretariat, to my paper on regulating not-for-profits which I have provided to members and senators and to the secretary. The key issue, Mr Bresnahan, is whether all not-for-profits of a material size deserve better regulation and conformity with respect to reporting and the way in which their statements are compiled and disclosed. The problem you outline applies to a hospital which is run by a church, it applies to a charity which is run by an international organisation, it applies to a Medibank or an HBF health fund, and it applies to a super fund. They have all got the same sensitivities: what are the management costs, advertising, sponsorship costs and remuneration costs? My question to you is: given your very professional analysis and understanding of the industry, why is it that, as far as I can ascertain, very little attempt has been made by professional

associations or participants to engage with regulators or the Australian Accounting Standards Board on these issues? Is it because they have had an insular, highly specialised kind of view? What is the reason? I cannot understand why there has not been a drive for a commonality in approach.

Mr Bresnahan—Could you be more specific about the types of associations you are talking about?

Senator MURRAY—I am thinking of IFSA, ASFA, the superbly capable peak bodies—large superannuation funds. They are highly expert, very able people, and yet—I am saying this because of this inquiry and the evidence coming to us—there has been no real effort to say, 'Exactly what should be the reporting, the accountability, the financial statement exposure? How should we make these common, consistent and transparent?' My question is: why? I do not understand why.

Mr Bresnahan—The reality, with any industry association, is: they have a client base and they best represent their client base to protect them against certain processes they may not think would show them in the best light. So none of those associations, by definition, are independent, because they are reliant on their clients for income.

Senator MURRAY—Where is the benefit in not having consistent disclosure? Where is the benefit in some funds, as you have outlined to us in your evidence, being quite full, in terms of disclosure and the way in which they present their financial statements and so on, and others not? I do not understand why there would be a motive to be less transparent, less disclosing.

Mr Bresnahan—Quite often, a lot of the resistance to change within this industry is based on administration costs involved in implementing these sorts of things. Our view is that it is not a significant issue—

Senator MURRAY—You mean cost is not a significant issue.

Mr Bresnahan—No. And it is generally overstated to protect them as some form of defence. I would strongly suggest that there should be uniform financial reporting right across the industry. So any superannuation trust or division of a trust should report in the same format as every other trust. There would be several benefits to that. We could benchmark certain expenditures of certain funds. We already identify poor-value-for money funds; but clearly there are a number of funds out there that have some things to hide, or they certainly do not want public scrutiny, which is disappointing.

Senator MURRAY—I agree with you, but I do not think it should apply only to the superannuation industry. I think that not-for-profits of a certain size and market impact need to report on the same basis—as do corporations under Corporations Law.

Mr Bresnahan—Our expertise is purely within the superannuation industry, so I could not comment on charities and other not-for-profit entities.

Senator MURRAY—They are huge enterprises. They run massive hospital systems, massive employment agency systems, and massive health fund systems.

Mr Bresnahan—We are disappointed with the level of disclosure in a lot of instances because we just cannot get to the bottom of the expense of that particular fund, how it is being run and what risks are associated with how that fund is being run. Part of our process is to identify funds that may be at risk or may have things that are not disclosed that should be disclosed.

CHAIRMAN—What is your view of the 'compare the pair' advertising campaign that industry funds are running as a generic endeavour?

Mr Bresnahan—As you are aware, we were commissioned to analyse those numbers and provide them to our clients. My personal view is that they are appropriate. They are highlighting a differential in fee structures, which is one part of a superannuation fund. Other funds are open to advertising a particular area where they have strengths and that may be a service strength; it may be an investment strength. There are numerous areas where they could promote their funds to Australians to gain market share. My view on the world is that it is a normal business process to promote the best part of your offering, whether it be superannuation or any other industry.

Senator SHERRY—What about sponsorship of football clubs? There has been a recent famous sponsorship in Melbourne—HOSTPLUS and the Melbourne Storm—do you think that is going a step too far?

Mr Bresnahan—No, I do not. HOSTPLUS in itself has three-quarters of a million members, so three-quarters of a million Australians are involved in that fund. These funds are, in a way, immature and they will grow into huge financial organisations in a decade or two's time. They are in our opinion the forerunner of the AMPs and the National Mutuals prior to demutualisation 20 or 30 years ago. If you think back, even prior to demutualisation of AMP and National Mutual, both of them used to advertise heavily after the introduction of SIS, so it is the same question. They were advertising then, HOSTPLUS and a lot of the not-for-profit funds are now advertising—is that appropriate? Our view is yes and one of the key things behind that is that any business needs to grow. If a business ignores its current membership or potential membership then it could well be to the detriment of the existing membership going forward. We have no issue with advertising from super funds than with anything else.

Senator SHERRY—Isn't there an argument from a systems point of view which is effectively underwritten by compulsion? This has been closely studied in the UK and other jurisdictions. Isn't there an argument that you need to compel people to save for retirement? That is an accepted approach. Therefore, you should minimise or heavily restrict in a variety of ways distribution costs and advertising costs because it increases total fees in a compulsory system, as distinct from reducing total fees and costs.

Mr Bresnahan—In some instances fees have gone up, but it is simply to meet ongoing expenditure. It would not be correct for boards of any of these funds to consider advertising as a way of maintaining their membership base going forward.

Senator SHERRY—You mentioned in your opening comments that related party transactions are too high, and unacceptable. It is partly the disclosure issue but more directly the regulatory issues of those disclosures. What sort of related party transactions are you referring to?

Mr Bresnahan—Primarily our view is that every trustee company should tender every service to the market on a regular basis to ensure that the members are receiving the best benefits. A trustee director's responsibility or fiduciary responsibility is to act in members' best interests at all times. What has happened historically, until we have shaken some funds up more recently, is that they have had the one administrator, they have had the in-house investment team, and they have had the in-house insurance arrangement. Our comment to them has been, 'How do you know that that insurance arrangement cannot be improved upon significantly externally?

CHAIRMAN—Typically, which organisations have been providing those services?

Mr Bresnahan—A related party. The trustee company—

CHAIRMAN—Are those industry fund services? Is that what you are talking about?

Mr Bresnahan—No, I am talking about the whole industry. Across the whole industry there are plentiful examples of where a trustee company is a related party to the administrator which is a related party to the investment advice part.

CHAIRMAN—So this applies to industry funds and to the for-profit funds—it is across the board?

Mr Bresnahan—Absolutely. It is across the board. We are not saying that you are wrong; what we are saying is that you need to ensure under your fiduciary responsibility that you are right.

Senator SHERRY—So where they do it internally or through a related ownership structure, it needs to be benchmarked regularly to show that it is value for money. Is that what you are arguing?

Mr Bresnahan—Yes. There is no way that a board can satisfy themselves that it is competitive without knowing what the other parts of the market are doing. In a lot of cases, they have been reluctant to do that. It is across the board. The report that we are currently running on eligible rollover funds, which account for something like $5.5 billion, has found that there is huge evidence of related party transactions in that specific area, and that is disappointing.

Senator MURRAY—Is there a predominant kind of related party transaction?

Mr Bresnahan—In some cases, there is a single investment manager. In ERF's case, they do not have insurance. But the trustee can be related directly to the single investment manager and the administrator is also a related party, so none of the moneys of the Australians is going outside that single institution.

Senator SHERRY—And they can basically charge what they like—presumably—given that an ERF is overwhelmingly lost members.

Mr Bresnahan—Absolutely. The profitability in the ERF sector is way in excess of what would be acceptable in the superannuation industry, and we highlighted that last year and we will do it again when we release our next paper next month.

CHAIRMAN—I asked a question about the 'compare the pair' advertising. Given that in a sense that is generic—it is an industry fund group advertising—and also given the fact, as we have heard repeatedly, that the overwhelming majority of industry fund members do not receive investment advice, is there a danger that potential fund members will see one industry fund as being as good as another in the context of that advertising?

Mr Bresnahan—That is an issue for their association. Our role is to analyse the data and come out with responses. You would have to ask IFS or IFN as to whether that is a risk for their members.

Senator SHERRY—I have looked at some of the performances of industry funds. As a generalisation, the vast majority perform very well, but some industry funds do not perform well in terms of investment outcome and their fees.

Mr Bresnahan—Absolutely. Again, there is no hard and fast rule that the not-for-profit sector is clearly superior to the commercial sector if you take every fund into account. If you took the IFN network of clients into account, then it holds true that they have shown superior performance at a lower cost. But if you take into account some not-for-profits that we have concerns with already, their performance has been woeful and their fees are incredibly high—in some cases, over 300 basis points per member per annum.

CHAIRMAN—From what I understand—and I have not seen it; I have just been told about it—in the *Financial Standard* today there is an article that says that the performance of HOSTPLUS has been three times the performance of the motor trades fund.

Mr Bresnahan—That is in *Investor Daily* today. That is probably the worst written article I have seen in my life.

CHAIRMAN—Was it an accurate assessment from your point of view?

Mr Bresnahan—It was the worst piece of journalism I have seen in my life.

CHAIRMAN—That does not answer my question. Was the analysis accurate?

Mr Bresnahan—No, it was not.

CHAIRMAN—Okay. The concern I had was that with this generic advertising people might be under the impression that, as long as they are in an industry fund, then it does not matter which one because industry funds perform well. But if there is there sort of scale of difference between industry funds, then—

Mr Bresnahan—Of course there is a differential between funds year on year. That particular article referred to an 18.86 per cent return from MTAA last year versus what they quoted as a 13.6 per cent result from HOSTPLUS over one year. They then projected that single year differential over 25 years, which is—

CHAIRMAN—The other way round, wasn't it?

Mr Bresnahan—No. It was MTAA ahead of HOSTPLUS, which is a totally inappropriate methodology for that sort of thing and disappointing that they would run with it from a methodology point of view.

Senator SHERRY—So you think that one-year comparisons can be invalid? Should it be five, seven or 10 years?

Mr Bresnahan—From an investment perspective I think five years is probably about the best measure. One year is certainly dangerous and that is something we try to push out into the marketplace. A five-year investment perspective is adequate because it generally goes through a number of market cycles. The other problem, when you start to get out to 10-year investment comparisons, is that the entity may well have changed significantly over that 10-year period. It has been shown historically that good past performance—and that is why the disclaimer is there—does not necessarily indicate future performance. So five years is probably about the mark.

Senator SHERRY—I accept your argument about the 10-year cycle. On an average five-year cycle I think you would have a negative rate of return one year in seven. Wouldn't seven be a more appropriate figure because you are more likely to pick up a negative?

Mr Bresnahan—Five or seven; we would not have a problem with either of those.

Senator SHERRY—One of my concerns is that we are getting to the point now where the negative rates of return of the early 2000s will drop out, which will artificially increase the average for the last four years.

Mr Bresnahan—Absolutely.

Senator SHERRY—And in the next year people will get the impression that the average rate of return over the last five years will continue. They will get that impression for a whole lot of reasons, I suspect, because there is no negative rate of return in this.

Mr Bresnahan—That is right. People have very short memories. The five-year rate over the last three years has gone from 5.6 per cent to 9.9 per cent as at the end of January.

Senator SHERRY—Is that because of the drop out of the negative years? It is not just the higher rate of return in the fifth year, is it?

Mr Bresnahan—No. It is predominantly because 2001-02 and 2002-03 are beginning to drop out to five-year numbers and that, by definition, will continue. So even if our market goes negative now, the five-year number will still hold fairly high.

CHAIRMAN—Have you done any analysis of the impact of the cost of the advertising programs on the member returns?

Mr Bresnahan—No, but we have analysed the total cost of membership of each of the funds and brought those into our analysis when we do any data management.

CHAIRMAN—How far do you drill down in your analysis? Do you look at the balanced fund outcomes or do you look at every individual fund to make your analysis and projections?

Mr Bresnahan—Are you talking about 'compare the pair' campaign?

CHAIRMAN—No, just your general analysis and the report on what you do—

Mr Bresnahan—We look at every major option of every fund. I think we measure between 700 and 1,000 investment options every month and produce results across the industry.

CHAIRMAN—In the context of 'compare the pair', how is that—

Mr Bresnahan—Investment performance is irrelevant in 'compare the pair' because it is assumed that all funds will return the same rate going forward.

Senator SHERRY—On the basis of at least the industry funds paying for the advertising it would be a conservative approach, wouldn't it?

Mr Bresnahan—Could you elaborate, Senator?

Senator SHERRY—I think there are 15 or 16 industry funds paying for the 'compare the pair' ad. They are using the same rate of return. If they used their own rate of return for the 15 or 16 funds on the default fund versus the rate of return for retail default, they are understating their position, aren't they?

Mr Bresnahan—'Compare the pair' is purely analysing fees and being projected forward. If there were a method of analysing a combination of past performance and future fees, then you would be correct in that statement because currently there is a differential between the performance of those industry funds and the universe of the commercial funds. Obviously that may change going forward because the investment is variable.

Senator SHERRY—Is that superior average performance just over the last five years? How far does that go back—10 or 15 years?

Mr Bresnahan—We do hold some 10-year data, but it is not sufficient to be a reasonable universe to make assumptions on.

CHAIRMAN—Is there a danger that the surveys you conduct encourage a 'set and forget' mentality among members in their asset allocation?

Mr Bresnahan—That is a good question. In an ideal world, there is a risk that certain Australians are in the wrong investment option. In reality our statistics show that about 82 per cent of Australians default on their investment and/or insurance structures and that the average fund has about a 70 per cent growth allocation and a 30 per cent defensive. We believe that the trustees have done a very good job in putting those defaults together. It is quite interesting. A number of funds have defaults set at as low as 12 per cent growth and 88 per cent defensive. In the last five years, members of those funds—and we are talking several billion dollars—have suffered because of the attitude that the trustees of those funds have taken. There is always a risk

that people are in the wrong investment option or have the wrong levels of insurance. We come back to what we were saying before. We need more education and financial literacy among Australians so that they understand how super works—let alone how to start picking the right investment options and coverage of insurance. I think those things are thrown up too often before we have even sorted the macro position, which is that Australians do not care about super.

Senator SHERRY—But in an ideal world you would not need any form of default or compulsion because 100 per cent of Australians would not just be financially literate; they would save for their retirement without being compelled to by government, wouldn't they?

Mr Bresnahan—Correct, and they would understand the benefits co-contribution, salary sacrificing and those sorts of things. This is the simple stuff. One of my earlier comments was that the licensing requirements of the planners at the moment are too onerous on simple stuff. Co-contribution, salary sacrifice, the investment option and the level of insurance all fall under that category where you need a complete 20-page or 50-page statement of advice to get any of that advice. We are not talking about product advice there. I know it is individual advice, but we are not talking about changing products; we are looking at what is in the best interests of that particular member—whether they can improve their savings or their risk position.

Senator SHERRY—It is limited or segmented advice about a particular aspect of superannuation within a fund.

Mr Bresnahan—Yes, and my view is that we should have that sort of advice segmented away from product changes so that, if you are trying to go from product A to product B, it is a separate requirement that the planner must show is in the members best interests. If the planner is simply trying to say, 'You should be salary sacrificing as opposed to paying after-tax dollars into your super fund,' why do you need a 20- or 30-page statement of advice?

Senator MURRAY—A witness earlier this week suggested that the key difference that we should consider exploring is between advice which details options and advice which detail recommendations, and they suggested that the strictures of the FSR regime should apply where their recommendations and advice have less onus, if you like, attached to them.

CHAIRMAN—Where you are explaining the options there should be less onus.

Senator MURRAY—Do you think that is a legitimate distinction?

Mr Bresnahan—I think advice and recommendation may easily blur. We all know that if you set a piece of legislation in stone a good marketer and a good lawyer will get around it the following day, unfortunately. I think that recommendation and advice are probably too aligned. What is the definition of the two relative to each other? This should be isolated to the superannuation industry as opposed to the general broad financial planning of an individual. I think just drawing a line between intra-fund advice, or whatever you want to call it, and actual switching as two separate parts of legislation may work.

Senator SHERRY—You made some comments about commission advice. I find the term 'advice' with respect to commissions a little misleading. There seems to me to be a component—very hard to identify—in advice delivery of selling a particular product. The commission is a

reward for selling and has an advice component to varying degrees. It seems to me impossible to differentiate between those two based on our current legislation and disclosure.

Mr Bresnahan—My main concern is with the mandated superannuation guarantee contributions. If someone is sold a personal superannuation policy then it is caveat emptor. They have met on a one-on-one basis with an adviser or professional planner who technically has disclosed all his remuneration in that environment. If they buy that, sorry, they have been a bit—

Senator SHERRY—You would have a stronger argument, wouldn't you, if we treated all superannuation products the same in terms of FSR? But we do not Self-managed super funds are treated differently.

Mr Bresnahan—SMSFs are a completely different discussion.

Senator SHERRY—Sure; I accept that but compulsory superannuation does flow into some SMSFs.

Mr Bresnahan—It does, yes.

Senator SHERRY—If not initially, later on. Put aside the debate about the efficacy of commissions for one moment: if you look at malpractice, theft and fraud, all of those activities that go on in our system—significant in the context of the system; I do not want to overstate the problem—it is predominantly the SMFS sector.

Mr Bresnahan—The SMSF sector is the most susceptible to it because it is controlled by individuals who are the members and trustees of that particular fund. There is obviously evidence of overselling in that part of the market but, again, they have made a conscious decision to go down that route because they believe that the advice and/or their own personal experience will be more professional and give them a better result.

Senator SHERRY—Is it acceptable in a compulsory superannuation system? I met the West Point victims last Sunday—200 of them—and a whole range of issues were discussed. About one-third of the moneys were superannuation. I asked them if they could tell me how many of them knew that there is no theft and fraud compensation in that sector when they signed up to an SMSF; not one of them knew that. When you are dealing with compulsory moneys and retirement savings, shouldn't we expect individuals to at least be informed that that circumstance and other circumstances are going to be different for an SMSF?

Mr Bresnahan—Arguably. The reality is we have a one trillion dollar industry which is going to attract fraud and malpractice through the whole process. People will get ripped off, no matter what regulations you have in place. You can probably try to go overboard on that and, again, you come back to the scenario where people have made a conscious decision to be in an SMSF. That is their responsibility. They may make a poor investment, such as West Point, or get sucked into the rollover schemes that have been going on for the last decade. You cannot protect everyone. All we are trying to say is: you probably need to put in place better structures for the majority of people.

Senator SHERRY—You mentioned one of the issues around commissions is paying for advice but not receiving it or receiving it to varying levels. Why is that a problem?

Mr Bresnahan—It is a huge problem. Let us go back a step: the majority of Australians are in the employer sponsored division of their superannuation fund—that is, through their employer. Even though we have had choice for some time, choice has not become a material issue, so the majority of employees still sit within their employer nominated fund.

The commercial sector has historically—although not in all funds; there are some very good commercial funds out there—particularly in the small to medium enterprise area, had an inbuilt commission component which purportedly is for advice to the members. So if I am in a company that employs 100 people and my company says, 'We are in XYZ super fund,' you are paying a fee to that adviser through a commission every year out of probably your insurance as well as your assets to get advice from that adviser. We would argue that, out of those 100 employees, the managing director, the financial controller and the HR manager would be getting lots of advice. The 97 others probably would not know that they even had an adviser involved. What we are trying to argue is that if someone is to pay for advice then they need to opt in, whereas the current methodology is, 'I'm paying for advice and I don't know I'm entitled to it. And I don't even know I can opt out of it.' It should be the other way around. This applies to the great majority of Australians in employer-sponsored superannuation: they are paying who knows how much money—it would total probably hundreds of millions of dollars—for advice they are not receiving.

Senator SHERRY—You are talking about group arrangements.

Mr Bresnahan—Yes, I am talking about group arrangements, which the majority of Australians are in. Forget personal super. That comes back to what I was saying before—that is a one-on-one sales scenario. That is fine. If they do not see their adviser for three years and they are still paying him, that is their problem. This is where the member has not had any involvement in the selection of that particular fund and is not even aware that they are paying fees for advice or education.

CHAIRMAN—So this applies to where the employer is using a commercial fund rather than an industry fund?

Mr Bresnahan—It is a problem with the commercial sector. There is an easy answer to it.

CHAIRMAN—So it is not a problem with the industry fund sector?

Mr Bresnahan—There is no commission built in there. The easy solution is that the cost of that advice component or services component needs to be stripped out of those fees and then the member applies for advice.

CHAIRMAN—So the member would opt in?

Mr Bresnahan—Yes. That would change the industry overnight and would make it a much cleaner arrangement.

Senator SHERRY—They are presumably monopoly arrangements where choice of fund does not necessarily apply.

Mr Bresnahan—No, not necessarily. The choice of fund would apply to most SMEs but again because of the apathy of Australians they assume that their employer has done the due diligence on that particular supplier. Again there is a conflict of interest. The managing director and the financial controller are getting all the advice and support. They are not going to move it. Let us be realistic here. Why would you move your fund away from all this support that you as an individual are getting to another fund where you will then have to pay for it.

Senator SHERRY—So they have a default arrangement effectively in place and a considerable majority of employees are in the default arrangement with that particular arrangement.

Mr Bresnahan—Absolutely.

CHAIRMAN—When you say that the managing director and the financial controller are getting advice are you talking about them getting personal financial advice through the system or advice in relation to the business in which they are involved?

Mr Bresnahan—The planner would obviously be assisting them with their personal financial affairs more so than with the boilermaker down on the floor.

CHAIRMAN—Do you have any evidence that that is occurring?

Mr Bresnahan—I have worked in the industry for 27 years and I know that is how it works.

Senator MURRAY—So you are suggesting really that choice is choice by employers not by employees.

Mr Bresnahan—Before choice it was purely an employer based decision and employees did not have any say in it.

Senator MURRAY—Not necessarily because in certain circumstances in certain industries under certain awards the application of a fund was determined through that process. What you are saying really is that, because of apathy, employees do not engage actively in the business of choice but employers will go where the deal is best from the employer's perspective.

Mr Bresnahan—Correct. This is where it comes back to the education of the general Australian populace. There is insufficient education for people to be aware that (a) they probably have choice and (b) to understand what that choice means for them.

Senator SHERRY—However successful your education campaign is—and I am a sceptic—how do you education the 18 per cent of the population who are functionally illiterate? Perhaps you can educate 82 per cent of the population to the required standard. They can read, write and understand forms; the other 18 per cent cannot. How do you educate them?

Mr Bresnahan—That is a very good question. I have no response other than to say that they have obviously somehow managed to maintain a bank account. This is very much a similar sort of arrangement.

Senator MURRAY—I might say in passing that I have known some top-flight businessmen who could not read and write.

Senator SHERRY—I think that one of the distinctions and the reason I have asked question is that we are dealing here with compulsion. At least I think there is a lesser ethical responsibility where you have a voluntary sign-up to a product as distinct from being compelled or forced to be in it and assuming that everyone then can automatically make informed decisions to exercise choice in whatever form the choice is offered.

Mr Bresnahan—Let us not overstate it. The reality is that this is a compulsory environment. A great majority of super funds—I will say the majority—have done a very good job for their membership. But, unfortunately, there are a number of super funds that do a very poor job for their membership.

Senator MURRAY—The direct implication of that statement is that therefore Australians at large are entitled to have trust in the system.

Mr Bresnahan—I think they should have trust as it sits at the moment. The level of fraud, dishonesty and losses within the industry has actually been miniscule relative to the assets in the industry. What I am worried about going forward is that it is a $1 trillion industry, it is becoming more and more electronic and fraud may be perpetrated to a higher degree.

Senator SHERRY—I agree with that. APRA has given me the answer to a question on notice that I asked about the actual levels of theft and fraud in the last three years. It was $42 million out of almost $1 trillion. However, for the members of the eight funds where there was theft and fraud it is catastrophic and it gets enormous publicity. Inevitably, that publicity flows on and discredits everyone else.

Mr Bresnahan—Yes, it does. That is a real risk. You try and purport to have a very safe system, which is in evidence, but the media may beat it up to say that suddenly everything is at risk and you can lose your retirement benefit. It is quite interesting—I have seen some surveys where one of the responses was: ‘We want a fund where we know that our retirement money is going to be there.’ The implication there is that they think someone is going to steal the whole lot—not that they will lose money on investments but that they will lose the whole lot. Realistically, that cannot happen with the larger funds.

CHAIRMAN—Both in your submission and in your remarks earlier you suggested the disaggregation of administration and adviser fees along the lines of wrap account statements. Would that be difficult for funds to achieve? Is it a fairly simple process?

Mr Bresnahan—No, but as soon as it is raised there will be arguments back that it is too expensive to implement. The reason for that is obviously that there would be a concern about the disclosure of those two components.

CHAIRMAN—I have just been refreshing my memory on the issue you raised about conflict of interest between trustee boards and suppliers in relation to both not-for-profits and commercial entities. Can you give some specific examples of that?

Mr Bresnahan—I would prefer not to give the committee specific examples.

Senator SHERRY—Perhaps you could provide us—without naming the names—with examples of clear conflicts that have occurred to your knowledge. You do not have to give us the names—for example, 'X entity did this.' At least it identifies the set of issues for us.

Mr Bresnahan—We could give you generic examples of that sort of thing. The main point we were trying to make was that it is easily fixed via a trustee having to tender each and every one of their major services. We are not talking about printing, or something that may not be a significant cost. All of their major services—which generally comprise insurance, admin and asset consulting; they are the three areas—could be tendered on a predetermined regular basis, and that may be every three or every five years. Again, you will get some kickback to say, 'That's not fair; it is going to cost us money.' Well, bad luck. At the end of it, superannuation fees across the board are actually fair and reasonable, and if they happen to go up by 20 basis points across the industry because of new changes toward transparency and safety then that is just a cost to the industry. And I think that that argument does not hold water—that fees may go up. At the moment they are still competitive and they are still fair and reasonable.

CHAIRMAN—What is the ownership structure of SuperRatings?

Mr Bresnahan—I own 75 per cent of the business. My colleague Jason Clarke owns 10 per cent of the business and the remaining 15 per cent is held by my accountant.

CHAIRMAN—So there are no conflicts of interest there, then!

Mr Bresnahan—There are no conflicts of interest in this organisation, and there have not been from day one. That is something we stand by.

CHAIRMAN—There being no further questions, thank you very much Mr Bresnahan for your appearance before the committee. You have been very helpful in terms of the issues relating to our inquiries.

Mr Bresnahan—Thank you.

[10.01 am]

CARNEY, Dr Barbara, Manager, Government Relations, Institute of Chartered Accountants in Australia

ELVY, Mr Hugh, Manager, Financial Planning and Superannuation, Institute of Chartered Accountants in Australia

CHAIRMAN—Welcome. The committee has before it your submission, which we have numbered 43. Are there any changes or alterations you wish to make to the written submission?

Mr Elvy—No.

CHAIRMAN—I invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Mr Elvy—Thank you. The Institute of Chartered Accountants thanks the committee for the opportunity to appear before it today. The institute is Australia's premier accounting body, representing over 40,000 members who are fully qualified chartered accountants working in diverse roles within private practice, business, industry, government and education, both in Australia and overseas. The institute is also a founding member of the Global Accounting Alliance, an international accounting coalition of the world's premier accounting bodies formed in 2006 that aims to promote quality professional services, support that global membership, share information and collaborate on international accounting issues.

The institute has taken a strong interest in the significant changes that have occurred in the superannuation industry in Australia since the 1980s, and our submission to the committee's current inquiry continues that interest and involvement. Many of our members are involved in the superannuation sector as trustees, service providers and members of funds of all sizes. Our submission highlights the key responses to the inquiry's terms of reference from these particular members. The institute supported the changes to superannuation that have recently been through parliament, and was actively involved in the consultation with Treasury as this legislation was developed and in the Senate economics committee inquiry into the legislation.

The challenges presented by demography make it essential that Australia has the strongest possible retirement income policies that encourage savings. Simplicity, equity and efficiency are essential ingredients, and we are still a way away from that. So we encourage and support ongoing improvements to the system. However, given the scale of the most recent changes, we—like others who have appeared before you—would urge that time be made for these to be bedded down and their impact assessed so that there is a full understanding of how the industry is operating before any further changes to its structure are contemplated. Rather than canvass these issues, I am more than happy to take some questions.

CHAIRMAN—Thank you very much. You refer on page 3 of your submission to the compliance burden imposed by the financial services reform legislation regime, particularly on the providers of financial advice. You refer to the increase in compliance requirements and also

the product disclosure statements. What is your view as to how this burden could be reduced? Is it possible to make financial advice more consumer focused?

Mr Elvy—I would suggest that the key issue is to make it consumer focused. At a meeting just recently we looked at, again, the question: what was the idea of all this legislation? I think part of what we need to look at is: why does the product disclosure statement need to be of such a size? Why does the statement of advice need to be of such a size? And the issue at the end of the day is of protecting the consumers. We have found that, despite all this disclosure, they basically still do not understand any of their superannuation requirements and why they are getting any of their advice.

CHAIRMAN—Are there any particular initiatives that you think should be taken to simplify it?

Mr Elvy—There are two areas which I think should be addressed. One is the complexity of superannuation fees, which I know even from my own experience in looking at superannuation funds. To try and understand how fees actually operate is very complex. In another role that I am involved in I mark for a tertiary institution. They provided me with real life case studies and so forth. Trying to understand what some of the fees are, even with some basic templates, is very confusing. I think the issue of how fees are templated and provided needs to be addressed more. It is almost impossible, basically, for the average consumer to look through three or four PDSs and understand what the fees are.

Senator SHERRY—On that point, at the estimates—not before us, but at estimates—I have questioned APRA about gathering information on fees to make comparisons, and they have struggled in some areas. They frankly admitted to me that it is almost as difficult as putting a man on the moon. I think that was their expression. If they cannot do it, and you cannot do it—and you are obviously well qualified—how is the average member able to do it?

Mr Elvy—I do not have a solution. It is an issue that I have grappled with, having been in the industry for 15 or 20 years now. Even over the last 12 months we have gone through a process of looking through some PDSs, just from a personal perspective. It is a problem, but I can honestly say that I do not have a solution at this stage. But it something that we are having ongoing discussions about.

Dr Carney—If I could I will also address your question about how PDSs and other documentation could be more consumer friendly. Looking at the question broadly from the institute's perspective, if we go back to when the FSR legislation was first being introduced, as we point out in our submission, the documentation surrounding the legislative requirements was very much introduced by corporates, not from a consumer education perspective but almost from a risk management or, in some cases, a risk avoidance perspective. So it is not being looked at in the context of: 'What do our consumers need to know that we are not telling them now? Do all of our customers need to have the information in the same form? What is the most appropriate way for different customer groups to receive this information?' It is been looked at in the context of the minimum information consumers need rather than the most effective information you can give consumers who are about to purchase one of these products. That goes to whether it is superannuation, whether it is insurance, whether it is looking at what sort of bank account you need—across the whole of the financial services spectrum.

When FSR was being introduced the approach that was being taken was, 'The whole idea is not to get caught out. We have to cover every possible eventuality.' This led to these great weights of documents even for quite simple matters like telephone sales, as members of this committee know very well. So we have been very encouraged by the refinements to the FSR that have been ongoing. But we would say that the fundamental question needs to be asked: what is it that consumers want? We understand that the Financial Literacy Foundation may be doing some work on how different demographic groups in the community best receive information about financial literacy. I understand that some research has been commissioned, but I have not seen any results of that so far. As a public good we would see that there is a role for public education here.

Senator SHERRY—On these documents and so-called refinements, last week I asked Jeremy Cooper from APRA how many short-form PDSs we had got and the answer was zero. I am now looking at the answer to a question on notice. I asked Treasurer and ASIC what they did about actually researching consumer testing on the readability of product disclosure statements both then and now. None has been done—

Dr Carney—That is our understanding.

Senator SHERRY—not by Treasury, by the financial services advice division of Treasury; not by ASIC. Shouldn't it be incumbent on the particular regulators and divisions of the public sector, if they are going to impose a system, to at least do research on it?

Dr Carney—Yes, I think we would have to agree with that. Although this might be an invidious comparison, I think many people would have been reminded of the first form of the BAS on which the same questions were probably asked of the ATO as to whether or not in fact there had been research. I cannot recall whether that question was asked, but certainly we remember the confusion and difficulty that that caused to small business in particular. We would say that it would be prudent to do such research so that you actually know what consumers need. Having said that, I note that from a previous witness, the one who has just appeared before you, and other witnesses who have appeared before the committee you have heard a lot of evidence—and you would have a lot of knowledge about this—about the fact that, whether it is apathy produced by confusion or whether it is apathy produced by apathy, there is a fairly low standard of confidence amongst members of the community generally about dealing with issues, particularly superannuation. Intuitively, you would think that a lot of people would prefer to outsource not only the management but some of the decision making as well because it appears so dauntingly difficult. I think you have to address that issue too in constructing that research. Yes, Senator, we would agree with that contention.

Mr Elvy—One of the challenges as to any research is for the consumer to know what they are actually looking for in the first place. I think that, even if you research this and ask them what they are after as to superannuation in a PDS, a lot of consumers would not actually know the information they need to be able to make an informed decision. I think that is probably one of the challenges that we actually have. When, with the complexity of superannuation and some other general investments, we say, 'Can you understand this?' the response is, 'I'm not sure why I need to understand this. What is the information that is actually in there?' I think that is part of the challenge that the industry has.

CHAIRMAN—You say in your submission that FSR has seen the regulation of advice take a ‘black-letter law’ approach. The whole intent of FSR was to take a principles based approach. How do you think that intended approach has transmogrified into what you say is a ‘black-letter law’ approach? What has been the cause of that?

Mr Elvy—The intent of that particular comment was that, while it was originally principles based, the industry’s interpretation has been to look for black-letter law on issues and, in terms of that, therefore to actually contact the regulators to get some information from them. Often they will not give you black-letter law or say that this is how the situation is. Instead they will give you some guidelines. Therefore the dealer groups and AFSL holders have done an analysis and, having come up with it, said, ‘Look, whilst it is principles based, we haven’t got a definitive answer. This is what we’re going to put in and we’ll make it particularly prescriptive.’

CHAIRMAN—Their legal advisers would tend to do that rather than them.

Mr Elvy—Yes. So the interpretation of it has been that the only way that we can ensure that we are actually meeting the requirements is by some way going through a tick a box approach. That is why you often see with statements of advice almost a checklist that says, ‘Is this information covered in a statement of advice?’ as opposed to, ‘Is it appropriate for the consumer?’

Similarly, even from a training perspective, with PS 146 there are set competencies that you must meet on an ongoing basis to meet your area of specialisation—be it managed funds or superannuation. Therefore, in terms of keeping people up to date, there is a need to tick a box to make sure that you have covered everything. If ASIC comes in and says, ‘What is your training register like and what training have you done?’ you can show them all your authorised representatives and what they have actually done. From a protection perspective, it is all ticked off.

Senator SHERRY—I think it is a little ironic, but isn’t black-letter law the only way around this—standard advices, where you can have them? We have a standard form for choice of fund and we are going to have a standard portability form. Isn’t the only way around this to have standard forms, once you have designed them—simply, hopefully—in the regulations so that there is no legal doubt?

Mr Elvy—That could very much be a consideration. One of the difficulties we have with financial planning and superannuation is the complexity of it. Whilst a standard form would be useful, a lot of advice is very personal. From the institute’s perspective, with a lot of them we talk about charging fees and so forth, so the advice you give and what you actually provide in the service is very personal to the particular individual.

Senator SHERRY—I understand that the advice is very personal, but I look at the PDSs required for determining the level of insurance in superannuation and, frankly, I do not think it is rocket science.

Mr Elvy—I would agree with that.

Senator SHERRY—Looking at the level of disclosure that is required, which does force up costs, it seems to me that, conceptually at least, you could come up with much simpler and, in particular, segmented advice. Not everyone wants advice about everything under the sun every year.

Mr Elvy—That is very true.

Senator SHERRY—From the evidence we have received, they have a particular need for a particular piece of advice at a particular point in time.

Mr Elvy—Yes. The only issue I would raise there is that, whilst an individual may require a particular piece of advice at a particular moment in time, again, when we are talking about financial literacy and understanding, in a lot of cases the consumer is not aware of the other areas they need to be aware of and to consider. I know from my own experience that you can speak to a client who comes to talk to you about superannuation and you would not raise insurance or anything else, but there are other issues that you have a responsibility to raise with the particular client in order to address it.

Senator SHERRY—I accept that as an argument. On the question of whether the superannuation system should pay for it, I accept the validity of 'if there are specific issues that are relevant to superannuation'. But surely in a compulsory superannuation system, if you see a planner and you raise all sorts of other issues that are not super specific, it should not be part of the payment structure based on the commission or the fee from the system as a whole.

Mr Elvy—Sorry, I am not sure what you mean.

Senator SHERRY—If you go to a planner, they will say that you need A, B, C and D, and the commission is hooked onto the super. It is a retirement income system, long-term and compulsory, not a general financial planning system to be paid for off the back of super.

Mr Elvy—From the institute's perspective, our view has been very clear, when it comes to the remuneration side of things, that you should be providing the advice on a fee-for-service basis. In terms of receiving commission, be it from superannuation or a third party and so forth, we believe that causes potential for perceived or real conflicts. That would be our position as far as that is concerned.

CHAIRMAN—You refer to the carve-out in relation to self-managed super funds for accountants. You say that you are still seeking the extension to be able to advise on structures—I suppose the best way of putting that would be a comparison of structures between self-managed funds and other types of superannuation.

Mr Elvy—The institute has not been pushing for extending the exemption and the carve-out. Yes, we believe that that there are some significant issues concerning how accountants operate under FSR, but we understand that the FSR regime and so forth should basically cover everybody.

Senator SHERRY—Regulatory neutrality?

Mr Elvy—That is right. I do not believe you can necessarily have it standing completely outside the system. I think the key problem that we have, or the key concern that we have been working on for the last 12 months—and also obviously trying to work on with the other accounting bodies—is how an unlicensed accountant operates at the moment and, therefore, if the consumer is missing out on receiving a form of advice. That to us is the major consideration. Quite often in our discussions with Treasury and so forth the question has come up: basically, why don't all accountants get fully licensed? And, seriously, that is what they are still waiting for. The easiest way would be to say everyone has to be fully licensed under the current regime, but from a cost perspective and a time perspective it is just not practical.

Senator SHERRY—I understand that, but do you appreciate the difficulty—and I frankly think it would be very difficult for it to continue long-term—for a self-managed super fund structure when, I understand, a significant proportion of the advice is provided by accountants and a significant proportion by planners, with different disclosure regimes? I just do not see how that can be maintained in the long term.

CHAIRMAN—My question was: how is the current carve-out working in practice?

Mr Elvy—In practice it does not work because, if you advise on the establishment of a self-managed super fund and you are unlicensed, and your client then says, 'By the way, I've got $50,000 in my industry fund; should I bring it across,' you cannot actually answer that question. That in particular came out after the ASIC super-switching findings last year, in the Q&A that came out. That makes it very difficult, basically, for the accountant to advise on that and ignore their industry fund or where their superannuation funds are at the moment.

Senator MURRAY—How many of your 40,000 members are now licensed under the FSR regime?

Mr Elvy—The last statistic we have for authorised representatives, who therefore operate under Australian financial services licences, was probably about 2,000. We asked them if they could tell us, and that was from the details they actually provided. So no doubt there would be those who have not filled out the paperwork and told us.

Senator SHERRY—I do understand the difficulties, the parameters, the reason the approach was taken about the carve-out. Would your concerns be lessened if we had a simpler operational FSR regime than we have at the moment, than we have had for the last couple of years?

Mr Elvy—I think that would have to be a serious consideration and it would be worth while. For example, I was speaking to a member probably just before Christmas who ran a three-partner practice, and he was concerned about FSR—and I get calls weekly on FSR, just to confirm the issues. He said: 'I wasn't sure what I should do. I know that we might actually breach FSR, so I've applied for an AFSL.' Their intent was not to provide advice on products—there was an ABC fund along those lines—it was purely a risk management position. 'That way,' he thought, 'if I give any advice, I've been through the process.' So he actually outsourced the application to get his licence. Part of getting an AFSL is that you need some responsible officers. Even though he had been a chartered accountant for 20-odd years with his partners, he was not classified as meeting the requirements to be a responsible officer, so they had to outsource the responsible officer role for $15,000 a year. He rang me to say: 'I'm doing this for risk

management. It’s going to cost me $45,000 over the next three years. This doesn’t make sense.’ Now, I raised that with ASIC and they said, ‘No, that doesn’t make sense.’ So he is not making any money out of it; he is trying to protect himself and it is not working.

Senator MURRAY—Why couldn’t he be a responsible officer?

Mr Elvy—Because of the definition—unfortunately, I do not have it with me—and what the requirements are, as in you have done the financial planning training and various bits of pieces. His experience did not apply directly to what was required in that role of responsible officer.

Dr Carney—We understand that some of that might have gone to—ironically enough in this particular case—the lack of experience in financial planning of this particular member which is understandable because he is a chartered accountant. We would say yes, some of these issues probably would be reduced in magnitude were the regime itself simplified. I think it is important for the committee that we make it really clear, from the institute’s point of view, that any accountant who wishes to give advice that goes to changing from fund to fund or where money should go let alone on product should be licensed, should get an AFSL and go through the process.

Since the committee opened its deliberations, since you met in October, there have been some more discussions amongst the accounting bodies and we have moved on. We are still nowhere near the end of this process but the accounting profession realises that it is incumbent upon us to come up with some suggestions about how things may be able to work better. The regime is in; it is about making FSR work better. It is very easy to look back and say, ‘If only we’d all thought of this at the time and made representations when the bill was going through the parliament,’ but this is one of these particular areas where we have learnt from experience. There is no advocacy to extend the carve-out further. We think that would only result in a lot of unnecessary turmoil and angst within the financial services sector. We know that the views of other organisations on this issue are very clear but we are trying to work towards some proposals to overcome some of these issues.

Senator SHERRY—Have you publicly announced this? I cannot recall any public statement.

Dr Carney—No, we have not. We are very happy to say to the committee that we are working through some issues but we are not in a position to say anything more than that at this stage.

Senator SHERRY—I must say I have to observe in the context of Westpoint that one of issues which intrigued me was that the misselling or ‘poor advice’, if I could use that term, was overwhelmingly from planners in the case of SMSFs and not accountants. It struck me, given I understand it is a fairly even split in terms of establishment of SMSFs, that it was planners not accountants, which begs a fundamental question about the professional approach of people in that context.

Mr Elvy—I think Westpoint was a very interesting case. Two issues came out of it more than anything else. One was obviously, as everyone has spoken about, the 10 per cent commissions and so forth. The reality is that if a product requires a 10 per cent commission, you have to work out why do they have to pay 10 per cent to someone to actually sell a particular product. It has to be to assist people or encourage people to sell a product. That in itself, the commission structure,

was obviously a major concern. The other issue, and I have no details, is that people seem to have lost vast amounts of their wealth through Westpoint. From a financial planning perspective of diversification—financial planning 101—you would know not to put all of your money into an asset class within one organisation, fund or anything along those lines.

Senator SHERRY—Which also then begs the question what was the ATO doing about regulating these things where they were self managed super funds?

Senator MURRAY—Because every SMSF must have a strategic plan and part of the strategic plan must be a diversified portfolio.

Mr Elvy—I agree in terms of the ATO's role in administration and regulation and so forth. However, the question whether it is the ATO's responsibility to go through each investment strategy and check whether it is actually—

Senator MURRAY—No, take the step forward. The requirement is that you must have an auditor to an SMSF and you must verify a strategic plan. If the auditor is not doing that, there is an issue.

Mr Elvy—Yes, but I guess it also comes down to clarifying the responsibility of auditors. So yes, there is an investment strategy, but is it the auditor's role to actually assess the investment strategy? I would suggest that the auditor would not necessarily be in a position to actually do an analysis of at what point you draw the line of 'that is an appropriate investment strategy.' I think the issue goes back more to, 'Yes, we need to assess it and examine it' and what the auditors do may well be involved. But it really comes back to the advice in the first place. That to me is the key issue. You can clean up the mess afterwards or have someone checking your work and so on. But in the first place it should be that your financial planner or accountant—whoever is giving the advice—is giving the most appropriate advice. That to me is the key issue. As I said beforehand, the part that I find hard to fathom with Westpoint, and I have not really got the information on it, is how someone could be recommended to put vast amounts of their wealth all into one area.

Senator SHERRY—In the case of self-managed super funds I accept that. But if two-thirds of it was not through self-managed super funds—it was a direct investment—in that sense, it does not seem to me to be unreasonable that you would put a very substantial amount of money into it, because it is not a retirement income product in that sense.

Mr Elvy—But I think if someone had wealth of, let's say $300,000—where there seem to be examples where $250,000 has gone into Westpoint projects—it just does not seem logical to me that you would put over three-quarters of your investment wealth into one organisation, as such, and basically sophisticated, complex, high-risk products. I think it would be particularly unusual for a consumer to make that decision. In a lot of cases they would have to be advised to do that.

Senator SHERRY—Perhaps in some cases, at least, they thought the asset class was as safe as bricks and mortar, because it was property—

Mr Elvy—Exactly.

Senator SHERRY—That seems to me at least to have been the appeal to some people.

Mr Elvy—I think that also comes down to a key issue that the senator mentioned beforehand about trust and as far as the industry is concerned. For a lot of clients, when consumers are looking for advice and so on, whilst they have a responsibility to fully understand their decisions and what they are actually doing, in a lot of cases they are outsourcing that advice. They do not know it, and they do not really want to know the details. Yes, they should have the responsibility to do it, but they should also have the comfort that, if they are going to see a financial planner of any kind, they are going to get a level of appropriate advice where they know the adviser is working in their best interests, in the interests of the consumer. I think that is probably one of the key issues.

With most professions—if you go to see a doctor or someone along those lines—you would rarely go through a whole list of questions, be sceptical and be querying what advice they are going to be providing. If you go and see a lawyer to get your will drawn up, it is unlikely you are going to go through all the details of: ‘Which university did you go to?’ ‘How long have you been doing this?’ and those sorts of things. You walk in, because someone has given you a referral, and you say, ‘I need to get a will. What are the key issues?’ You go through it and obviously you pay for the service and so forth. I think that is part of the issue that we have with the financial planning industry and where it is heading: can you go and see a financial planner understanding that all financial planners are basically the same and you will get the same sort of advice. That is a key to it.

Senator MURRAY—On the same issue of regulation, in your submission you said in item 15:

> The SIS Act and Regulations are very complicated and result in high administration and audit costs. There is scope for further simplification and improvements in efficiency.

Are you referring there to matters other than those we have discussed?

Mr Elvy—What we are looking at there is, just generally speaking, the superannuation industry—the SI(S) Act and regulations and so forth—is complex and it requires an ongoing review to try to—

Senator MURRAY—So you are referring to matters other than FSR matters.

Mr Elvy—Yes. Across the board in terms of—

Senator MURRAY—Then I have a specific question. You know that the government has decided to try to get rid of unnecessary, complex or conflicting regulation in the interests of greater efficiency. Are you able to tell us whether the SI(S) Act and regulations are subject to that process or whether they are looked at by the Productivity Commission? Are they in hand?

Mr Elvy—I would have to take that on notice. I cannot remember. An email popped in as I walked up today that something had come out about that in general terms today, but I would have to take that question on notice.

Senator MURRAY—It would seem to me that it would be a bit silly, if we as the legislators and the policy makers were to pay a great deal of attention to trying to make FSR simpler, more workable, more effective and more applicable—doing that in one area—and not to try to do it in other areas as well. So I would appreciate it if you could let us know if there is a program for review, what it is, who is doing it, what its timeline is and so on.

Mr Elvy—Yes. I think one of the key issues, particularly in the financial services industry—superannuation, banking and everything else—is that the industry is just so unbelievably enormous now that, anytime that you want to make a change or introduce anything, it cannot be done simply. I think sometimes we do need to take a step back and say, 'Yes, it needs to be simpler but, in reality, is it practically possible?' But, on an ongoing basis, we still need to improve it where we can.

Dr Carney—I brought with me a summary of the recommendations from the banks' review on rethinking regulation, if that would be helpful. The SI(S) Act is not mentioned specifically in the review in the section of recommendations that go to improvements in financial and corporate regulation. We will obviously get back to you on this. It is of interest that the Productivity Commission came out yesterday and said that they believed it is not only possible but also desirable to benchmark best practice in regulation. They have named a number of sectors that they think should be first cabs off the rank for such work. That was their recommendation. The financial services sector is one of those sectors.

Senator MURRAY—I would assume that, because the SI(S) Act is federal, that it will not be as complicated a process. With many regulations you have to coordinate the matter between the state and territory governments and the federal government. As to being the first cab off the rank, if you statement is accurate—and I am not suggesting it might not be; I just do not know the regulations—it would seem an area that could benefit from early attention.

On another issue, did you hear my remarks and the general discussion we had about consistent, clear, transparent and useful reporting both of financial statements and of key issues within annual reports? Has your association made any submissions to the Australian Accounting Standards Board or any regulator with respect to improving the reporting of not-for-profit entities, particularly in this sector?

Mr Elvy—I am personally not aware of the details that we have been involved in. I know that we have done some recent papers on not-for-profits, but I would also have to take it on notice to come back on that one.

Senator MURRAY—If there are areas in your papers on not-for-profits which are applicable or relevant to this inquiry and this industry, would you mind sending them through to the committee and highlighting the areas?

Dr Carney—We will do so.

CHAIRMAN—As there are no further questions, I thank you both for your appearance before the committee and your assistance with our inquiry. It has been very helpful,

Proceedings suspended from 10.39 am to 10.55 am

COATES, Dr Nicholas (Nick) Jordan, Senior Policy Officer, Superannuation and Financial Services, Choice

CHAIRMAN—Welcome. We have before us your submission, which we have numbered 75. Are there any alterations or additions that you wish to make to the written submission?

Dr Coates—I draw the committee's attention to a report we released recently which adds to some of the information that was in our original submission. It looks at the issue of multiple superannuation accounts and portability of superannuation.

CHAIRMAN—Do you want to lodge this as an additional submission?

Dr Coates—It is a public document.

CHAIRMAN—Okay. That is tabled and received by the committee. I invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Dr Coates—Firstly, I thank the committee for the opportunity to appear before you. I will tell you a bit about Choice. Formerly we were known as the Australian Consumers Association. We have become known as Choice just recently. In the past we have had Choice and the publications of Choice and the Australian Consumers Association as dual brands. They now wrap in under Choice. We are not-for-profit. I guess in the context of this committee's inquiry that means that the money we make from our publications is not passed on to shareholders—we do not have any shareholders. In fact, it goes back to purchasing test goods, which we test in our laboratories, and providing for the policy and campaigns team, which is what I am part of. We advocate on behalf of consumers.

We are an independent organisation. We do not receive any ongoing funding or advertising or revenue from any commercial, government or other organisation. Our money comes solely from our 220,000 subscribers to our information products. The money we earn we use to test the goods, as I was saying, and to support our campaigns. In the campaigns area we conduct research, publish policy reports and online information, and generally give presentations to keep people informed of our policy views.

We did not address all of the committee's terms of reference. We concentrated on a few. In my opening statement I would like to nominate three of those as the more important ones for us, if that is okay with you. I think the most important one for us is the role of advice in superannuation. We still believe that conflicts of interest are a significant and continuing problem in the superannuation area and the advice area more generally. They erode the quality of financial advice that consumers can receive about their superannuation. We have an estimate that Australian consumers spend over $800 million on commission payments on compulsory superannuation in a year. That is the front-end commission plus trailing commission. The aggregate effects of those incentives really need to be considered. Also, conflicts of interest are not limited to financial advisers. I note the recent Rice Warner newsletter which had an extensive discussion about the sorts of conflicts of interest that a trustee can encounter.

There are some important and welcome developments on the advice front. We can actually say from the point of view of a consumer association which has been advocating on the issue of quality, unbiased advice for some time that there are some welcome developments. The emergence and proliferation of the fee-for-service model we see as a good development. Also, the development of some of the industry codes of conduct on things like soft-dollar commissions are a good start. But more progress needs to be made. However, the collapse of Westpoint together with some of the results from ASIC shadow shopping and one notable enforceable undertaking suggest that more needs to be done.

There is some discussion currently about the FSR regime and its limits on the ability to give advice to consumers. Certainly, the boundaries between personal and general advice could do with reconsideration under FSR. I guess we would respond by saying that the expansion of advice does not matter if it is an expansion of inferior, poor quality or biased advice. Some of the considerations under FSR like monetary limits on the statement of advice are attempting to find ways to expand that advice, but we should not do it at the cost of consumer protection. A paper trail, whether it is a statement of advice or some light version of a statement of advice, is essential for consumer external dispute resolution schemes and for ASIC determining a reasonable basis of advice.

Investment choice is an area we commented on substantially in our submission. I guess the only point we were making was about not necessarily seeing the expansion of investment choice as a panacea for consumers. Often consumers can be swamped with too many investment options. In fact, increased investment choice can sometimes increase administration costs on consumers. Some of the behavioural finance research is indicating that, in fact, when faced with a large variety of investment options, consumers can be dazzled by the complexity and not make a decision. In other words, you could increase the number of people choosing a default fund by expanding the number of investment choices within a super fund.

Lastly, I draw your attention to the issue of multiple superannuation accounts. As I said, we have just released a research report, since we made our submission, called *The Super Secret.* I have made copies available today. The point there is that there are 28 million superannuation accounts in Australia and we estimate that 13 million of those are unnecessary and they are costing about $1.2 billion a year. This is a bigger problem than just lost superannuation. It includes active and inactive second and third accounts and so should be seen as a larger problem than just lost superannuation. An individual consumer can lose tens of thousands of dollars if they have two or three accounts, so they can gain by consolidating into one account.

There are still problems in the current system in the way it promotes multiple accounts, particularly in the portability and transfer area. There probably also needs to be a consideration of the way advice can facilitate consumers to consolidate their super into one account. I think there needs to be a more coordinated response on the problem of multiple accounts with targets for reducing the number of accounts. We do not want to be having this discussion again in a couple of years time when there are 40 million accounts rather than 30 million accounts. Thank you for the opportunity to make this opening statement.

CHAIRMAN—Thank you, Dr Coates. Why do you think fund managers pay commissions? In essence, the commission they pay comes out of the funds that are to be invested. So it is

reducing the amount of funds they have got under management. Why wouldn't they compete on the basis of superior performance rather than paying a commission?

Dr Coates—I believe that fund managers pay commission partly as a way of distributing their product. The complexity of superannuation at times means that they believe they need advisers to distribute the product and provide advice about the product, and the commission structure is one of the ways that they do that. The concern we have as a consumer association is when you start to attach the advice to a commission; we become concerned that the advice is not necessarily in the consumers' best interests. I think some of ASIC's findings on not having a reasonable basis of advice illustrates some of the problems that can emerge.

CHAIRMAN—Are you saying their capacity to market on the basis of performance is not sufficient for them to be able to effectively distribute their product? If they offer a product that obviously is outperforming another product—

Dr Coates—Past performance is not necessarily an indicator of future performance. I think any adviser would probably explain that. We believe that the way in which the selling of superannuation—particularly funds managed products—has evolved in Australia means that you have come out of the old life insurance model when you used someone to act as a salesman for your product. As we have moved into compulsory superannuation and other funds management products, those distribution networks have continued on and evolved into the advisers that we have today. I think that commission structures are very pervasive in the financial system. Some parts of the funds management industry are trying to learn to live without them. That is a good step but, unfortunately, those distribution mechanisms can lead to conflicts of interest.

Senator SHERRY—I have a fundamental question: why do you need distribution in a compulsory system?

Dr Coates—It does beg that question. A compulsory system should not need distribution mechanisms. I think the danger with some of the switching results from ASIC showed that, where there are commissions and decisions and advice about which super fund the consumer should have their money in, we have had situations where there really has not been a reasonable basis for that advice. I think the commission structure has been behind that.

Senator SHERRY—One of the things that struck me about commissions—there are many things about them which strike me, and they are often undesirable—is that it seems to be difficult to distinguish between that element of the commission which is purely advice based, which may or may not be legitimate and appropriate, and the other element of the commission which is clearly a reward for selling. Is there any satisfactory way in which we could differentiate between the two?

Dr Coates—You have to detach the commission structure from the advice itself. That is why we talk positively about fee for service, because it probably does that. I take your point that the lines blur and it becomes difficult. For a consumer, you do not understand when their salesman's hat is on and when their adviser hat is on, so you become confused—

Senator SHERRY—Even if they declare it?

Dr Coates—Yes. I think consumers become confused by that. In fact, the research that we have seen on declaring commissions shows that it has the perverse effect. How does a consumer discount, for example, a four per cent commission and a three per cent commission? How do they discount the value of the advice on the basis of that commission? It is very difficult for them to do that. When the commission is disclosed, the behavioural finance research is that they trust the adviser more because they feel that they have been told a secret. The other side of it is that the adviser then thinks that their advice is objective because they have disclosed the commission to the consumer, so it can have a perverse effect.

Senator SHERRY—It seems that this is also linked, to some extent, to product authorised lists. Authorised lists exist because the planner group has done research on a range of products and is happy with the efficacy of that product. But is it valid in the context of superannuation? We know the efficacy of the product is sound because it is clearly licensed—there are 300. It just seems to me that the product list then effectively becomes a form of restraint on trade. The planner cannot recommend unless it is on the product list. The difficulty is that non-commissioned products often do not get on the product list.

Dr Coates—We have concerns in that area for the same sorts of reasons that you have outlined, particularly in the superannuation area where there are authorised lists. We would want to see the best quality products making those authorised lists, but I think some of the experience has been that, because there are no commissions behind some of the products, they do not make those lists. In addition, we have become concerned about authorised lists becoming attached to platform fees. The product might make the authorised list because it has paid a platform fee. It might not make the list on its own merits but it might make the list because it has paid for the research to be done on the product—the various things that they have to do to change their computer systems to be able to list it. Our concern is that other products that are possibly good value and at lower cost to consumers are not making those lists.

Senator SHERRY—In the context of superannuation, if we were to move to no commissions and if it was not allowed under the sole-purpose test, for example—I am looking at the practical issues involved here—wouldn't it still be open to a superannuation fund to reward a planner internally on the basis of the sales? It might not be a direct sales model through the planner—at the retail level—but wouldn't some funds simply switch a commission based structure to the remuneration of the planner on the basis of the amount of fund-flow coming through that planner?

Dr Coates—With conflicts of interest it is an evolving issue. If you eliminate commissions in one area, it might move somewhere else. The example that I thought of when you asked your question was: can the base salary of a planner be revised on a year-to-year basis and if they do not meet a certain target their base salary goes down the next year? I could imagine something like that emerging as a major way of replacing the commission structure.

Senator SHERRY—It happens to a certain extent at the moment anyway. They are really an agent; they are not an independent planner. They are clearly not at the moment. But if you go to a bank or a retail fund and the planner is employed by them, shouldn't it be clearer and sharper that they are not an independent planner, whereas at the moment we blur that distinction?

Dr Coates—We do blur that distinction, but I also wonder whether the labelling of ‘independent planner’ versus ‘tied planner’ would work. I think the answer with some consumers—particularly more naive consumers—is that they will not be able to understand the difference in the type of advice that they are getting.

Again, I think it comes back to principles on conflicts of interest. This might sound frustrating for people who are looking for immediate solutions, but when you tie remuneration to the advice you are getting you are going to generate conflicts of interest. So you have got to detach that remuneration structure. We do not have any hard and fast answers—in some areas fee for service is one example. There will be an evolution to other forms of conflicts of interest if we have the ability to eradicate the commission structure tomorrow. It is an ongoing issue and it will probably remain an ongoing issue.

CHAIRMAN—Accepting that there are issues in relation to financial literacy, aren’t you underestimating consumers a little bit when you say they would not understand a branded plan? If they go to a Ford dealer, they understand they are going to buy a Ford car. If they went to a branded planner, surely they would understand they were going to get that planner’s brand—if we make the distinction that Senator Sherry was talking about.

Dr Coates—I think it depends on the product that is being sold. Certainly if it were a basic financial services product they would probably understand they were dealing with a salesman. But where you are dealing with a more complicated financial services product like superannuation, which probably requires broader advice about the product, then I think it starts to become confusing for consumers about where advice stops and starts and where sales begin. I did say ‘naive’ consumers; there are different ways that behavioural finance classifies consumers, from disciplined and sophisticated consumers through to naive and unsophisticated consumers. It is probably that group of naive to relatively unsophisticated consumers that are the group that are going be most confused by the various hats.

Senator MURRAY—So you are using it as a class. If you have done the research, do you have a breakdown of a typical 100 consumers—how many are sophisticated, unsophisticated or naive? How big is the class of naive?

Dr Coates—Unfortunately I am just using terms that come out of the behavioural finance literature. To my knowledge, it has not been empirically tested at this stage in Australia. I think it has been empirically tested on university students in the US by various US academics, but it has not been tested here.

Senator MURRAY—So there is no quantification of naive.

Dr Coates—Not at this stage, but you could look at it with credit cards, for example. The consumer that repays their credit card balance in full before the end date is clearly going to be one of those sophisticated, disciplined consumers. The consumer that takes out a credit card thinking that they will repay it by the end of the month but does not is probably the sophisticated but undisciplined consumer. And the consumer that just continually pays interest on their credit card would be the naive and undisciplined consumer. With that product you can think about it that way, but in terms of aggregate figures I am afraid I cannot divide up Australian society on the basis of that categorisation.

Senator SHERRY—Isn't one of the solutions to minimise advice where we really do not need it or it should not apply? I read your multiple accounts report, and there is the related lost accounts issue. It seems to beg the question: why shouldn't we have an effective default solution that minimises this problem, rather than expecting individuals to solve that problem themselves? It is such a big problem and a big issue in our system.

Dr Coates—I think we could look at things like defaults as a way of eliminating the question of where advice is needed or not. To take that example: we looked at a default for casual employees, who are the most likely to have multiple accounts, because they have gone through multiple jobs. A default fund that could be put out to tender commercially would be a way of providing, I guess, economies of scale to those consumers so they do not have lots of little accounts, and it would be a way of providing higher returns to them. Then when they re-enter the workforce as full-time employees they would go with their standard fund at that point in time.

The other thing, though, is that you have got to look at the issue of product complexity. It seems to me that competition in financial services is about creating product complexity and creating differentiation in products. That competitive trend is the one that creates the need for advice. You cannot ask a consumer to choose between 200 various investment options on a particular platform and know exactly which one suits their interests.

It is those sorts of moves to try to bang on additional services, to make the product have even more bells and whistles, that generate the need for them to have advice on that product. Faced with 200 options, they need advice on which particular investment option suits their stage of the life cycle on the basis of where they are at at that particular point in time. So there needs to be some addressing of the way that competition works to create product complexity as well.

Senator SHERRY—The irony—and this is studied in behavioural economics—is that it increases the total cost rather than reducing it.

Dr Coates—It does. It increases the cost of running the farm, which is passed on to the consumer in the management expense ratios. They are alienated in their decision about what particular investment option they choose because they cannot work it out. In fact, they do not make a decision and they become part of the 93 per cent who are in a default option.

Senator MURRAY—Which is the other irony. The irony is that the industry is generating these highly differentiated and sophisticated products, not based on demand. Would you agree that the majority of consumers in superannuation regard superannuation as a commodity and do not see it as a highly differentiated product—which is why they go to the default option? They simply say, 'I want superannuation—a commodity.' They are not looking for a differentiated and sophisticated product.

Dr Coates—They are basically concerned about how much money they will have to live on when they retire. I agree with you that they want some superannuation, but they do not necessarily—

Senator MURRAY—I used the word 'commodity' deliberately in the professional marketing sense. A commodity has characteristics which, to a consumer, do not signify differentiation. Although they are in a differentiated sector, because they go for a default option the attitude of

the consumer is that it is a commodity, not a highly segmented, complex and differentiated product.

Dr Coates—I agree that there are probably differing expectations between what consumers think they are getting and what is available out there. I am not a marketing expert so I do not quite understand your point about commodities.

Senator MURRAY—It is the point that Senator Sherry has been making. There is dissonance between the products which are being provided, which have great variety, great segmentation and great differentiation, and the attitude of consumers, who simply say: 'This is a compulsory product. I want superannuation and I accept the default option.' That means, from a marketing point of view, they have the characteristics of a commodity buyer. A typical commodity is petrol. You do not care whether it is BP, Shell, Caltex or whatever; it is petrol. That is the default option. So then you would ask, 'If the market knows that, why are they producing segmented, highly differentiated and complex products?' The answer may be that it is because that is the best way to confuse or make complex the market to maximise the profit and generate the highest fee structure.

Dr Coates—If you put it that way, I agree with your point. The behavioural finance people have a term for it. They call it a 'confusopoly'.

Senator SHERRY—If we had a perfect world and every consumer were knowledgeable and rational when it came to financial services, you would not need compulsion in the first place because every consumer would save for their retirement. But we know that, fundamentally, they fail to do that. Do you think there is a higher duty of care where something is compulsory—where you are in it and you have no say—as distinct from where something is voluntary and you have to convince a person to be in it?

Dr Coates—The compulsion aspect is a classical example of behavioural finance. People do not think about the future and you have to force them to think about the future so that they will find their own retirement. So, yes, I agree that there is a higher standard here as a result of that compulsory aspect.

Senator SHERRY—In your submission you referred to the UK. I am familiar with some of the work there, particularly around their pension fund proposals. You say on page 6 that a model for such a service has been proposed in the UK and should be examined by the committee. Can you provide us with some more detailed documentation on that?

Dr Coates—I can certainly do that, but I will need to take it on notice.

Senator SHERRY—I did not expect you to have it here now. I am familiar with some of the work there, but it would be useful to have that information for the committee's evidence.

CHAIRMAN—Coming back to conflicts of interest, do you advocate any specific legislative proposals?

Dr Coates—We believe that some forms of conflicts of interest need further consideration and that there may be some more reform questions there. I do not think that the current way of

disclosing conflicts of interest is necessarily a solution. There may need to be a review of ASIC's regulatory toolbox to see what they are able to do so that some forms of conflicts of interest are ruled out.

There are some welcome developments in some parts of the industry on soft-dollar commissions. They are attempting—it is the start of a journey—to rule out some forms of soft-dollar commissions, so clearly you can prohibit some things. Trailing commissions would be the area that we would draw the most attention to for law reform. It is our belief that often the consumers who are paying trailing commissions on products are not receiving ongoing financial advice and that those trailing commissions can act as a substantial distortion to the quality of the advice that they are receiving. There needs to be at the very least a way of turning off those trailing commissions when the consumers are not receiving financial advice. Preferably there needs to be a way of turning off trailing commissions full-stop.

Senator SHERRY—When you say turn them off, can they not turn them off legally or is it simply the issue of a lack of knowledge and inertia and they do not turn them off? Otherwise, is it both?

Dr Coates—From discussions we have had with financial services providers about trailing commissions, our understanding is that, given the way that a lot of their systems are designed, it is simply impossible to turn off the trailing commissions. Recently there has been some engineering of some of those systems so as to be able to turn them off, but there is also an education of consumers issue there. Most of them do not realise that they are paying trailing commissions and would not know to contact the funds manager to tell them to turn off the trailing commissions to their adviser because they are no longer receiving financial advice from the adviser.

Senator SHERRY—I understand that quite a number of the retail operators say that you can dial down the commission. It starts at X per cent, one per cent or 1½ per cent, and the consumer, who has great power in these circumstances—I say that sarcastically; sarcasm does not appear in the transcript—can dial it down. Have you done any analysis of the actual number of consumers who succeed in using their bargaining power to dial down a commission or those who convince the planner to drop it or those who threaten to go to another planner by saying, 'Look, competition's going to work. That planner down the road, Joe Blow, will do the same job for 0.5 as distinct from 1'? Do you have any analysis of this?

Dr Coates—We do not have any research on it. All that we have is anecdotal evidence. Most consumers, when they go to get advice, will probably take the advice from the first adviser they go to, because they are worried about their finances. It is unlikely they will be savvy enough to then negotiate a dial-down commission by going to another planner and then coming back and saying, 'I can get a better deal on the basis of the commission that I've been offered over there.'

Senator SHERRY—What about if you reversed it and said, 'If the commission is going to continue, it has to be dial up,' and the planner then had to argue about the level, starting from zero up? That would differ from the current practice, where the individual consumer is expected to argue for dial down from whatever fee was initially established as the dial-down benchmark.

Dr Coates—In an ideal world we would not need to have the remuneration structure attached to product recommendation. But if we were going to talk about a commission, then probably dial up gives the consumer more market power. That having been said, you might only need a relatively small amount of advice and the adviser, to be able to expand their dial-up commission, starts to throw in all the bells and whistles he possibly can to expand the size of that commission.

Senator SHERRY—What about a requirement that, before commission can be charged, a consumer must have visited two or three planners, to try to create some competitive tension in the system where planners would have to bid against each other?

Dr Coates—That is not an issue that we have actively considered. I am happy to take that on notice and go away and bring something back to the committee on that, if that is okay.

Senator SHERRY—That would be okay.

CHAIRMAN—While we now have an industry benchmark standard interest rate—although on top of that we have a lot of differences in the bells and whistles options—would a similar establishment industry benchmark work for superannuation or is it too different and too complex for that?

Dr Coates—How would that benchmark work in practice?

CHAIRMAN—That is what I am asking: whether you have considered that.

Dr Coates—It is not something that I have thought of, but from my experience with mortgages and a standard benchmark of the interest rates I know there are ways around it. There are ways of putting in other fees and things that do not necessarily appear in the comparison rates. Maybe part of the experience there is a lesson for what could occur in superannuation. But it is not an issue we have considered actively, so I am sorry that I cannot answer in full.

CHAIRMAN—In practical terms, how would you distinguish the way planners are remunerated in relation to the advice that they are giving as against their product-marketing role?

Dr Coates—Fee for service is one way. You would pay an upfront fee for the advice when you go to the planner. First of all, you would establish the sort of advice that you need and what your background is and they would talk about the advice that you would need. You would then negotiate the size of that fee and then they would move to advise and there may or may not be product recommendations on the back of that advice. It may be fairly holistic advice. It could be anything from advice about mortgage commitments through to maybe even discussions about reverse mortgages if the consumers are of a certain age. But I think the really important thing is that that advice is broad, professional and delivered on the basis of the fee that is being paid, not necessarily on the product that is being recommended at the end. I accept commissions will not go away even in the next 10 years, but we do need to look at ways of trying to make sure that we do not have the situation that occurred with some of the shadow shopping and that enforceable undertaking where there really was not a reasonable basis of advice when the superannuation product was recommended.

CHAIRMAN—So you would not provide any component of the remuneration for the distribution or marketing side of it?

Dr Coates—That is open for discussion. I think the goal is that you want to avoid a situation where poor or biased advice is being given because of the remuneration structure. I wish I had a test that could say a commission above a certain level is going to lead to biased advice, but it is a quite subtle process and, frankly, I am pretty sure parts of the industry would have difficulties answering that question and I do not have the answer to it myself.

CHAIRMAN—Do you have concerns about the relatively higher number of fund members who remain in default funds?

Dr Coates—We think that default funds play an important role. You want to make sure that the consumer's money is in a reasonably good option which pays a reasonable return and has a default risk attached to or associated with that. You do not want to see a situation where consumers that do not make a decision have their money thrown into a cash management fund and do not earn enough on their superannuation to retire on later. So in that context I think the default fund is providing an important role and acts as a default to the compulsion aspect, to pick up on Senator Sherry's point.

CHAIRMAN—Do you think the approximate 90 per cent who are in default funds represents an excessive proportion of the total number of members who are in the default option? Does it indicate there is in fact a lack of advice or apathy? If so, how can this be overcome? An issue we discussed at yesterday's hearing concerned the fact that a lot of the members of funds would be young people who would probably benefit more from being in a growth fund option than in a balanced fund option given the length of time they have until retirement. What is your consideration of those sorts of issues?

Dr Coates—I wonder whether it is a question of the role of advice or the role of financial literacy. I cannot see why financial literacy programs cannot be addressing those sorts of questions. Certainly as the Financial Literacy Foundation's school program expands you will have generations of people coming through with more ability to be able to make those decisions. I would only make the point we made in our submission about default funds: the more you expand the investment choice, the more likely it is that people are going to finish up in a default fund. I think that is probably Senator Murray's point about super being a commodity playing out there.

Senator SHERRY—Doesn't the Australian approach to having what I think is an effective default investment solution avoid the problem of, if you did not have one, expecting 100 per cent of consumers in a compulsory superannuation environment to actually sit down and select one—that is, opt in, not opt out, of the current default? They would all need advice in that circumstance, wouldn't they?

Dr Coates—They would. I think the default fund is providing an effective safeguard here. The only issue I would raise about the way default funds work is that the risk-return characteristics on default funds vary slightly from super fund to super fund and I do not think consumers understand that, as they move from one fund to another, if they do not take an investment option, they might be changing the risk-return characteristics on their investment. Maybe the committee

could look at the benchmarks or the parameters within which a default fund operates on a risk-return basis.

Senator SHERRY—But that leads to a retreat from what I think is one of the foundations—the prudent person test, where the trustees have responsibility at arm's length. It would mean government, and this does happen in some systems, saying the default fund will be X. It might be all bonds, it might be 50 per cent bonds and 50 per cent equities or it might be a four-way even split. Government would then have to make the call. Don't you think on balance we have the design of our default, with a trustee delegated responsibility, right on balance?

Dr Coates—I think probably the prudent person rule is doing a good job there. The only point I was making was a minor one: it can vary between funds, and consumers do not necessarily understand.

Senator SHERRY—I will give a practical example. In Chile, where they have compulsion in personal accounts—put aside the issue of the commission based selling, which is horrendous—the government mandate the default, which is government bonds, and they mandate and exclude overseas investment. They actually warp and try and secure the underlying investment. The argument is that the long-term rate of return through that approach in a compulsory system gives a lower rate of return to the member over time.

Dr Coates—I think that the strength of our super system is the way the trustee investment committees have lots of expert people on them from a variety of backgrounds, and I think they function quite effectively in choosing those options. I was just making the point that the default fund can vary slightly and consumers can become confused by that.

Senator SHERRY—It seems to me that is the great strength of our system, and there are other areas where we could apply a default solution, such as lost accounts. In a sense you cannot force choice on individuals. The bottom line is that you can offer it but you cannot expect them or force them to do it.

Dr Coates—And with a compulsory system they are then in the situation where they might not take an active decision, then you do need the use of defaults to do that. I agree with your point.

CHAIRMAN—In relation to the failure to consolidate multiple accounts, multiple funds, is it the administrative barriers that are the principal reason for that or disinterest and inertia? Do you have any hard and fast research on that and, if so, what might be the means of overcoming that?

Dr Coates—For our research we asked consumers to write in to us and give us examples of where they have or have not consolidated multiple accounts and the sorts of issues that they had. I think it is a combination. There is a financial literacy aspect there. Consumers need to realise being in two or three accounts costs them money. I do not think that message is clearly out there at this stage.

The overwhelming evidence that came in from our research was that there were significant problems with transferring superannuation and consumers not knowing the requirements on them to transfer their superannuation. It became very much a hit and miss sort of thing. They

would get 90 points of identification as proof of identification to be able to consolidate their super into one area and then the super fund would not tell them what they needed for the additional 10 points. It is that level of communication that became a problem. Also it is a paper based portability system. It takes a lot of time to do. We cannot see why, in this day and age, it cannot be done real-time and online as a much more efficient process. I think that efficiency of portability will make it easier for consumers to take charge and then be able to consolidate their super.

CHAIRMAN—Are there any legislative amendments required to achieve that or is it purely administrative?

Dr Coates—I think it is largely in the hands of super funds, but there have been some welcome developments with, for example, the tax file number on the single super proposals. I would like to now see the tax file number being used to engage multiple accounts more generally, not just with the problem of lost accounts. I think you could use that as the unique identifier for some sort of online system.

Senator SHERRY—How would you deal with the issue of exit fees in this context though? We have two sets of exit fees. We have the so-called legacy products, where there are about half a million people, where it is clearly against their best interests to transfer out because of the size of the exit fees. The industry says that is all gone now. I notice you do have some level of penalty exit fee on some superannuation products. It declines quite rapidly over time—it does not lock them in for 30 years, but it might apply for five years. How you deal with that sort of issue?

Dr Coates—I think you need to look at the issue on compulsory superannuation of whether exit fees should be charged at all. I think they are an impediment to competition. On the legacy product side of things clearly there needs to be some sort of mechanism for product rationalisation and a way of moving consumers out of legacy products and into modern ones that do not disadvantage them—and I put the emphasis on 'do not disadvantage them', particularly in terms of taxation arrangements. Looking in that area and dealing with some of those old legacy products would probably be of benefit to both consumers and industry, because I suspect industry are losing their professional expertise to manage those old legacy products.

Senator SHERRY—Presumably industry would be having to maintain systems with declining moneys and participants over time, which would become more costly over time.

Dr Coates—Yes, I would imagine so. I believe IFSA, for example, have a product rationalisation proposal, which we are happy to comment on at this stage. We look forward to working with them on making sure that there is a good no-disadvantage test on those for consumers. Moving back to the issue of a standard compulsory superannuation product post 1992, there probably cannot be a justification for exit fees if you want true competition on those products.

Senator MURRAY—I think the consequence of having a compulsory system is that you lose some of the market mechanisms which will deliver clarity in the interests of trying to generate demand. If you contrast superannuation with, say, insurance everybody—

Dr Coates—General insurance?

Senator MURRAY—Yes, insurance. Everybody out there knows the difference between car insurance, household insurance, life insurance et cetera. If you ask the consumer what a defined benefit is, what a growth fund is or what an annuity is then you will find that many do not know. I think that is one of the consequences of a market which has not had to pay attention to the sales and marketing side, historically, as much as other industries where you do not have a compulsory system and a huge flow of funds coming in.

My question to you arising from that observation is: has your consumer organisation paid enough attention to language and nomenclature with respect to superannuation? And, before you answer, can I say that I have pursued on previous hearing days the issue of nomenclature with the industry, because there are parallels in other marketplaces. People understand what a manufacturers agent is, what a dealer is, what a tied house is or what a free house is. I think it would assist people in knowing what to expect when they go to a financial planner. As Senator Chapman puts it, a branded planner, so you know that is the brand you are going to be advised on. So my question is: what work have you done in the area of simplified, easily understood language and nomenclature in the superannuation industry?

Dr Coates—In terms of simplified language and that side of things, we are, I guess, an organisation that is involved in financial literacy. We regularly have stories on superannuation in our publications looking at the issue of how you choose between super funds and the sorts of things you need to take into account. I am not sure that answers your question, but we have done that since—

Senator MURRAY—No, it does not answer my question because I have read your material and I think it is most unhelpful from a consumer point of view because they are unable to attach a tag which has an automatic understanding applying to it, like life insurance. People know what that means. Although the way you describe things is very helpful, the tag is not there that people can attach that range of understanding to.

Dr Coates—Sure. In another area, we have been responsible for bringing up the whole issue of commissions and conflicts of interest. We were the first organisation to shadow shop financial planners and financial advisers, and we did that because we did not think consumers understood that some of the advice they were getting was biased. So in that area we have tried to set about defining boundaries and tags for consumers. Up until about three or four years ago we were the sole organisation doing shadow shopping of financial planners and financial advisers.

Senator MURRAY—This is not designed to be rude or critical in that sense but I do not think either your organisation or any other has really attended to this area which I am picking up on. I would like to ask you, if you would not mind, to go away and think about this a bit and perhaps come back to us with your view as to whether developing some kind of nomenclature system or an agreed form of language to which consumers could then attach a broader understanding of the products on offer would help.

Dr Coates—I will do that, but may I make one quick comment about the current FSR proposals in that area where there was a recommendation for a salesman category on financial advice. We could see the salesman category as having a use, but in the current form that was

suggested for it we did not think it was going to work because ‘salesman’ would be just a hat that you had under a particular education program and you had a particular remuneration structure the consumer knew about but you could still earn a commission and be an adviser and not a salesman. I think in that area the critical boundary as to whether you were a salesman or an adviser was how you were remunerated and, unfortunately, the test of a salesman or adviser in that proposal was not on the basis of how you were remunerated.

Senator MURRAY—Let me take you to the most simple approach that I am suggesting. More and more consumers of superannuation products will be encouraged to or may think they should take financial advice. Without a personal reference from someone they trust or know—word of mouth, in other words—they are likely to let their fingers do the walking, so they will go to the yellow pages. Maybe under the yellow pages they will see ‘Financial planners’. How are they going to select those?

What if you have a number of categories, such as ‘branded financial planner’—using Senator Chapman’s words—and a limited products list from a specific company or sets of companies so people would know what to look for? They might be called an agent, a dealer or a franchisee—I do not know. I do not want to try to determine the nomenclature. But you would have a series of people so that consumers would know what they were looking for. They would then be able to make a few phone calls and decide whom they were going to see and where they could go from there. It is that sort of entry point I am looking for that would assist consumers. I think the entry points for consumers to get financial advice at present are extremely poor and very weak, unless they are referred by an accountant whom they trust—most people have tax agents and not accountants—or an employer or a lawyer whom they trust. How do you find a financial planner who meets your needs?

Dr Coates—You could to add to that list an independent adviser defined on the basis that they do not earn commissions. It is something that we would be happy to look at and come back to you.

Senator MURRAY—Thank you.

CHAIRMAN—Thank you very much for your appearance before the committee and for your assistance with our inquiry.

[11.46 am]

ASHER, Mr Anthony, Consultant, Trowbridge Deloitte

GALE, Mr Andrew, Partner, Trowbridge Deloitte

CHAIRMAN—The committee has before it your submission which we have numbered 80. Are there any changes, alterations or additions you wish to make to the written submission?

Mr Gale—Not to the written submission.

CHAIRMAN—I invite you to make an opening statement after which we will have some questions.

Mr Gale—Thank you for the opportunity to present to the committee. In our written submission we responded to 11 of the 14 points in the terms of reference, including noting some academic references and statistics that the committee might find useful. Our conclusion on each of the points is that there are no major issues that cannot be addressed by the industry perhaps with a little help from the regulators. There are three key issues we want to cover in the opening comments which support our submission. Firstly, there are the risks incurred by superannuation funds and their constituent members and alternatives for protecting against those risks. Secondly, there is the simplification of governance and regulations and making them more effective. Thirdly, there is the simplification of advice requirements. I will cover the first of those and Anthony will address the other two.

In terms of protection against risks, superannuation funds do face a range of risks that need to be managed and disclosed, but there are a variety of frameworks in which they can do so either through capital or reserves or through insurance. There are three particular risks to consider which are covered in our submission: market risk, insurance risk and business and operational risks. Today we will restrict our comments to the last one. Key operational risks include fraud and malfeasance, business disruption and errors with unit pricing or crediting rate errors. The latter ones can be very significant. As reported by Ross Jones, Deputy Chairman of APRA, on 1 March, compensation bills for unit pricing errors have reached a total of $750 million for the industry. He commented that to date all the unit pricing errors which had been discovered had involved retail funds with the capital backing of institutions. He also commented that ‘so far they have been able to fix the problems at no cost to investors’ and ‘perhaps people need to look at how this could be dealt with the not-for-profits.’

Our written submission canvasses the various options in sections 1.4 to 1.6 in terms of dealing with those issues. In particular, we canvass five options for dealing with risk and the protection of members. They were that, if losses occur, that can be dealt with by debiting members, building up reserves within funds, having explicit capital requirements, having outsourcing arrangements or having some form of government protection. So they are the five forms in which you might deal with those issues. Each of those has its pros and cons. For example, with debiting members as costs occurred, let’s say there was a unit pricing error, if that was done under the first alternative, that just gets charged on some sort of pro rata basis to existing

members. A disadvantage of that is that it may fall unfairly on the current members in terms of who incurs that cost. In terms of capital requirements, that does offer explicit protection, but arguably it is also a more expensive form of protection. So there are pros and cons to each of the approaches. We also comment on government protection alternatives. One of the downsides of the government protection is the moral hazard that if you are offering that sort of protection those who most need it are those who might be the less reputable operators in the industry.

They are just a few comments we wanted to make. There are risks involved with super funds. The particular one which has been significant of late has been operational risks in the form of unit pricing. We submit that that would be an area worthy of review by the committee in terms of dealing with that issue.

Mr Asher—The second point we want to raise relates to the complexity of the governance and regulations and the legal structure, which we think this committee is closest to being able to do something about. The complexity is a problem, because it does three things. Firstly, it increases the risk of error. Secondly, it means that the cost to the consumer in terms of the administration costs of running the industry are much higher. Thirdly, there is the problem that it actually means that they have to spend a lot of time trying to understand what is going on. So there are serious issues related to complexity.

In section 3.3 we make some suggestions and there is some discussion. We make the point that the SI(S) Act and the associated laws and regulations make up over 1,000 pages, two income tax acts, a large section of the Corporations Act, ASIC class orders, APRA guidance notes and licence conditions. Now, I am not a lawyer; I am an actuary. But I do want to say that I have read very large sections of the legislation. I have worked in the policy area at APRA, so I am familiar with chunks of it. For comparison purposes, I have worked in South Africa. I have spent most of my life in South Africa and in the UK. I make the point that Canadian legislation actually offers quite a nice, simple alternative. So I do think there are opportunities for simplification. We have got some specific suggestions in section 3.3 as to how the SI(S) Act particularly could be made less repetitive and less clumsy and take out some of what I regard as unnecessary definitions that make life very difficult for anyone working in the industry.

We also agree with some other submissions that have been made relating to APRA's powers—that there is an overlap between regulations and APRA's powers. APRA uses guidance notes in superannuation and standards in the other industries which involve the same questions. It would be better for the same process to be used throughout all the industries and for APRA's guidance notes to be subject to parliamentary oversight. So simplicity is the area that I do think is worth really investigating and enabling the industry to function better.

In this, we would support the recommendation for simpler disclosure on the terms of the Corporations Act and the financial sector reform, emphasising low income people are effectively disenfranchised. They cannot get advice and they face considerable complexity both in this area of superannuation and in the income and asset test that the social security system imposes on them. It is enormously difficult and it is almost impossible for them to afford advice if it is charged to them or the commissions are very often too small. We also support the product rationalisation initiatives that have been taken by IFSA and the Treasury, and we hope that that will see some action.

Finally, just quickly, I have two points to underline. We discuss a number of points in section 2 relating to disclosure and participation of the members of not-for-profit funds, particularly in the running of their funds and we would like to see that improve. At section 4.4 we mention that we would like to see ASIC set standardised projection rates for superannuation so that it is easier for people to make comparisons between products and to work out how much they should be contributing for their retirement.

CHAIRMAN—What level of insurance do you think is prudent or appropriate in terms of addressing business risks faced by trustees of superannuation funds? We had SuperRatings before us this morning and they recommended a minimum insurance standard for trustees. Is that in line with your thinking?

Mr Gale—Are you referring to the protection of the fund or to being in an imperilled financial position?

CHAIRMAN—I suppose there are two issues. There is the imperilled financial position of the fund itself and there is also in some instances the issue of mispricing of units and whether that can be a problem.

Mr Gale—In a range of sectors of the financial services market there are protection standards in many forms. They are called a capital standard, which is to protect against a one in 400-year event. If one were to follow a similar principle then you could look at how that is best achieved. That might be through a capital requirement or building up reserves and funds or effectively outsourcing the risk, which can be done if you are outsourcing areas like investment management to wholesale investment managers, who then wear the cost of the unit pricing issues. There is probably not a straightforward answer to the question of how much insurance is required, but there should be a certain standard in protecting the fund and consequently protecting members of the fund in terms of something like a one in 400-year event and what sorts of mechanisms should apply to that.

CHAIRMAN—But you come down on the side of insurance rather than capital requirements?

Mr Gale—No. We canvass five options and work through those. It varies within the industry at the moment. For the retail institutions or the vast majority of those, it is covered by capital requirements. It is an issue for the not-for-profit sector to address. Some of that is covered through reserving. In many cases it might be covered effectively through outsourcing arrangements that they have in place with wholesale investment managers whereby some of that unit pricing type risk, for example, flows through to the wholesale fund managers. We are not advocating a particular means. What we are saying is that you should be able to satisfy a test which protects the fund from a one in 400-year event.

CHAIRMAN—But you do not have a particular preferred model?

Mr Asher—No—uniform requirements but not uniform capital requirements.

Senator MURRAY—That essentially replicates most industry circumstances at present. Most are covered by insurance or reserves or a capital fund or a combination of those. That is right, isn’t it?

Mr Asher—That is right.

Senator SHERRY—So it is not a uniform solution because the issues that are faced are different from fund to find and from sector to sector.

Mr Gale—Yes. So, rather than advocate a particular means, what we are advocating is that there is a standard that should be met. Funds should be able to demonstrate that they can meet that standard through a range of different means.

Senator MURRAY—That makes a lot of sense to me, I must say.

CHAIRMAN—You also propose the extension of the superannuation protection account—that is one option in this area—only to the extent that you include this additional criterion of gross negligence. Is that right?

Mr Gale—There is one issue in terms of extending those arrangements. It is partly a philosophical question, I guess. If you go down that route, it is the extent to which you believe in, if you like, the operation of market forces with a requirement of meeting some sort of protection requirement, or the extent to which there is some form of government overlay. The downside on the government type solution is that you do have the moral hazard with that.

Senator SHERRY—Just on that issue, I put a question on notice to the regulator about the part 23 SIS compensation provision: up to 90 per cent in the event of theft and fraud. There was about $43½ million under that provision from seven or eight funds over a three-year period. In the context of the cost to the entire sector, because the levy is a post-event levy, it seems to be miniscule and a highly cost-effective way of dealing with that issue. The second part of my question went to investment losses from malfeasance, which are not covered by part 23. I must say I was pleasantly surprised that it was only approximately $20 million from seven funds over the same period. If we extend part 23 to include investment losses as a consequence of malfeasance—if not theft and fraud, but malpractice et cetera—the costs are pretty modest.

Mr Gale—I think the key issue in that context is, when you look at the materiality of the various risks there, that clearly the fraud-malfeasance one is not the most significant.

Senator MURRAY—It is not.

Mr Gale—No. If you look at the overall experience of the industry—and, as I say, all of these have been incurred through the retail sector thus far—unit pricing errors of various forms have involved a total cost of $750 million, and there have been some well-publicised cases around that. In those circumstances, because they have happened through retail institutions with capital backing, full and proper restitution has been able to be given to members, and that has effectively been covered by the capital of those institutions. It would be reasonable to say that there are other issues of that variety, which one would expect to exist in the industry, which have yet not been discovered. I cannot say whether the experience thus far is a good indication of that, but if you are going to extend it through the protection account, it has the potential to be a significant cost.

Mr Asher—One could make the point that, internationally, the British and American governments are guaranteeing investment returns. I am not suggesting that at all, but governments have got quite involved in fairly large sums of money. So, to make some extension here, to provide protection to members where effectively both the trustees and APRA or ASIC have dropped the ball seems to be a reasonable way of doing it. We have made the suggestion that there should be a bit more clarity and perhaps less discretion in paying just to facilitate people's reimbursement quicker rather than more slowly.

Senator SHERRY—Can I just take you up on one point. Firstly, your submission is very good; it is very comprehensive. You deal with a lot of issues which other submissions have not. But there are a couple of areas where I was a little intrigued as to your view. One is the proposal that trustees be elected by members. Just how practical is that in a fund, particularly a large industry fund? I would accept that it is practical in a corporate sense, where it is confined largely to one employer and a concentrated workforce, but how practical would that be with a membership of 100,000, 200,000, 300,000 spread across a country?

Mr Asher—This is one of my favourites. Having come from South Africa, where there is a greater requirement for election rather than necessarily union representation, I have found such a major advantage in participation—community benefits for the election apart from the governance issues. But to answer your question as to whether it is practical, in some instances it is not, particularly if they are small and scattered. But, if they are very large and there are major groups of employees, one can operate on regional committees that can play a role in—if not the investment side the allocation of benefits—the discretions that are involved on that score. So they can be advisory. The recommendations say that, where it is possible, increase involvement. After all, we vote for government and that is pretty scattered with very large numbers of people.

Senator SHERRY—Sure, but it is a once in three, four or six years event. And you vote for government; government takes the decisions. It is a delegated responsibility. A trustee model is not dissimilar.

Mr Asher—You vote for the trustees and the trustees make the decisions. That is right.

Senator SHERRY—Another practical issue is choice of fund. The theory is that people will move around from one fund to another. I think the practical implications of that in a large industry-type structure are just too difficult to overcome.

Mr Asher—It is true that it is by no means a panacea of any sort, but the old mutual life companies had three or four million policyholders, and the policyholders voted for boards of directors.

Senator SHERRY—How many of them voted? Was it truly democratic—

Mr Asher—I think the advantage is not that they are going to have detailed control, but in the event of problems it is another layer of diverse protection and governance. The trustees are meant to be operating in your interests. You do have a final vote. It is small but—

Senator SHERRY—There are some funds that do have trustee-elected representatives. How do you solve the dilemma of the election throwing up a trustee who does not satisfy the requirements that APRA have of trustees?

Mr Asher—I think for any of those candidates you would have a minimum requirement that they satisfy the fit and proper test.

Senator SHERRY—But it is not just a fit and proper test. It is also the application. APRA is requiring a range of expertise, experience, background and qualifications amongst the trustees as a whole. It seems to me that that just adds another difficulty to an elected trustee model in a mass compulsory system where you have got big memberships. South Africa does not have compulsion—not yet; I understand that they may. I do not want to spend too much time on it, but I just think it has got some difficulties.

Mr Asher—As an adviser to boards of trustees in South Africa, I was only once asked for an actuarial formula, and that was by a union trustee who probably had three years of schooling. And he made me go through the formula. I have found that very often the least trained are most prepared to ask the silly questions.

Senator SHERRY—They are not silly; and I agree with you. The one trustee in the Maxwell fraud in the UK who actually dared to ask questions about why the assets were being transferred over to Maxwells was actually a shopfloor print worker who was a bit suspicious about what was being proposed. All the other trustees, many of whom were the smartest in the world, apparently, failed to ask the basic question and make the basic objections. It seems to me that a trustee model basically comes back to commonsense and the ability, independence and contestability of the trustees and their willingness to exercise that.

On the simplification, the regulation, have you had a look at the single financial services regulatory model? An APRA-ASIC one financial services regulator as distinct from two?

Mr Gale—We have not studied it in detail as part of this submission. The most obvious examples of that are the FSA in the UK and the like organisation in Japan. ASIC as a regulator covers all industry sectors, whereas APRA is focused on the financial services sector. A simple unification obviously could not be part of that answer. People do talk about the issues associated with having two regulators. An alternative way of addressing that is just some clarification around responsibilities, and in this case we are submitting, in the case of APRA, that some of the things need to be covered through Treasury, in the case of superannuation. If they could actually be done through standards issued by APRA as opposed to guidance then, in the context of the scope of this inquiry, that could be a more effective governance model.

Senator SHERRY—I appreciate that. Effectively, what is the difference between a standard and a guidance? I have talked to funds. There is a routine issuing by APRA of guidance notes which, in reality, the fund has to follow. It may have been because there was a licensing process going on and they did not dare not follow them. We will be talking to the Law Council, which has provided the submission that some of these guidance notes in fact have no legal standing. When you have the sword of the licensing process over you, you effectively have to follow them, don't you?

Mr Asher—I was involved very much in APRA’s development of the prudential practice guidelines. It is clearly a problem—you want to create principle based legislation and self-regulation. If you want to encourage self-regulation, you do not give people the answer. Requiring people to regulate themselves is uncomfortable. They would much rather say, ‘Tell us what you want.’ The pressure from the industry is to ask APRA or APRA officials to give them guidance so that they can just tick the box and work on it. People always say: ‘Can I have some definite box to tick? Give me a quick answer.’

I know that APRA is very concerned about finding a way of making it principles based and ensuring that the responsibility for regulation remains with the trustees and not with APRA. I think the principle of having guidance and standards separate is actually very important. It is extremely important for getting the system to operate. Currently, though, they have fit and proper standards for life companies, which apply to the group that the trustees belong to, and a guidance note, which is for the superannuation trustees, because they do not have the power to issue standards.

This is a problem. If you happen to be part of a life company or a life company group, they will wave the life company standard—LPS 210 or whatever it is—in front of your nose, but if you are independent there is a guidance note which starts off saying, ‘This is not legally blinding, but you have agreed to it for your licence requirement so you have to perform.’ It is not clear. APRA is working at trying to make it clear. My sense from having worked inside APRA is that it is very difficult to make it clear when you are operating under a completely different legislative regime between two very similar industries.

Mr Gale—The advantage of moving in that direction could be that, if APRA were in a position to issue both, clearly you could have standards which are principles based and which need to be followed and the guidance in many respects can be a bit more descriptive. It gives people some ideas in terms of how to interpret how they respond to those standards. Secondly, there is a lot of convergence occurring in the industry. If you have convergence between different forms of institution leading to a situation where you have a greater consistency in the government’s framework in terms of standards and guidance, it would also be beneficial.

Senator MURRAY—I was quite taken with your section on reducing costs—rationalisation, legislative and tax rationalisation—and its reference back to sections 3.2 to 3.4. Earlier in the day we had a discussion with the Institute of Chartered Accountants—with Mr Hugh Elvy and Dr Barbara Carney. I asked them if the issue of regulation in the SI(S) Act context had been the subject of the Productivity Commission inquiry into regulation or of the government response to that inquiry—mainly the desire to harmonise regulation, cut out unnecessary regulation and ensure regulation is not inconsistent et cetera. The answer, broadly, was no.

You presented it in terms of legislative and tax rationalisation, and have indicated that it is a process underway with Treasury. Do you think it would get more impetus and political and policy interest if in fact it was part of this broad attack which is supposedly underway on regulation? In answering that question, of course, you should bear in mind that it is probably easier to deal with than, say, regulations which cover nine governments and need the COAG sort of approach, since this is just one federal government. In other words, at the heart of my questioning is: how can we accelerate and energise this process?

Mr Gale—There are probably a couple of different dimensions in some respects. You gentlemen would be in a better position to assess what might be the most effective process within government. My understanding of the processes happening in terms of the IFSA working group on product rationalisation and their interaction with Treasury is that they are making good progress. I think it is up to the stage of being subject to a regulatory impact sort of assessment through Treasury in terms of some of the product rationalisation debate.

Senator MURRAY—But that does not cover these areas that you have concentrated on.

Mr Gale—It covers a range of areas, particularly if you are looking at rationalisation of funds, which applies to both superannuation and non-superannuation, and it actually picks up on some of these successor arrangement principles in super funds as part of the product rationalisation debate.

Senator MURRAY—But, if I turn to those dot points on page 17 of your submission, what you have just said does not really cover those.

Mr Asher—No.

Mr Gale—There are a set of issues which could be addressed through this product rationalisation stream of work, which I understand is making some good progress. The question is whether, if you threw up the overall review of the regulation as being the way to address all these, that would reduce the pace at which some of those other product rationalisation initiatives are happening—but that is an assessment I cannot make. That would be a deliberation you would need to work through.

Senator MURRAY—Let me put it into a little context for you, if I can. Years ago I was enormously impressed by the process known as the Business Coalition for Tax Reform, which aggregated, I think, 30 or so organisations and worked in community organisations as well, most notably ACOSS, so they could present a united argument to the government which was reasonably well fleshed out. From that eventually flowed the major A New Tax System reforms. My question is whether the industry in conjunction with the community, because I think the community in isolation would be a mistake—ASFA, IFSA, perhaps people from Choice—would be able to do essentially the groundbreaking work in this area and present that to Treasury and advance it thereafter. Because, if you wait in an environment where there is enormous pressure in other areas of regulatory change, I think you are going to have delays. I am asking you these questions deliberately because, when the committee has to report, I think it will need to cover this area and will need to have thought through the best ways of advancing what I think is a legitimate cause.

Mr Asher—It is quite a complex thing. My comments, I think, should be expressed as hypothetical rather than tentative. But let’s look at the success that we have had in terms of the proposals to simplify superannuation tax that have recently been brought out. Now, I do not think they went nearly far enough to simplify the environment, but they are certainly getting rid of the RBLs and all these things, which is really a major advantage. You are ripping out sections of the tax act—

Senator MURRAY—All three of us participated in that debate, so we understand exactly what you are on about.

Mr Asher—Obviously, it is a parliamentary decision, but it seems to me it needs help and it needs a number of champions, either in Treasury or in the Attorney-General's office, in terms of the actual wording of the legislation and getting things simplified.

That particular reform was relatively easy in the sense that there were only beneficiaries and there was money to be spread and so it was a question of no-one going to be worse off and no-one going to object. In many instances here, you are going to have some people who are worse off, so I think you are asking too much if you are going to ask for community input in a situation where the industry has to get consensus before going to government.

Senator MURRAY—I am not sure. That is why I gave you the example of the BCTR. Amongst themselves they realised that some of them were losers and some of them were winners on particular aspects but, taken as a whole, they all agreed that it was in the national interest to advance it, so I do not think it is beyond the means. However, rather than our trying to solve it at this table, what I want to say to you is this. You presented a case for change but you have not suggested the best way of arriving at that change in a relatively rapid time. Would you be prepared to go away and think about it a bit and perhaps come back to the committee with some views as to how that could best be progressed?

Mr Gale—We would be very happy to elaborate on that. As I have said, I think that we could be looking at that in conjunction with some of the initiatives which are currently also happening in the product rationalisation debate through Treasury and some of the issues that they are looking at. Looking at those two things in conjunction could provide some useful insights. We would be very happy to come back to you with some views.

Senator MURRAY—Thank you.

Senator SHERRY—I have some things to raise. Let us take your comments on page 17. I was a little bit concerned by the statement on the member protection of $1,000—although I agree with you that we should not have it, and that members have not bothered to consolidate—and this is now the $5.7 million lost accounts amount and it is a bigger problem. How can we expect members in a compulsory system, without a default solution to this, to consolidate when they are not? There is a significant proportion who will not fill in the forms or take the necessary interest.

Mr Asher—What I am trying to do there is to set a standard of materiality as to what counts and to use that as a statement that I think members do not regard the additional cost that they are paying as worth going through admittedly the sometimes really difficult administrative procedures that you heard about earlier. Another measure of materiality which I did not raise is that when people send out cheques of less than $20 less than half are cashed. There is no administrative difficulty in that; it is just that it is not worth the effort. It is merely to ask what is the level of materiality. This seems to me to fall below the level of materiality by quite a large amount at this point. That was the point of that data.

Senator SHERRY—Whilst I agree with you about removing the $1,000, from a policy point of view I would agree with removing that only if you dealt with what is effectively the much bigger problem, which is the lost accounts, by consolidating them automatically rather than relying on individuals of whom a significant proportion simply do not do it.

Mr Asher—Yes, if that could be done.

Mr Gale—I think that is entirely reasonable. We have to look at the lost accounts issue, at whether it is done through default arrangements or through more effective advertising promotion and at how to address it. Having been through that experience myself and having had children go through that process, I note the administrative difficulties in doing it are actually not that great in terms of consolidating but if there is a perception that—

Senator MURRAY—You have got to be persistent though.

Senator SHERRY—But isn't it about inertia? You have got a group of people in a compulsory system who will not fill in forms and who will not be activists. If you base the solution to the problem on assuming that everyone will be an activist, it is not going to happen, so you would want default.

On another point, yours was the only submission that attempted to look at the international comparison issue. Thank you for that. You acknowledge that it is not easy to obtain the information. But while systems do vary significantly from jurisdiction to jurisdiction, and you have had some experience in other jurisdictions, do you think that a comparison is useful? We are actually dealing in private pension and superannuation systems with quite similar issues in many respects—fee structures, commissions, default solutions. The debates and the issues are the same worldwide but the solutions tend to be quite different. Don't you think it would be useful if we could have a better idea about the comparative international experience because some of the solutions may be useful for us and vice versa?

Mr Asher—I heard the previous submission from Choice and I think one option that is worth keeping a close eye on is the Swedish one. I do not know if you know what they are doing there: a compulsory system, one collector and then, from there—

Senator SHERRY—Bulk subcontract, forecast, red envelope, all the rest of it.

Mr Asher—Yes. I calculated there is an approximately $3 billion cost of distribution that is probably unnecessary in the Australian system so, yes, we should be looking at options around that, and Sweden has a potential that might well be worth thinking about.

Senator SHERRY—And the proposed new system in the UK. Who do you think should coordinate this sort of work at a government level?

Mr Gale—In terms of doing a review of international practice?

Senator SHERRY—Yes, just seeing what is happening, what the solutions are, from a government point of view.

Mr Gale—Well, potentially, given your terms of reference, would that be a logical starting point?

Senator SHERRY—I mean should it be Treasury or APRA or the Government Actuary?

Mr Asher—There is the Council of Financial Regulators, which includes Treasury, APRA, ASIC and the Reserve Bank. APRA is busy with the study on super research, so they would be the obvious people to do that type of thing.

Senator SHERRY—We might raise it with them.

CHAIRMAN—You referred to the committee doing it. It is part of our terms of reference but there has been very little in the way of submissions on that issue.

Senator SHERRY—That is right, so I thank you for yours; you were one of the few, if not the only one, who attempted to give us some ideas.

Mr Gale—The other obvious issue to draw out whenever those comparisons are being applied is one that applies for all mandatory and voluntary comparisons, and that is that the mandatory ones are typically charges relating to product only and the voluntary ones are typically charges relating to product and advice.

CHAIRMAN—Page 16 of your submission refers to instances of APRA giving:

... detailed directions on matters that could, more appropriately, be the subject of regulation.

Can you give us some examples of that? What sorts of detailed directions are you referring to?

Mr Asher—I would be reluctant to give you an example because this relates to clients of ours, but I have found particularly in the licence conditions a level of direction that I think is inappropriate. It is erring on the side of government regulation rather than self-regulation.

CHAIRMAN—Trying to micromanage business?

Mr Asher—Effectively, yes.

CHAIRMAN—Any further questions?

Senator MURRAY—No. This is a very useful submission.

CHAIRMAN—Mr Asher and Mr Gale, thank you very much for your appearance before our committee and for the detail of your submission which, as Senator Murray said, is certainly very helpful to our inquiry.

Proceedings suspended from 12.28 pm to 1.59 pm

BRIGDEN, Mr Terry Wayne, Member, Superannuation Committee, Law Council of Australia

CHAIRMAN—Welcome. The committee has before it your submission, which we have numbered 76. Are there any additions or alterations that you wish to make to the written submission?

Mr Brigden—No, not at this stage.

CHAIRMAN—I invite you to make an opening statement at the conclusion of which I am sure we will have some questions.

Mr Brigden—The only thing I would really like to say is that the Superannuation Committee of the Law Council of Australia does not comment on policy. We see that as being very much the role of government. Our role as we see it is to comment on the legal implications of how policy is actually implemented. We obviously can do that most effectively when we are involved at the stage when legislation is being drafted. We think this most successfully occurred when the SIS legislation was introduced in 1993. Our focus therefore is very much on the superannuation industry having well-drafted legislation which has been appropriately regulated and is based on a sound understanding of legal principle. You can argue whether that always actually occurs.

CHAIRMAN—Thank you. Your submission argues that APRA's powers have been inappropriately extended through the licensing regime so that APRA can achieve, through non-legislative means, results which are not expressly allowed or intended by the SI(S) Act or by announced government policy. Could you give us an idea as to how we might redress the problem you have highlighted?

Mr Brigden—The problem comes in areas where guidance notes which APRA puts out to basically explain to the industry what its view of the law is and how it should operate are quite often taken to be the law by APRA in saying: 'If you don't do this, you are not complying with the legislation. Therefore in certain circumstances you are not acting in a fit and proper way and we question why you should be a trustee.' Where those guidance notes represent a fairly fair summation of what the law is, that may be okay but at times we may not believe that APRA's view of the law is entirely correct. Then you have conflict where participants in the industry say, 'No, that isn't really the law' and the guidance notes say, 'Don't rely on this, it's just our view,' but then they say, 'If you don't do it, we are going to hold you to account.'

Senator MURRAY—Through the licence.

Mr Brigden—Through the licence is part of it, yes and also for individuals.

Senator SHERRY—Don't you think that was the implied threat? Certainly some of the funds I have talked to took it as an implied threat because there was a licensing implication that, if they did not follow APRA's view via the guidance notes, they may not get their licence.

Mr Brigden—Yes. Quite often what happens is that once you have your licence and you are up and running, there are times where funds may very well take a view that they do not agree with the approach being taken by APRA, but nonetheless they do not believe that they can use members' money to contest that view, so quite often they acquiesce and go along. While this is not intended to be a criticism of APRA and it certainly is not, it is just that in certain areas I think that they need to have greater dialogue with the industry prior to actually producing and introducing guidelines and about how they actually apply them.

Senator MURRAY—Trowbridge Deloitte suggested that a solution was to give APRA the powers to actually promulgate standards which then do have legal status and would stand alone. They argued that guidance notes should then be an expanded or explanatory version of those standards. Do you have any explicit objection to APRA being given the power to promulgate standards?

Mr Brigden—If they are going to have the effect of law then it is very much going to the same area of promulgating regulations. I think they have to be subject to the same review. Whether it is set out in guidance notes or in standards, you can still have the same difficulties, it seems to us.

Senator SHERRY—Going to your comment about the legal response to APRA, surely it would be within the sole purpose test that a fund does have a right, where it disagrees with APRA, to contest a position legally and ultimately in the courts if it believes it is in the fund's and the members' best interests.

Mr Brigden—If it affects the fund as a whole adversely then that is certainly the case. But quite often what you get is, 'We don't agree with the way you are managing this fund and therefore we query whether you are fit and proper persons to be managing the fund.' Then you get into the much more difficult area of saying, 'Is it in the interests of members that I'm effectively protecting my position as a trustee and my own reputation or not?' If it is a fund which is operated by a financial institution then clearly they have the resources to be able to pursue that. But smaller funds have less ability to do so, and that is where I see part of the problem. Once again, it can be unfair that APRA takes a different view. We have seen it in a few cases—for example, the intervention in the Invensys case in Melbourne, where they thought the trustees should have made a decision in a different way. In the whole area of trustee decisions, there can be a range of correct decisions. The fact that I may take a different view from what a different set of trustees may decide does not necessarily mean that their view is wrong. That is always the way the courts have taken it as well. They have said, 'We'll only intervene if the decision you make seems to be a decision which no reasonable trustee would make.' I think we are in quite a dangerous area if APRA sees its role as second guessing trustees' decisions. That is not to say that they do not have an appropriate and correct role in monitoring what trustees are doing, but it seems to be getting down to the micro level rather than the macro level.

Senator SHERRY—What was the case you referred to?

Mr Brigden—Invensys.

Senator SHERRY—Are you familiar with the AXA case and the action they took against the CEO, Andrew Penn?

Mr Brigden—Yes.

Senator SHERRY—Do you think that would fall into the same category?

Mr Brigden—That is very difficult to answer because our firm was also involved in that case. I have to be careful on that one. Personally, I think there have to be better ways of resolving those issues than having trustees being labelled 'not fit and proper' and then having to spend a lot of time and money trying to defend their reputations. That is probably not the most appropriate way unless it is very clear and blatant breach of trustee responsibilities or duties.

Senator SHERRY—I know—because we got an answer to a question on notice on that case—that it cost APRA directly in excess of $1.5 million. I do know no what it cost AXA, but the legal costs would have been extraordinary and APRA did not win—and there is a question as to whether they would have won. AXA clearly had the legal resources, but I suspect that most superannuation funds would not have had the legal resources to contest and dispute APRA's view.

Mr Brigden—No, that is exactly right. Perhaps there has to be some other mechanism where you have genuine disputes with APRA over the way you have acted.

CHAIRMAN—In your submission you suggest that it would be helpful to permit employers and other non-licensed entities to provide certain information in relation to superannuation without requiring a licence or other authorisation via an Australian financial services licence. You do not specify what information you see as falling into that category. Could you enlarge upon that for us?

Mr Brigden—Yes, certainly. This always raises the very difficult question of what is advice as compared to information. We come across this particularly in regard to advertising and whether that provides advice or not. The reason for the difficulty we get here is that quite deliberately the definition of 'advice' in the Corporations Act is very broadly drafted, so you can pick up a broad range of persuasive activity where you may be trying to persuade people to buy particular products.

Where it gets quite difficult is where you say, 'Am I just giving information?'—which basically means that, objectively, you would give the same information every time—or 'Am I giving advice?' It should be remembered that, under the definition, 'advice' can be quite broad. If somebody rings up their employer or their superannuation fund and they are told, 'I think it would be a good idea if you put extra money into superannuation,' that seems to be, self-evidently, a good thing to do, but that is actually advice and, strictly, you do have to have a licence in order to do that. Another case would be where you have additional levels of voluntary insurance. As a general statement, you might say, 'It is a good idea to have extra insurance because, if you become disabled or you die, there is money for you or your dependants.' But, once again, if you actually say that, that is advice. Even if you say, 'If it were me I would actually do it,' that is still advice. It is the grey area where I think the difficulty comes in.

Senator MURRAY—One witness tried to draw a distinction between advice in the general sense of options—'on the one hand you have this and on the other hand you have that' sort of approach—and recommendations, which Senator Sherry sometimes styles as selling, where, for

example, you recommend that someone go into a switched product or something of that sort. We have put this proposition to a number of witnesses and they have said that making a distinction between those two within legislation would still leave fuzzy areas or grey areas. I think they described it with the word ‘fuzzy’. Given your particular legal background and your understanding of superannuation, what do you think about distinguishing between advice and recommendations?

Mr Brigden—A recommendation is obviously just a very clear form of advice—for example, ‘I think you should invest in this particular product or in this particular class of products.’ Clearly, that is getting right into personal advice because you are saying to someone that they should actually do that. Part of the difficulty with more general advice is that people quite often still take that as your recommendation. I think the grey area comes in when people try to craft what they say so that it does not seem like a direct recommendation but the implicit understanding is that that is exactly what they are doing. That is where the difficulty once again comes.

Senator MURRAY—Even recognising that, given that the law at present does not say that a recommendation is clearly advice—the definition is framed more broadly than that—

Mr Brigden—It is, yes.

Senator MURRAY—would it be any improvement to the law or the practice if at least that area were to be made precise? For example, bearing in mind that advice has to be translated into writing, it could be that a recommendation that is written constitutes clear advice and advice which says there is no recommendation does not. I must stress to you that I have not made up my mind. Let me help you with your answer. I will not lead you, but let me help you with your answer. Many witnesses are simply saying that the whole advice area in the general sense of discussing options and laying out the superannuation scenario should not be caught within advice because it then leads to very lengthy statements of advice, product statements and so on. They are putting the proposition such that you can have a financial discussion without getting into the heavy paperwork that is presently involved.

Mr Brigden—That to me seems very much like the distinction at the moment between what is general advice and what is personal advice—personal advice being where you have taken into account at least some of the individual’s personal circumstances and said, ‘This is what I think you should do,’ or ‘This is what I would recommend,’ as compared to giving general advice about superannuation and its investment characteristics compared to other types of non-super investments or even particular asset classes within superannuation.

Senator MURRAY—Except these witnesses are saying to us, ‘Personal advice is often general; it is not specific. It does not involve recommendations; it involves options. For instance, “Your option is this type of product, that type of product, the other type of product or the status quo.”’ That sort of thing, they maintain, does not lead to a recommendation.

Mr Brigden—It is true that at the moment the legislation says that personal advice is where you take into account at least some of the individual’s personal circumstances, and you have to let them know what that is. I guess the question is, ‘To what extent are you actually doing that?’ If you are not doing that at all, then it is still just general advice. And yes you do have to say, ‘I

have not looked at your circumstances in actually telling you this.' I think it would be hard at the moment, without taking it on notice, to clearly differentiate the circumstances and to avoid those circumstances of people who are covertly providing advice but want to avoid the disclosure that that requires. That is where the difficulty comes in.

Senator SHERRY—Can I can give you further indications of the sorts of issues we are getting at here. If it involves personal advice about one particular aspect—let us say, level of death and disability insurance—at the moment you need some individual characteristics about, say, age, family circumstances. That is clearly personal advice. You have one piece of personal information. That then triggers under FSR a whole range of disclosure and also a much more detailed examination. If you are looking at death and disability insurance it then triggers a whole range of information gathering about the person's budget, capacity to pay and expenses and income. Therefore, it cannot be delivered cost-effectively. That is a constant complaint from almost everyone. You cannot do that cost-effectively because of the wide range of information required, the extensive nature of the process and the inquiry and the extensive documentation and time et cetera. Perhaps you could take on notice how we could design a system where, if you want specific advice about an aspect of superannuation, you do not need to trigger a significant volume of paperwork, compliance and a whole series of further questions, which substantially add to cost to no good effect.

Mr Brigden—Are you suggesting a distinction between the consequence of giving advice and the disclosure you have to give or is it more just in being qualified to actually give that advice or recommendation? Or is that both parts?

Senator SHERRY—I think it is both parts. Put aside the issue of switching from one fund to another, because that tends to be much more controversial in terms of what is at stake in a massive transfer of moneys and the way in which the adviser or the planner is paid. We are talking of limited advice within a fund. Most funds do want to be able to give simple, relevant advice about a particular characteristic issue within a fund without the need to trigger disclosure, which under FSR is particularly onerous for, I think, most players at the moment.

Mr Brigden—Yes, it is. I think you probably could usefully put that distinction into the legislation.

Senator MURRAY—Would you be able to write back to us? I am not suggesting you give us a legal opinion, but frankly we are struggling with it and so are the witnesses we are speaking to. If you were able to give us a decent steer, it would help.

Mr Brigden—Yes, I could certainly do that.

CHAIRMAN—Can we move on to your issues with APRA and member investment choice. You go into that in some detail. How do you see that situation being rectified?

Mr Brigden—Much of the APRA sector is very good, very sound and certainly very sensible. I think where the difficulty comes about is in how you marry the general obligation. When you choose investment strategies for a fund, they have to be obviously appropriate for retirement savings. Where the fund is holding this is section 52(2)(f). You have to look at the circumstances of the fund—diversification, liquidity et cetera—and how they marry in a fund where you are

giving members investment choice. I think how the circular dealt with that went off the rails a little. Where the difficulty comes—I understand, although, unfortunately, the advice has not been released to actually be tested—is in saying, 'We know that parliament gave members power under section 52(4) to direct where the money will be invested. We are talking about circumstances in which, through a range of options, a fund might have a very broad range of options, with APRA saying, 'Well, we understand that but that is still subject to 52(2(f).' That is where I think discontinuity has come in because they are saying that where you give members a broad range of investment options, then how members exercise that may still have an impact on the diversity and liquidity of the fund as a whole and therefore they are suggesting that you somehow have to manage members' investments to take that into account. I am not too sure how that actually works and I think it is slightly misconceived, which I will go into.

More disturbingly, they seem to be saying, 'Well, you actually have to look at how each member decides to invest and if you don't think they've done the right thing you have to say, "Well, no, you cannot do that."' That seems to be the complete opposite of the whole intention of giving choice, that members can actually make their own decisions based on their own circumstances.

The thing with member investment choice in looking broadly at how does that impact on funds' diversification and liquidity as a whole, is that a member's entitlements and the return they get is entirely dependent on the returns on the particular investment options they chose. It really does not make any difference to the fund as a whole if everybody chooses that they will invest in cash options or everybody invests in Australian equities. What does it really matter? Is the fund diversified? No, it is not where ACCI is talking about one individual and that is how they have invested.

You cannot measure the individual's decisions on what the members as a whole do and what that effect has on the funds diversification. It is an entirely different issue. Where you are looking at the fund as a whole, that is where the trustees have an obligation to pay out benefits in accordance with the terms of the trustee but members do not make any choices as to how the trustee does it, so the trustee in most cases will say, 'Given the types of members we have, given the likelihood of people wanting their money, what their expectations are, then this is how we will establish our investment portfolio.' But that is very different from where you say to individual members, 'Well, from this suite of options, you can choose which ones you want.'

I think where correctly stated, it should have said that provided that firstly the investment options you choose are all suitable for investment for retirement purposes which, as the general statement implies, is longer term investment. Some of those may be more risky than others; some may be less liquid than others. We will not necessarily preclude those provided they satisfy the initial test—suitable for retirement savings—but we would limit the amount which individual members can put into a particular high-risk strategy or a particular liquid strategy.

If the trustee does that then I think that should satisfy a lot of APRA's concerns. But I think the way they have articulated it in the paper goes further than that, and I do not think you can really do that. The second part is where trustees are requested to actually monitor each member's decisions and go back and say: 'No, we don't think you should do that.' That is inconsistent with freedom of choice and member investment choice in a circumstance where investment options

are all suitable investment options to have. I think that is where the difficulty and our disagreement with what they are saying in the circular arise from.

CHAIRMAN—So does this need legislative change to prevent them acting inappropriately or does it need some direction from the minister? How do we get around this?

Mr Brigden—It would seem to us that APRA has said—and, I must say, quite honestly and genuinely—'Look, we've got legal advice. This is what it says.' I think the first good thing would be to have that legal advice subject to review then, from that, have a better dialogue with APRA, based on them having a firm understanding of what the law really is. It is probably just a bit of a genuine misunderstanding on their part as to what the law is in this case. I am not sure we need to go to a stage of direction from the government yet. But certainly this does need to be subject to review.

CHAIRMAN—You also deal with the issue of promotional advertising. You say it is appropriate in a competitive market as such. Do you think there is a need for better disclosure to members of the specific costs of promotional advertising?

Mr Brigden—That is a cost which members would probably want to know about, if it is significant. Probably the way we frame it is by saying that, per se, advertising is not contrary to the sole purpose test. Whether or not a particular fund actually engages in advertising, in the circumstance where they are using fund money rather than where they have their own resources to do so, trustees have to look very closely and be well satisfied that spending the money at all is worth it. If they decide, 'Well, yes, there are benefits to members in doing so,' the amount they spend must be in the best interest of members. That is the more difficult decision for the trustees to make. However, if you just say there is a blanket prohibition then I think that does create competitive disadvantages in the marketplace.

CHAIRMAN—You also accept as valid the statement that all profits go to members, but you make the point in paragraph 12.5:

> ... that these representations are typically made where the trustee is owned or the fund is promoted by non-profit organisations - which do not receive a return from the operation of the fund (contrasted with the "retail" sector ...

You also say in 12.6 that it 'is a reference to the fact that there are no payments to related parties or financial advisers involved in the "selling" of an interest in the relevant superannuation fund'. What about the situation where you have related parties providing services to the funds?

Mr Brigden—It is quite interesting. I notice that funds are tending to use that sort of point of distinction less than they were before. The first comment I would like to make is that there is a bit of misunderstanding about what people are really saying when they say, 'We are not for profit.' What do you really mean? Do you mean that you just do everything on a pure cost recovery basis or do you mean cost recovery plus extra money so that you can provide other related services that you think the members should have? For example, you may use that for your advertising or for providing financial planning services and things like that. What you are really saying is: 'No money here goes back to a shareholder.' That is probably the most extreme—nobody else is getting the money.

Certainly it is true that, if you do have a related service provider providing administration or other services, I think that has to be disclosed. It is part of a cost of a fund. Also, if a trustee is doing it internally it would be purely on at least a cost recovery basis if you assume it is not for profit. If a third party is doing it, whether they are related or not, that immediately raises the question of whether they are doing it on just a cost recovery basis or for cost recovery plus profit. If a related party is doing it on profit then I think you do have to be careful about how you explain that. I think if you then said, 'Yes, we are not for profit,' without a qualification, that could arguably be misleading.

Senator MURRAY—Is it as simple as that? A third party might be constituted a not-for-profit entity but might generate a surplus or simply have a higher fee. It might be disguised profit, if you like. Isn't it easier just to ensure that all related party transactions and the basis on which they are made are fully disclosed?

Mr Brigden—I do not think there is any question that they should be disclosed.

Senator SHERRY—The concept of 'profit for members' is increasingly the terminology being used, as distinct from 'not for profit'. Isn't it an attempt to convey to members that they make some money? If you say you are not for profit in a superannuation context, the implication, for some people at least, would be that they are not making any rate of return.

Mr Brigden—Yes.

Senator SHERRY—Isn't the implication in terms of profit for members that the moneys that are generated after expenses all go back to the member as distinct from a shareholder?

Mr Brigden—Yes.

Senator SHERRY—So, all other things being equal, the member will gain, as distinct from a shareholder?

Mr Brigden—That is true. In terms of its money, which is profit, if you like, generated by the fund itself and how it has invested, as a matter of law that is all the members' money anyway, so you are not really saying a lot. That sort of terminology to me only makes sense in the context of where a trustee is providing other services—once again, for example, financial planning or other related services—that generate profit and where that profit goes back into the fund. I could understand it in that context.

Senator SHERRY—I note with interest that you did address that international benchmark question.

Mr Brigden—Yes.

Senator SHERRY—Not many did. Certainly, I was very interested in your reference to the fact that the International Pension and Benefits Lawyers Association are doing this international survey. Could you provide us with a copy of that?

Mr Brigden—We certainly will.

Senator SHERRY—There is a paucity of international comparative information available. Do you have any time line on when that is likely to be finished?

Mr Brigden—No, but I will find out. I know that it is in the process now but I will find out about the timeline.

Senator MURRAY—On the issue of disclosure and reporting and so on, I am obviously alert to both the need and the requirement for APRA to have industry specific and, indeed, enterprise specific reporting and accountability mechanisms. But I am a bit concerned that, on the broader front, there seems to be a desire for sectional reporting. I refer particularly to the advertising and sponsorship area.

My broad view is that not-for-profit entities as a class, as distinguished from public sector for-profit entities, should be governed either by general accounting standards and requirements or by category-specific accounting standards. I know the AASB, the Australian Accounting Standards Board, is indeed looking at a not-for-profit accounting standard which takes into account some differences in the approach. I am not sure exactly what elements they are picking up in that. I gather from your commentary on advertising that you pretty well think, 'One in, all in.'

Mr Brigden—There is still a decision that a trustee has to make: is it in the interest of members to do so?

Senator MURRAY—Yes, which I think should remain. But here is the simple point I am trying to ask you about. If it remains an enterprise decision as to whether advertising or sponsorship should go on then the basis for that disclosure should not be determined by APRA or anybody else; it should be determined in terms of normal accounting standards and reporting by bodies of some substance. Obviously I am not talking about the local soccer team. Do you agree with that? Do you think it is an area better covered by broad application than narrow application?

Mr Brigden—We are talking about disclosure in terms of the costs of the fund as distinct from the trustee as a corporate entity itself.

Senator MURRAY—Yes, but the issue is whether it is appropriate for a superannuation fund, which is in the trustee structure, to use some of the member funds for advertising promotion and sponsorship. I think it is appropriate. Let me be clear about my prejudice. If it is then allowed, the next issue is how it should be disclosed and reported on, and there are criticisms that when it is reported it is reported very badly—it may be a small note in the accounts, it may not appear at all or it may be separate in the annual report to the financial statements. I just think the principles of how it should be reported should be subject to the normal standards applicable through the Australian accounting standards.

Mr Brigden—I would agree with that. I think it has to be consistent reporting across all funds. If part of members' money is going into doing that then members, quite frankly, need to know about that, particularly in an area of member choice. If members disagree, there may be choices they wish to make—if they think it is inappropriate.

CHAIRMAN—I note that you refer to the ‘relevant provisions of the Corporations Act and other regulation directly affecting superannuation funds’ in your comments on any other relevant matters. The provision of custodial services is another issue you raise. Would you care to elaborate on your concerns in those areas?

Mr Brigden—In terms of the corporations legislation, it is purely the fact that only half of trustee responsibilities are now included in the SIS legislation. Obviously a lot of the disclosure is in the Corporations Act. If you are doing a review of how efficiently superannuation is being operated then you do need to look at those aspects of it as well. We have already covered some aspects of it in terms of disclosure—when you are giving advice to compare the recommendations et cetera.

Another matter I refer to is custodians, and it may very well get to the same stage with administrators. Previously there were a broader number of custodians; they are becoming less. One of the things I think the industry does have to look at is: are there risks in getting concentration in having just one or two custodians? Obviously, if something goes wrong, there is a greater possibility of it affecting a lot more superannuation funds. In a similar way, if you have a systemic problem with an administrator, if they are doing a very broad range of funds, there is a greater possibility of more people being affected. In both these areas, with the rationalisation of the industry, there are a lot less funds about now, and therefore there is a lot more concentration of fund assets with particular custodians and administration activities with particular administrators as well. So we are just alerting people to that. It is an issue that the industry generally has to realise and address in the longer term.

Senator SHERRY—On that point, I have seen statistics on the number of funds—the providers—but not on the number of administrators and custodians. Does that data exist? Maybe we should ask APRA.

Mr Brigden—I have not seen the data myself. Our observations are from just noticing that there are fewer administrators around than before.

Senator SHERRY—I agree. I have noticed the same; you are right. With respect to the theory of competition, we have got, say, 300 funds—plenty to choose from, to the extent that individuals choose. But if we end up with two or three administration companies, effective competition in that sector would be relatively small, I suspect.

Mr Brigden—It would be. The only time you are going to get competition between them—and I guess real competition, if you like—is where you do have standard funds, where it is relatively easy to migrate from one administrator to another administrator. But if they have got different operating systems, different benefit designs, it can be a reasonably expensive process going from one to another. It is not an easy decision that a trustee makes.

Senator SHERRY—So effectively you can have inertia in changing the contracted provider. It just becomes too difficult.

Mr Brigden—Yes, which really means there is less competitive pressure on the administrators than there might otherwise be.

CHAIRMAN—I do not think I have any further questions.

Senator MURRAY—I have not either. That was very helpful.

CHAIRMAN—Mr Brigden, thank you very much for appearing before the committee. Your comments have been very helpful in relation to our inquiry.

[2.43 pm]

BURN, Dr Peter, Associate Director, Public Policy, Australian Industry Group

CHAIRMAN—Welcome. The committee has before it your submission, which it has numbered 78. Are there any alterations or additions you wish to make?

Dr Burn—No, there are not.

CHAIRMAN—I invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Dr Burn—I am here in my capacity as Associate Director of Public Policy for the Australian Industry Group. I should also declare that I am an alternate director for Dr Walter Uhlenbruch on the board of AustralianSuper. Ai Group is the sole employer organisation shareholder of AustralianSuper Pty Ltd, which is the trustee for AustralianSuper. As you know, AustralianSuper is a not-for-profit superannuation fund that was formed as a result of the merger between the Australian Retirement Fund and the Superannuation Trust of Australia and the amalgamation of Finsuper. Ai Group also participates in the management and control of CARE Super and Aust Q, two other industry superannuation funds.

Our group are very pleased to be able to contribute to this inquiry. We certainly share the desire for an efficient, effective and safe regulatory structure for the management of superannuation funds. We are very pleased to be able to say that, from our perspective, the new licensing and registration regime administered by APRA appears to be working well. There is strong investor confidence in superannuation and a strong degree of stability evident, following the introduction of super choice. We address a number of more detailed issues in our submission and I will not go over those again right now.

CHAIRMAN—You indicate on page 4 of your submission that there are legislative barriers to advice. Would you care to elaborate on that? Do you consider that there is a requirement for an amendment of the Corporations Act in relation to the definition of personal advice?

Dr Burn—I am not sure that we actually say that there are barriers to advice. We do say that we need to assess that they do not act as a barrier to advice. We are just wary that there can be inhibitions about the provision of advice.

CHAIRMAN—You are saying that there is a need to explore ways in which the regulations can be modified to improve investors’ access to appropriate advice.

Dr Burn—My understanding is that there are inhibitions about providing information. People are wary of providing advice and infringing regulations. We think that that can act as a barrier to provision. One example is the idea of providing tables and calculators so that people can estimate their end benefits. There are inhibitions, as I understand it, to providing that sort of information, which is really nothing more than an extension of a spreadsheet. And if that is the

case then we think that the regulation probably is not working as well as it ought to be or is having unintended consequences.

CHAIRMAN—Do you have any concerns with regard to the way APRA is administering the trustee's role in member choice and the other issues that have been raised by a previous witness?

Dr Burn—I did not really hear the previous witness on this. But we do not really have any major issues with the way APRA is administering it. We understand that the regime is quite new, that these things take a while to settle down and that APRA is very rigorous, but we expect that and respect that.

CHAIRMAN—What do you see as the need for enhanced transparency and objectivity in the general provision of advice?

Dr Burn—We are wary that people providing advice may not always disclose—or their disclosure might not be all that clear to people—the nature of commissions in particular. The interests of the adviser should be made very clear to the person receiving the advice, and the nature of any commissions should also be made very clear. We think there is tremendous potential for a conflict of interest.

It is important that, if someone is receiving a commission, that is made absolutely clear, because that can clearly colour what they recommend to a person. They might not recommend something which does not provide a commission. If they are not declaring the commissions that they are receiving then it is not apparent that there may well be a bias in their recommendation.

CHAIRMAN—Right. Do you think the increasing cost of compliance has reflected an increase in consumer protection levels?

Dr Burn—I am sceptical. If it has, it would be very marginal, because consumer protection levels were pretty strong—or do you mean specifically in relation to advice?

CHAIRMAN—No, generally. You referred to the increasing cost of compliance—

Dr Burn—Yes, so I am answering the question in a general sense. I think that security was pretty high in any case and I think that a marginal improvement would be the best that you could expect from that, whereas the compliance costs have increased substantially. I would make that observation.

CHAIRMAN—Okay. With regard to advertising, which you see as a benefit to members, do you think there should be specific disclosure to members of the costs of advertising?

Dr Burn—I think significant expenditure should be disclosed to members. We certainly have nothing against that. Members should be able to access financial accounts and it is my understanding that they can do so. I wonder about the motive for identifying advertising costs as opposed to other expenditure in the area; I am not too sure why advertising is so—

Senator SHERRY—It is an issue of contention as much as it is about satisfying people that the expenditure is open and above board and appropriate. Therefore, disclosing it would

probably resolve, from my point of view, a perception of difficulty as distinct from a real difficulty.

Dr Burn—Yes. If the premise of the question is that there is a perception problem, the solution may be that it addresses that problem. That would follow.

Senator SHERRY—Again, if you look at the annual reports for a fund, to varying degrees—and it does vary significantly, and not just with industry funds; it is true of corporate and some retail funds—the level of remuneration of executives and trustees is an issue. I think it is as much a perception issue as it is a real issue for many people. And I am talking about what appears in the annual report as distinct from the annual accounts. The reason I draw that distinction between the annual report and the annual accounts is that everyone is sent a copy of the annual report—in law, they have to receive it—but to take the next step to access the accounts is a step that very few members would take. So ensuring that that sort of information is at least made available to every member would, I think, be an advantage in terms of openness and transparency, and minimising what at times is ill-informed criticism.

Dr Burn—Yes. Providing people with more information, as long as the information is clear, coherent and has integrity, would improve transparency. I do not disagree with that. But at the back of my mind is: where does that end and at what point does the provision of information in such a format as an annual report blow out so that the annual report is something very heavy that people throw away?

Senator SHERRY—Let us take a so-called not-for-profit. I would think a member is entitled to know what the CEO or general manager is being paid, as with a public company, where you have got a pretty good idea. The member is entitled to know that. It is the same with the trustees: directors fees are readily available but trustees fees are not. Again, there is a significant range of reporting in not-for-profit entities. I am conscious of the need not to overload people with information; that is one of the problems of FSR. Indeed, I am sceptical of the degree to which the average member actually reads the annual report—I understand the surveys show that, in the main, they go into the rubbish bin. But it is a question of dealing with perceptions as much as any sort of real difficulties in this area.

Dr Burn—I can see the case for it. I certainly have no problem with disclosure of those things.

CHAIRMAN—What is your view on disclosure of related party transactions? That is an issue that has been raised, that there is a need for greater disclosure of related party transactions, service providers and the like.

Dr Burn—I think that is an important area, and where there is an area of contention then I can pick up the general argument that has just been made about the desire to raise people's confidence and that disclosure is a good idea. But that is tempered, of course, with this other tension, I guess, and that is about: where does it end, how much information are you providing, what is the integrity of the information and what is the utility of the information? People can sit around and think of lots and lots of things where there are small risks and they can impose significant costs on people to address those small risks and feel good about it. If there is evidence that it is coming from the people it is intended to provide the information to then that is

a solid case, but often I think it is coming from the interests of someone else who is trying to think of something else that they might provide to people. And there is a case of overload in a lot of information provision, the FSR being a case in point.

CHAIRMAN—Does AustralianSuper put its service provision out to tender? How does it determine who are its service providers?

Dr Burn—We certainly comply with all the outsourcing regulations that APRA oversee. I mentioned that I was an alternate director of AustralianSuper and I know that there is very, very thorough examination of all service providers. This is not an insignificant area of discussion. Of course, the criteria are the benefit to members, the appropriateness of existing arrangements and alternatives that might be offered. I know that it receives very close attention.

CHAIRMAN—You mentioned you were an alternate director. How is the board for AustralianSuper structured—how is it made up?

Dr Burn—There are a number of directors—I have just forgotten how many, but I think it is 10. The chair is Geoff Ashton, who is appointed to the board by the Ai Group. Then I think it is an even number of nominees between the employers and the unions.

Senator SHERRY—Do you have any independent trustees?

Dr Burn—I stand to be corrected but my understanding is we do not.

CHAIRMAN—Are you a public offer fund now?

Dr Burn—Yes.

CHAIRMAN—We heard from, for instance, HOSTPLUS yesterday who are a public offer fund. They have now gone to a 3:3:3 structure: three employer reps, three employee reps and three independent reps. I do not think that originated because they are a public offer fund, but I think now they are a public offer fund they recognise there are advantages in having some independent board members as well as the industry representatives from both sides. Do you think that might be looked at as a mandatory requirement now that a lot of the industry funds are public offer funds and have members coming from outside of the traditional industry sector that they represent?

Dr Burn—I am sure that it would be looked at as something that there might be a mandatory requirement for. It is also something that does come up in discussion about the evolution of the governance arrangements of AustralianSuper and how things might be improved further in the future. We are certainly open to that idea and it would certainly be discussed and considered for its advantages.

Senator SHERRY—I would like to go to two issues relating to the last term of reference: ‘compensation in the event of theft and fraud’. One response in your submission did not surprise me but, frankly, one did—although I note that it is written with a heavy caveat. You say in the last paragraph:

While we are not entirely convinced of the argument, Ai Group does see some points of merit in suggestions that there could be a role for some form of community fund to act as a last resort in replacing all or part of superannuation benefits losses incurred by members of a regulated fund where the loss is due to theft or fraud.

Would you apply that to the self-managed superannuation fund sector, which is currently excluded from the section 23 theft and fraud provisions?

Dr Burn—I am not too sure about that. They are a very different sort of fund, and I have not thought it through.

Senator SHERRY—I asked APRA to give me a response on notice to the actual grants under section 23 in the event of theft and fraud. I am advised that there have been seven major cases of theft and fraud, totalling $43½ million, over the last three financial years. That is a post-event levy, not a pre-levy. There is no distinct fund and the assets of the entire superannuation are levied as appropriate post event. Don’t you think the current model is, conceptually and in the way it is operating, a reasonable model? Why would we change it?

Dr Burn—I guess it is, again, an issue of perception. We can see some argument on the basis of perception. The post model is one approach, and some people might not see that as adequate and confidence could be increased if it were another thing. As I say, we are not entirely convinced of the argument but we see some merit. I think that is where the merit might lie.

Senator SHERRY—My concern with a pre-event levy is that, if you look at the actual cases of theft and fraud, one stands out—Commercial Nominees, where it was $40 million. None of the other cases make it to $1 million. That begs the question: if you have a theft and fraud in a year of, say, $40 million, how do you determine what the effective levy would be pre event as distinct from post event? Presumably, on the basis of that figure, we would have been levying the industry and setting up a fund with $40 million to $50 million every year when in fact it was not needed and is effectively a waste of resources that are taken from the industry.

Dr Burn—I think you make a very strong argument. We might have phrased that differently in our submission had we thought through those issues.

Senator SHERRY—I am a bit surprised that the Ai Group was advancing an argument for a pre levy, because it is a contentious issue in other areas as well.

Dr Burn—I take your point, though it does have a heavy caveat.

Senator SHERRY—It does. It is almost a bet each way.

Dr Burn—That is the way to go!

Senator SHERRY—One area where you did not proffer a view—and, frankly, it is one of the biggest areas of consumer complaint that I get across my desk—is the issue of non-payment in the event of employer insolvency. The argument is that statutory obligations are covered by GEERS. As you would be aware, redundancy pay, annual leave and matters of that type are covered by GEERS. However, unpaid superannuation, SG, in the event of insolvency is not

covered by GEERS. It is a statutory entitlement and, in fact, it is generally accepted that compulsory super is unpaid wages. So why should that not be covered by GEERS as well?

Dr Burn—There is always a case to extend the range of taxpayer funded services. In this case, I guess that is another argument.

Senator SHERRY—Before you go on: our system is actually more of a real worry to the average person than theft and fraud is.

Dr Burn—People may be worried about it, so the issue is how they can be reassured. Our experience is that the Taxation Office are pretty heavy-handed in all of this. They have very strong penalties in there to ensure that people's contributions are up to date and employers' contributions are up to date.

Senator SHERRY—I accept all of that. But there are about, as best as can be estimated, 10,000 or 12,000 cases a year of unpaid super—probably a quantum of $30 million or $40 million according to the tax office's material. It is a niggling problem for those who do not get their money, which discredits the system. Perhaps you could take that on notice. I have probably been a bit unfair in putting you on the spot. I am hoping to get AiG's endorsement of an extension of the GEER Scheme. Perhaps you could take the matter back to your board and they could consider their view.

Senator MURRAY—But our distinct impression was that he showed great commitment without actually saying so; he was very enthusiastic! Is that right, Dr Burn?

Dr Burn—That is distinctly wrong!

Senator MURRAY—Dr Burn, I doubt you have enough broad experience across the superannuation industry to comment on regulation as a whole, in terms of its impact, but I would be interested in your views on this from your own experience: we have had witnesses say to us that superannuation in Australia is very well managed, very efficient and safe, with a high level of prudential concern and benefit from regulation. As an alternate director do you hear specific complaints about specific areas of overregulation, inconsistent regulations and so on? I will quote to you some of the words of an earlier witness today. With respect to the SI(S) Act and regulations, they said, 'They are particularly repetitive and clumsy and contain a number of alternative and counterintuitive definitions, and compare unfavourably with other acts administered by APRA, as well as some international legislation such as the Canadian Pension Benefits Standards Act.' So there are people who feel quite strongly about this matter. As someone involved with a specific super fund do you hear those sorts of complaints—from your executive directors and so on?

Dr Burn—I can only answer in a very general way. We certainly do hear complaints about the compliance burden and bemusement at times about the specific compliance obligations. Beyond that, as you say, I do not really have the breadth of experience to comment on specific areas.

Senator MURRAY—At your board level, is there a sense of resignation about it or is there a sense that things need to be done about it? I am putting this in a specific policy context that we have right now, whereby the Business Council of Australia and other people have persuaded the

government—and the state and territory governments are keen to get involved as well—to overhaul regulation in all sorts of areas. Is there a sense of activism at all on this issue?

Dr Burn—I would not call it activism, but I would not call it resignation either. There is certainly a desire to see something done. You were asking about the attitude at the board level; I can give you a completely different answer at the Ai Group level.

Senator MURRAY—I am really talking about superannuation. You see, our witnesses are coming to us, by and large, because of agitation specifically about the area of FSR and its efficacy. But, in terms of a broad overhaul of the SI(S) Act and its regulations, we have only had a couple of witnesses, to my memory, really comment on that specific area, distinct from FSR. That is why I would be interested in the attitude of the fund for which you are an alternate director. Is it a fair question to ask you to take that on notice and come back to us with a view?

Dr Burn—I could certainly do that. I am sure that they would only be too happy to respond, to give you some detailed answers.

Senator SHERRY—The Ai Group has participated in the various analyses of so-called red tape?

Dr Burn—Yes, that is right—very much so.

Senator MURRAY—It would be interesting were you to ask the Ai Group whether they looked at superannuation regulation when they looked at red tape or whether it was in all the other areas about which we know.

Dr Burn—We did not look specifically at superannuation. We tend to be wary, because we ourselves are involved in that area. We do not want to be putting forward our own experience lest it overshadowed the experience of what our members are saying—and our members are putting forward to us issues in other areas ahead of superannuation. Other than at times like when member choice is introduced and they have a one-off significant compliance task and perhaps an ongoing one, from our members' point of view, superannuation does not reach the top of the list of compliance concerns. That is perhaps not surprising, given the range of other regulation areas that our businesses are involved in and the day-to-day things. Of course, the Australian Industry Group sees superannuation regulation in a different light to most members.

Senator MURRAY—It is not core business for you, is it?

Dr Burn—Superannuation?

Senator MURRAY—Yes.

Dr Burn—Very much so. We take those responsibilities very seriously—

Senator MURRAY—Yes, but it is not the direct function of your members out there.

Dr Burn—For our members it is not.

Senator SHERRY—It would be core business, though, if contributions were increased from the employer to 15 per cent, wouldn't it?

Dr Burn—It would be very core—that would be a big issue, if our members had to confront that. I think you have been recently in the news on this issue—

Senator SHERRY—It certainly has been in the news.

Dr Burn—The news has been about you on this issue.

Senator SHERRY—Yes, it has. I have been, very responsibly, ruling it out.

Senator MURRAY—And failing to respond to gross provocation.

Senator SHERRY—Yes.

CHAIRMAN—There being no further questions, Dr Burn, thank you very much for your assistance with our inquiry and for appearing before the committee today. It has been very helpful. Thank you.

Proceedings suspended from 3.12 pm to 3.26 pm

McINERNEY, Mr Dallas James, Government Affairs, MLC

TUCKER, Mr Steve, Chief Executive Officer, MLC

CHAIRMAN—The committee has before it your submission, which it has numbered 82. Are there any alterations or additions you wish to make to the written submission?

Mr Tucker—No. There are no alterations at the moment.

CHAIRMAN—Thank you. I ask you to make your opening statement, at the close of which I am sure we will have some questions.

Mr Tucker—Thank you. It is a pleasure to be here spending some time with the committee this afternoon. MLC felt it was important that we did come along or at least make a submission to the inquiry, given that we are such a major player in the financial services arena. We are a division of the National Australia Bank. We are currently in our 120th year of operation in Australia. We have over $100 billion in funds under management and we serve over a million customers in the Australian marketplace. We are particularly well represented in the superannuation arena, where we operate in all the sectors of the super industry: personal superannuation or self-managed superannuation, small to medium enterprise and small business superannuation and also large corporate superannuation, through our subsidiary Plum Financial Services. As a major player in the superannuation industry, it is good to have the opportunity to be here today.

I will mention a couple of other things regarding our background. We are strong advocates of the value of advice in this country and the need for more Australians to get access to good quality advice. We have made some comments in our submission about that. We also believe that the industry needs to address some significant issues around transparency, which we have made statements on in the past, as we are moving towards trying to grow the trust that consumers have in the financial services system and particularly in financial advice.

In our submission we really only focused on three key areas. You have received other industry submissions that cover the broad range of your scope, but there were three areas that we thought required some further comment. The first is on the issues of capital and unit pricing. The capital issues are very important when it comes member protection. Obviously, capital is there in the instance of something going wrong, and occasionally it does. For example, at MLC, because we write superannuation business through our statutory funds, we hold over $100 million worth of capital against those client accounts.

We have had a look at the capital requirements across the industry and we would recommend a review of the use of the custodian option with regard to sufficiency of capital and also that there should be a review of the minimum of $5 million. The reason is that when errors occur—and occasionally they do—it is not always possible to go back to the custodian for recourse. Other errors or risk failures occur inside businesses, as indeed they have in ours.

We thought it might be helpful for the committee to have a bit of background on what happened with MLC. We had a unit pricing error which went back over many years. It was a small error that affected a large number of accounts, which was quite a big problem in the end—over $70 million, which was made good back to the investors from the shareholders.

The other thing is that we believe unit pricing is the most equitable model for ensuring equity amongst members. We believe that it should be considered a requirement of all public offer super funds that they operate under a daily unit pricing structure. The second area we have focused on is the role of advice. I think the submission speaks for itself, except to say that there are a couple of areas where there is inconsistency between the way APRA views the role of trustees, with regard to underlying investment decisions of members, and the role of the financial planner. They come into conflict at points in time: when the planner is directing an investor, with regard to all of their financial affairs, to invest in a certain way. APRA has certain views, such as that the trustee has an obligation—if sufficient diversification is not there, for example—to change that. There is a contradiction there.

We would also suggest that, for more people to get access to quality advice, it may be appropriate to extend the opportunity for people to use their superannuation money to pay for advice—not just as it relates to their superannuation in that particular fund, but that all financial planners these days must have regard to all of the financial affairs of a particular customer—and that they can only take fees through the super fund for the superannuation part of that. It might be helpful to extend that across the entire range of advice and make it more affordable for members. We think we would only do that under a dial-up regime which allows the fee to be negotiated directly with the customer and that essentially the dollar amount would be very transparently disclosed on their annual statement.

Finally, on self-managed superannuation funds—an area of quite explosive growth, and we can understand the popularity—we suggest there are a couple of areas where caution may be appropriate, particularly around two areas. The first is the review of the tax office's ability to effectively administer all of the different self-managed super funds out there in the marketplace. It is quite complex, there are many of them, and it is a different regime than the rest of the superannuation industry is under, as you are aware. The second is the role of accounts with regard to advice around superannuation. You would be aware that there is a carve-out of accountants when it comes to giving advice on the structure of superannuation funds. It is very difficult for them to do that without moving into the area of giving advice around other financial issues which are regulated under FSR. We have seen quite a lot of confusion. We recommend that consideration be given to creating a level playing field and not carving out accountants with regard to their need to be licensed to give advice on superannuation under FSR. Having said all that, our submission is available and clear. I would be happy to answer any questions.

CHAIRMAN—Thank you. Could you perhaps enlarge on what you see as the importance of unit pricing? Are you advocating that that is made a mandatory requirement for superannuation?

Mr Tucker—Yes—for public offer funds. We think that unit pricing—and it is quite clearly agreed with by APRA and ASIC in their best practice guides—is the best way to ensure equity amongst members coming and going from funds. The move to a unit pricing system allows people to come in and leave at the right price every day. It is a very fair, if not slightly complex, way of making sure that there is equity amongst members.

CHAIRMAN—I take it you are advocating uniform capital requirements?

Mr Tucker—Yes.

CHAIRMAN—You are one of the few witnesses we have had before us who is advocating that. Most are advocating insurance as the means to protect members' interests. What is your comment on what seems to be the broad range of witnesses that we have had before us who are advocating that alternative as a means of protecting members—

Senator SHERRY—Or reserving.

CHAIRMAN—Yes, using reserves.

Mr Tucker—Maybe I could be a little bit clearer. What we are advocating is that there is a need for the provision of funds for occurrences where things go wrong. There is currently $5 million through three different means. One of those is through the custodian. We are not convinced that the custodian option offers real protection. There are other ways we can do it: through reserving, through providing capital itself or through insurance. All of those are a cost to members in some form if it is a not-for-profit fund. We obviously have capital put aside for our statutory funds. As I said before, there is $100 million to protect the interests of members. It is a concern of ours that for some funds there is not enough protection for members in the case of something going wrong, so we would recommend that consideration be given to either increasing the limits or making sure that, through appropriate means—whether it be those means you mentioned—that is put in place.

CHAIRMAN—I suppose the two things that could go wrong are either the collapse of the fund through some very bad event or a unit pricing error, which you referred to. How does the unit pricing error come about?

Mr Tucker—There are many different reasons why unit pricing errors would occur. I can give you an example. Different funds have different pricing systems. In our case, an adjustment was required every six months to take into account the costs in the fund. That adjustment was not made over a period of a number of years, through error, and that accumulated into a fairly large number of members being affected over many years in the old NAFM business. That is one way that it can occur. Assumptions are made in funds with regard to tax and with regard to asset values. Those assumptions are often inaccurate. That does not mean an error has been made but occasionally an error is made. With respect to those errors, if you multiply them out with a player of our scale, they can be quite large. It is reported that there have been something like $750 million worth of unit pricing errors in the industry in the last few years. Although the occurrence is slowing down, that is a large number. All of those have been in retail funds at this stage, so the cost has been met by the shareholders. But it would be unlikely that they would be the only funds that are affected by some of the complexities around unit pricing.

Senator SHERRY—To that extent, the $5 million capital adequacy is, frankly, a waste of time, isn't it?

Mr Tucker—It depends on the size of the business and whether the error is anything like what happened with MLC. There are many others where it has been a large amount as well. I am sure

there are plenty of small errors as well. With respect to the $5 million figure, quite frankly, if you end up with a unit pricing error of the magnitude of ours, it is not going to get you anywhere. But some of these very large funds need to either have something in place to protect the member or some recourse for the member if something like that does go wrong, because they do not have a commercial shareholder behind them.

Senator SHERRY—If they do not have a shareholder, in the case of an industry fund or indeed a corporate fund where it is a subcontracted arrangement—most of the arrangements are subcontracted; not a lot is done in-house—who would bear the legal responsibility? Obviously, it would be the trustee in the first instance, but they would have a legal recourse against the administrator/funds manager, wouldn't they, if they made an error?

Mr Tucker—It depends on the error and it depends on the arrangement and the outsourcing process. As industry funds grow, and as other funds become more sophisticated, they will in-source certain arrangements. If you take our error, we have an external custodian but it was not the external custodian's issue. The prices were issued by MLC; that was where the error resulted. Insurance can cover some of that, of course, but these are not small issues. In our case, the error of $70 million was part of it. There was another $30 million required to make the members whole, in terms of finding them, tracking them down and dealing with the administrative issues. So it is quite a complex area. Our concern is that, quite frankly, in some cases, if it were to happen, we are not sure what would happen with regard to the members.

Senator SHERRY—Presumably some of the members you had to adjust had died.

Mr Tucker—In our case some had. We compensated back to the cent, to the estates, but finding those people is difficult.

Senator MURRAY—I hope none died of surprise when you compensated them!

Senator SHERRY—You sent them a cheque for 7c through the mail.

Mr Tucker—We did have to do that. I think there are now some reasonable limits, and dialogue in place with the regulators as to what is reasonable.

Senator MURRAY—Mr Tucker, I picked up more flexibility in your response to the chair's question than in your submission. It seems to me—and please correct the record if I have got it wrong—your position somewhat mirrors that of a witness earlier today who said there has to be a provision, but to mandate a type of provision, such as a uniform capital provision, is unwise, and the particular fund or operator should be able to choose whether it is reserving, insurance or a capital provision, or a combination of those, checked off against the regulator: 'They have arrived at this decision for these reasons,' and so on. He said that the key thing was that the provision was made, and the implication was that in some circumstances it is not made. Is that, broadly speaking, your approach, or have I misread it?

Mr Tucker—Broadly speaking, that would be right. Where we are coming from is that there must be provision made. The simple answer is to have a uniform capital requirement and solve the problem once and for all. That is a difficult issue, I think, for some. So as a minimum our view would be—

Senator MURRAY—And there is the question of quantum.

Mr Tucker—And there is the question of quantum, and that needs to be some function of science.

Senator SHERRY—So $5 million at the moment is probably under what is required for a firm or institution of your size but over what is required for others. So if it were expressed as a percentage of a fund's—

Mr Tucker—That would not be an unreasonable approach. Having said that, there should still be a minimum, because if you get to the point where it is 20 bucks, that is not really going to cover the thing that needs to be done. But we believe that provision must be made. These errors will happen. We are sitting here as an example of that. In our view there is an inadequacy at the moment in some of the provisions, particularly around relying on the custodian for the provision of the $5 million of capital. So, whether it be—and I agree with you, Senator Murray—through reserving or insurance or providing capital itself, these measures need to be put in place and agreed with the regulator. Each has a cost; each has a different level of complexity attached to it. But we would just advocate that this be put in place and provisions put aside.

CHAIRMAN—Do the retail or commercial funds all apply unit pricing?

Mr Tucker—In the main, yes, I understand. I could not categorically say every single fund does—not some of the older funds. I think we probably have one where it is not completely daily unitised, but, in the main, yes.

CHAIRMAN—What about the corporate funds and industry funds?

Mr Tucker—No.

CHAIRMAN—None of them?

Mr Tucker—No, some of them do, and many of them are moving towards it, I think.

CHAIRMAN—But they are in the minority?

Mr Tucker—I would not say they were in the minority now. I cannot give you a categorical answer to that question.

Senator SHERRY—Perhaps we could ask APRA to give us a list. They must know.

Mr Tucker—I think, historically, not-for-profit funds or industry funds have not provided daily unit pricing; they have provided a crediting rate and a declared rate. But more and more are moving to that because I think the best practice guide suggests it is the way to go. There are two issues that raises. One is, 'Okay, we've got to move to that, get the capability, build the systems and so on,' and that will expose errors more transparently if there are errors occurring. The other is that, with the current process, if you are not unit pricing, it is very difficult to determine whether there are any adjustments being made.

CHAIRMAN—So, when the performance of funds is assessed or highlighted, as is done by SuperRatings and other organisations, does unit pricing affect how that is measured?

Mr Tucker—It does not affect the way the performance is seen in terms of the percentage returns reported. It will affect the way a fund is rated by some of the research organisations who rate whether or not a fund is a good, well-run fund. They will look at whether unit pricing is provided as one of the categories if you are looking for an outsourced provider, for example. Pricing is important. With regard to reported returns, they are done in different ways by different types of business models, and some would advocate a change to that, including the consideration of some of the tax issues, but I think generally performance is not too badly reported.

CHAIRMAN—As the representative of a retail fund, do you have a reason why the industry funds seem to be consistently given better ratings than the retail funds in terms of returns?

Mr Tucker—In terms of their performance?

CHAIRMAN—Yes.

Mr Tucker—I could give you a view on that. It is that performance is measured in lots of different ways and over different periods of time. I believe that in recent times industry funds have had a higher allocation as to some private assets or some infrastructure type assets than the retail funds have had and that sector has performed very well. I think recently they have been coming back to the pack, as we would expect over time. There is no reason why an industry fund would outperform a retail fund as to investment performance over time. I would think that over time there would be reversion to a mean.

Senator MURRAY—As you know, economists always say that in the long run it always returns to equilibrium.

Mr Tucker—Exactly. I think the industry funds were well advised in some circumstances to move into some different asset classes that performed well. That has been to the benefit of their members.

Senator SHERRY—I think it is more accurate to say ‘some’ industry funds. I was particularly interested in trying to get information as to the bottom 50, which I understand does contain as many industry funds as the top 50 does.

Mr Tucker—There is some good marketing around those issues as well, and that is fine. With a typical retail fund, it is hard to compare the performance of that fund in a particular single category. Take us, for example. We are the largest platform provider in Australia. Through our platforms we offer access to hundreds of funds, some of which are run by MLC and many of which are not. So what are you comparing to? That is a fair question. Most people compare performance over a very short period of time. When you are considering superannuation investments, as you are all very well aware, you should be looking at a much longer term.

CHAIRMAN—How realistic is it to make forward projections of 40 years, as some funds do?

Mr Tucker—It is not hard to do. I am not sure how meaningful it is.

CHAIRMAN—That is what I meant.

Senator MURRAY—By the time you are proved wrong we are all dead.

Mr Tucker—We used to provide projections on our superannuation products many years ago, and all you knew was that they were going to be wrong, so that is how helpful they were. In many cases they can mislead people who think that they are going to get a lot more than what they are going to get if something does not work for them. It certainly might be helpful in determining whether they should go into a higher return asset class.

Senator SHERRY—I understand the argument. But I know that in the case of the Swedish model everyone gets a projection—but it is a projection; it is not a guarantee—and the parameters are set by the government actuary. I think that in the past in the case of some projections they have been part of the sales effort and have been a bit on the optimistic side, to put it mildly.

Mr Tucker—The crediting rates that were allowed to be used in the projections were actually set by either the actuarial standards or regulation. I think that when advisers are doing their work with their customers most of the time they will have a discussion with them about what they can expect. The way that advice works today is that there is as much to be gained by the investor understanding the differences in asset class performance as there is from picking a particular stock or a particular fund. What most advisers are doing is working back from the point where they know what a person needs to retire on for the lifestyle that they want to live, so it is about how much that requires them to have under certain assumptions. They work back from there as to how people should asset allocate and how much money they should be putting into things like superannuation. It is a quite sophisticated process for those who get advice. For those who do not get advice, it might be helpful for them to know they might not have enough in retirement under certain projection criteria, but I am not sure just how helpful that really is.

Senator SHERRY—On that, it is very difficult, given that we have got a means tested age pension, to work it out for a lot of low- to middle-income earners. You can do it but it is difficult. What will be their non-housing asset when they get to 65? That affects their age pension. What will be their super balance? That affects their age pension. It is pretty damn difficult to do. That is one of the arguments against having a means tested system.

I have just one other question relating to this underpinning issue, which is not touched on in any of the submissions, which is PI insurance and compulsory PI insurance. Do you have a view about that? It is currently an issue of contention that has not been finalised.

Mr Tucker—Whether there should be compulsory PI?

Senator SHERRY—Yes. Is PI insurance the correct model and should it be compulsory?

Mr McInerney—For planners?

Senator SHERRY—Yes.

Mr Tucker—My view is that it should be compulsory for planners, and there should be a minimum requirement for them to have the PI insurance. PI insurance only works when you honestly make a mistake, and that happens in any profession. It is good to have a safety net of some insurance to cover that. I am not too sure if there are too many who would disagree that there is a need for PI. It is prudent to have some.

Senator SHERRY—It is an issue of contention with the Westpoint outcomes. Some have it; some do not. Some have it, but it is not enough.

Mr Tucker—All of our advisers do.

Senator SHERRY—Okay.

CHAIRMAN—I want to go back to the foreword projections and the 'compare the pair' advertising. We heard I think this morning that essentially the comparison of foreword projections that were made in that promotional campaign assume the same rate of return for all funds but the differences are simply based on the fees that will be charged over the term being projected. Have you any comment on that?

Mr Tucker—I think the 'compare the pair' campaign is effective marketing. I think the information with regard to the dollars is difficult to understand completely. If you take the way I think those calculations were done it was taken on the average MERs of a retail fund, whatever that is, compared to the average fees in an industry fund. By the time the ads were out there, most of the retail funds had already dropped their fees and have continued to do so ever since because it is a very competitive marketplace. I assure you we have.

Senator MURRAY—Have you seen the current figures?

Mr Tucker—They are certainly not current if they have our numbers in there because we have changed our fee structures. Looking out over many years and assuming that there will be a fee differential for all those years is fraught with danger. I am sure they have thought it through and that is fine, but it is not something that we would do because we know that it will change. At the end of the day it is possible that the costs of industry funds may well go up and the cost of retail funds may well come down. In that scenario the numbers are, quite frankly, wrong.

CHAIRMAN—Another issue that has been raised quite strongly at our hearings is the issue of paying for advice through commissions, the argument about conflicts of interest this raises and that commissions in fact relate to selling a product rather giving advice. There has been a very strong argument put by a number of witnesses that for superannuation guarantees in particular commissions should be banned. What is your view on that particular issue and on the issue of paying for advice through the means of commissions generally?

Mr Tucker—I think we are on the record as stating that the commission system no longer delivers the value to the industry that it once did but, having said that, we do not judge people who take commissions as doing the wrong thing. Neither do we think that we will, for example, stop paying commissions. We would like the industry to voluntarily move towards a fee model over time. We think it is more transparent, we think it is more in the interests of advisers because they will attract more customers and we also think it is better for the customers in terms of

understanding how they are paying for the advice they are getting. We do not advocate any bans or changes to the regulations. We think the industry can move on this in a fairly short period of time to avoid the need for that, as any responsible industry should. It does take some time. The industry has been structured around commission for many, many years and it is very difficult for people to go home over the weekend and come back and change their business model. We cannot change the past—that is the past; what we can do is work together to stop creating the legacy of the future.

Senator SHERRY—I do not think that anyone responsibly would suggest a period of time over the weekend. Can you clarify what you mean by a 'short period of time'?

Mr Tucker—We are already getting over 40 per cent of our business on a fee-for-service basis. That is up from only 20 per cent a couple of years ago. We have been progressing the debate on this as much as we can, and my personal view is that over the next three to five years the majority of advisers will be operating for new business, new customers, on a fee-for-service basis. At the end of the day, the difference between commissions and fees is not that great, although it is built to be that great. Commissions must be disclosed now; they have to be understood by the customer. The difference between a commission and a fee is that a fee gives a client two fundamental rights. One is to negotiate that fee up-front and agree it and understand it with the adviser. The second is that they can stop paying it if they no longer think they are getting value for it. It could be exactly the same amount of money, the same dollars: two per cent is two per cent, whether it is a fee or a commission. It is simply that the client can see a fee more clearly and they can stop it if they do not like it at a future point in time.

Senator SHERRY—We have had a fairly significant discussion with other witnesses about some issues around FSR and the ability to deliver what is called limited advice within a fund. It might just be an advice around the level of death and disability insurance which you do not need every year but it may be desirable to deliver that in a limited form. It appears that FSR makes that quite difficult to do in a cost-effective way. Do you have any observations to make about the delivery of that form of advice in a fund in the context of FSR?

Mr Tucker—FSR has certainly added some cost to the provision of advice. I think its intent is fine, and I think the implementation is being worked through and some of the FSR refinements we have seen have been very good. There is still some work to be done around the definition of 'general advice' to ensure that where fairly simple and packaged advice is being provided it is not too cost heavy for most investors. I think there is work to be done on that. We would certainly agree that exempting or allowing some broadening of the general advice definition would be helpful to allow smaller account balance members, particularly younger people, to get access to advice without all of the cost related to the full advice service under FSR.

Senator SHERRY—The suggestion is made that in those circumstances the cost of the fee for that specific advice be debited against the member's account. Would you agree with that?

Mr Tucker—Yes, I would agree that we should allow members to access their super balances to pay for advice.

Senator MURRAY—To a capped level?

Mr Tucker—I do not have a strong view on that.

Senator MURRAY—The danger is that people might be gulled or conned by the unscrupulous—and I am not suggesting your company or your people would be, but there might be people out there who would be. Someone with a superannuation balance who does not have a sense of it being their money and of the same importance as if it was in their bank account might agree to a higher level of fee than they would otherwise accept. So for a trialling period you might want to see what the effects of that allowance was.

Mr Tucker—I am not an advocate of intervention with regard to what fees or commissions should be. I think the market should work on that.

Senator MURRAY—I am not suggesting that. I am suggesting the ability to access the account to a certain amount.

Mr Tucker—I think it is a difficult thing to do. What we are advocating when it comes to advice is that superannuation is one part of it. There are many other things that an adviser will deal with: budgets, cash flows, debt and other structuring, insurance and so on. Some may choose to access their superannuation to pay for all of that advice, and that might appear to be a larger amount of money than what would just be related to the particular superannuation fund balance. So a cap would be difficult. But I understand that concern, and perhaps we could come back to you with a thought on that.

Senator MURRAY—I do not know how the market will play out, and that is my caution. You know better than I what the average balance is now, but let us assume that we are talking about a low balance for a lowish income person of, say, $20,000 and the fee amounts to a third of that. It would be a very large slice of their balance gone. Until you have seen how the market plays out you would not know if that negative effect would occur. I wonder if you need an initial threshold just to see what is happening, and you can lift it later.

Mr Tucker—Your scenario is unacceptable—$8,000 out of $20,000 or something like that would be very strange unless there were complex and significant other affairs, in which case I would have thought the account balance would have been higher. Having said that, I think some safety net might be appropriate.

Senator MURRAY—Would you mind coming back to us on that?

Mr Tucker—We will.

CHAIRMAN—In your introductory remarks I think you advocated allowing fees to be taken from the superannuation accounts for purposes broader than just advice on superannuation. Can you enlarge on why you think that is justified.

Mr Tucker—In the provision of advice many other circumstances are taken into account than just the superannuation fund, and that is a cost. For affordability and accessibility to advice reasons, if we allowed people to take the cost of that advice out of their superannuation fund—

Senator MURRAY—Are you thinking of related issues, like insurance, wills, that sort of thing?

Mr Tucker—Yes.

Senator SHERRY—I think wills can be taken into account legitimately at the moment—next of kin. That does cause me concern, because we are dealing here with a retirement income system. I think there is a legitimate question around insurance in a retirement income system—maybe not so much TPD but certainly salary continuance. Is a retirement system an unemployment insurance system? That money will be diverted away from retirement income into other purposes. That is my general concern about that approach.

Mr Tucker—It will divert money out of the superannuation account in the short term, but it is recognising that somebody's holistic affairs revolve around more than just superannuation. A significant impact to their retirement outcome could be had by dealing with advice around cash flow issues or advice around how they structure their debt—with regard to the amalgamation of debt, with regard to gearing, and with regard to investing in moneys outside superannuation. So we suggest that thinking about protection of superannuation to the extent of 'We will not take fees out of that to help us to pay for advice on the whole lot' might slightly impact on their superannuation outcome but the advice, when taken in its totality, might have a huge impact on them.

Senator SHERRY—My concern is how slight. I accept it is a valid issue. You do need advice around a whole range of issues. The extent to which you can pay for it in the retirement income system is a difficult issue.

Mr Tucker—The example would be somebody who has, say, $50,000 or $60,000 in their superannuation account and has no other savings. Their affairs are not in good shape, and they need to get some advice around their entire affairs. The total cost is $4,000 or $5,000. They cannot afford to pay for it elsewhere. Do they forgo the advice on all the other matters and just deal with their superannuation fund and pay for it out of their fund? Or do they access the broader advice service, have a big impact on their overall circumstances, allowing them to then contribute more to superannuation because they have found free cash flow et cetera and therefore enhanced their retirement outcome?

Senator MURRAY—That is fine if the planner is ethical, honest, decent, properly motivated and professional, but for that small minority of humanity whom we always have to keep an eye on, that might not be fine because they might simply use that circumstance for profit, not for the benefit of the customer.

Mr Tucker—Unfortunately, there are circumstances where those planners do exist—very much in the minority. Hardly any still operate because of the change to the way advisers operate today.

Senator MURRAY—I am sorry, I don't believe you.

Mr Tucker—If we don't trust the advisers—

Senator MURRAY—There are crooked lawyers, crooked accountants, crooked politicians. You are not going to stop having crooked financial planners.

Mr Tucker—I agree that there are always going to be people like that, but that does not mean we cannot design a system for those who are honest. There are many other ways for advisers to make ill-gotten gains, if they are dishonest, than simply accessing somebody's super fund for advice fees. We have seen that, unfortunately, in many different ways. This is just another potential opportunity, although I think the benefits of this far outweigh the risks.

Senator SHERRY—You mentioned dial-up in your introduction, which is a fairly radical flip-around of the dial-down model. We were talking about this to some previous witnesses before you came. Is it the MLC's intention to introduce dial-up?

Mr Tucker—We have dial-up on all of our product range. We have introduced a platform and service that is specifically designed for fee-for-service advisers. They can collect their fees through the platform, through a specific dial-up. It is dollar disclosed in the statement annually and it can be turned off by the customer. Having said that, we need to be clear we still pay commissions on other products and services. As the industry transitions, that will be less of the new business; more of the new business will be on these more modern products.

Senator SHERRY—I think I have asked the FPA, I would have to double check—I would not expect you as a company to answer this as I think it would be unfair, but I am interested in retail industry statistics about what is the average level of commission, how many people do succeed in managing to get it negotiated down or up. I just do not get the sense that it is competitive, that there are price pressures on the commission structure. I would be a bit more confident if I knew that Joe Smith was going to your planner, then into Colonials and then into AMP and sitting down and saying, 'That person is the best person for me, the fees are lower and they're going to give me the best service.' I do not get any sort of impression that we have got tough competition on your planners out there.

Mr Tucker—Perhaps I could give you a view. I think it was in 1994 that the up-front commission on the average superannuation contract was 127½ per cent. Today it is more like two.

Senator MURRAY—Was it? Goodness me!

Mr Tucker—Those contracts were old-fashioned contracts; they were sold as products in a product sales environment—and there was nothing wrong with that. There was nothing wrong with what people were doing; that was the design of the product at the time. Today the product is much different to that. The average commission is more around two per cent. I could not give you a specific industry statistic, but that is more like our—

Senator SHERRY—Does the industry have statistics on this? I am not expecting you to give me yours; it is the industry statistics that would be useful.

Mr Tucker—We could find out for you. If you take where the market will head, Godfrey Pembroke, one of our dealer groups, has 100 per cent fee-for-service for new business from now and their growth is very strong. The world did not end and plenty of customers choose to do

business with them in that way. Granted they deal with people with considerably large amounts of money in the main, so it is easier for them to do that, but there is progress that is going on in the industry and I think that circumvents any need for any regulatory or legislative change around commissions.

Senator MURRAY—Or interventions.

Mr Tucker—Yes.

Senator MURRAY—Your message is what, that it is essentially early days and we need to let the market mature? Is that what you are saying?

Mr Tucker—It has been a debate for some time that the system is fine, leave it alone. But today, what you see in reasonably large numbers is advisers choose themselves to change their business model, for very good commercial reasons mind you, to a fee model—that is, they are finding more customers to talk to because they like to deal with them on that basis. They are in control of their own destiny when it comes to their remuneration, how they get paid by the clients, so we are seeing that challenge being taken up by many advisers. The product providers, such as us and many others, are providing the products that allow them to operate in that—

Senator MURRAY—Sorry to interrupt: does that mean you are seeing a greater sense of independence and you are less able to—I do not mean MLC; the industry producers, if you like—leverage these people?

Mr Tucker—I think that is—

Senator MURRAY—Shifting to fee-for-service implies that you are not dependent on—

Mr Tucker—Shifting to fee-for-service means that you are not being paid by the product provider, you are being paid by the customer who is getting advice from you. We are seeing a transition between a product sales world into a professional world. We have been there for about five or six years now. FSR has been pushing that along quite nicely. Advisers are choosing to move to the more transparent model because—

Senator MURRAY—My question is different. I want to know if you are seeing more aggressive competitive pressures because those people who are at the front end selling the product are no longer dependent or no longer as dependent on the product supply as they were before, because they have changed their fee system. I would expect there would be upstream pressures therefore on the product supplier to adjust their product to meet the needs of the new marketplace. I am really looking for an answer as to whether in your view enhanced competition is resulting at the front end.

Mr Tucker—Yes, I think competitive pressure is emerging in the fees on the products and platforms themselves. They are coming down all the time. A scale emerges and so on. In the advice world, whilst advisers will be aligned to a group like ours where they get certain services and certain licensing arrangements, they actually pay us a fee now rather than a percentage of their revenue. In many cases they are not dependent on the revenue that is coming from a product from commissions for their livelihood. So they can operate and choose to move around

if they want to do so. Many of them still get a large amount of revenue from commissions from the past. We cannot change that. That is the old regime.

Senator MURRAY—It is contractual.

Mr Tucker—Yes.

CHAIRMAN—How do you deal with this issue that has been put to us, particularly by representatives from the industry funds, that financial planners will not have them on their approved product list because they refuse to pay commissions to planners? How are you handling that as a product provider?

Mr Tucker—The reality is that we have plenty of advisers who are operating 100 per cent fee-for-service who also do not choose to use industry funds. The reason is these advisers are operating in a sophisticated advice world and they need to implement their recommendations through a platform that allows them to do that. Industry funds offer one tax structure—superannuation—and in many cases limited investment options beneath that. If you take our platform, we offer ordinary money, superannuation money and pension money. We have a significant choice of investment manager. We offer sophisticated consolidated reporting, tax reporting, access to daily unit pricing and so on. If an adviser is going to implement sophisticated advice, they need all of those services in the platform that they choose. So I do not think they are not choosing to use an industry fund because it does not pay commission; I think they are not choosing an industry fund because it does not offer, in many cases, all of those services they need to implement their advice. That might change over time. Industry funds might start to move into ordinary money and insurance. That might mean that they become more appropriate as a choice.

CHAIRMAN—So what you are saying is it is a matter of comparing a Caprice with a Commodore or something?

Mr Tucker—I think it is a matter of, in many cases, when industry funds or retail funds are compared, we are not comparing apples with apples.

Senator SHERRY—To some degree, but what about where an individual goes to a planner specifically for a superannuation product—specifically. I question the validity of the approved product list in that context. Why shouldn't it be open to a planner? We have got 300 licensed super funds in this country. I accept there is an access to information issue, but I think that is resolvable. Why should we have an approved product list for superannuation? Other financial products are a different issue. I accept that that is a different debate altogether. But why shouldn't a planner be able to recommend an e-fund, provided they get an income?

Mr Tucker—Superannuation is not an asset class. It is a tax structure.

Senator SHERRY—Yes, I agree.

Mr Tucker—So when you have a recommended list as we do as a licence holder, we have responsibilities to ensure that what the advisers are using to implement their advice is appropriate. We have all sorts of different reasons for a recommended list. Should hedge funds

be on a recommended list? Well, they can be on a recommended list, but you should only be able to use them if you have been trained in them. Should we allow lending margin facilities? Should we rate those providers? When it comes to superannuation you are not just choosing a licensed fund. In many cases you are choosing investment beneath that fund. That needs to be researched and rated so that we ensure that when our advisers are giving advice they are using the high-quality products that are out there. We cannot research and recommend every single investment option in the marketplace.

Senator SHERRY—I was not suggesting that. I was suggesting that, in respect of superannuation, if there are 300 and they are all licensed—

Mr Tucker—They are all licensed but they all have an investment strategy. They all have underlying funds that are available or not. The research is not so much being done on whether that is a well-run, well-administered fund. The research is done on the investment process, the investment philosophy, the investment techniques and the quality of the investment managers underneath that.

Senator SHERRY—But, as you said earlier, longer term there is no reason why the investment rate of return for the various classes of investment would be any different.

Mr Tucker—What I said is that there is no reason to believe that, for a balanced fund over 30 or 40 years, an industry fund would outperform. I did not say that does not mean a retail fund would outperform.

Senator SHERRY—I do not think you used the word ‘balance’—but anyway. It begs the question as to why AMP put 12 industry funds on their platform.

Mr Tucker—I have no comment.

Senator SHERRY—They are not here to hear my questions on that, but, if they can do it—although I have suspicions about why they did it—

Mr Tucker—There is no demand from the advisers who are doing complete advice for industry funds at this stage, because they very rarely only implement advice as it relates to superannuation.

Senator SHERRY—But wouldn’t there be some consumer demand, particularly around the advertising campaigns that have been conducted? If someone goes to a planner and says, ‘What do you think about HOSTPLUS?’ the planner will say: ‘I can’t tell you; it’s not on my approved list.’

Mr Tucker—If somebody goes to a planner and says, ‘What do you think of HOSTPLUS, I presume the planner would say: ‘They’re fine. Let’s go through a financial planning process and work out what you really need.’

Senator SHERRY—Yes—and switch you out. That is what I think they would do.

CHAIRMAN—Another issue that has been raised, not quite so frequently but on several occasions, is the issue of planners requiring fund managers or product providers to pay platform fees to get their product onto their list. In a sense, it is the reverse of the commission issue. What is your view on that process? I have had representations from several fund managers who say, ‘We refuse point-blank to pay platform fees and, on that basis, we don’t get onto some of these planners lists even though our performance is among the best.’

Mr Tucker—We are working very hard as a company and as part of an industry to move to a more transparent business model, as we have said before, around fees and commissions. I do not think that shelf-space fees are in the interests of the industry; we do not pay them. When we use our scale to receive lower prices on funds that are on our list, we pass them 100 per cent on to the customer by way of lower prices; we have done this for four years now. It is our strong view that, whether or not shelf-space fees in reality introduce actual conflict, the perception must be that the reason why you are paying a shelf-space fee is to get on the platform, and there must be a question about whether that biases towards that fund the underlying advice that is given.

Senator MURRAY—Absolutely. It pushes other products off the shelf; that is what it does.

Mr Tucker—We have said, no, we will not be paying shelf-space fees. In its simplest description it looks like another form of commission.

CHAIRMAN—Are you suffering as a consequence of that?

Mr Tucker—We suffer from anything through these funds! Yes, there is a lot of discussion and debate about this in the industry, but again I think it is another matter for the industry and it will resolve itself over time. I think people will choose their business model as the market allows them to. It is not a practice we support.

Senator MURRAY—I think shelf-space fees have a deeper problem. I think they are an anticompetitive device and result in the arbitrary exclusion of products for profit. I think it leads to poor outcomes. I know they are common—that is why it is called shelf space—but I think the anticompetitive aspect deserves a good look.

Mr Tucker—In our view, a platform is an administrative service, not a distribution business. Your product might get looked at and knocked back, but if, due to not paying an access fee or a shelf-space fee, you do not get your product looked at, that is potentially reducing the choice the investor might have. It is often said, ‘What is the difference between paying a shelf-space fee to a platform and paying a shelf-space fee to get your toothpaste on an eye-level shelf in a supermarket aisle?’ But we are dealing with people’s financial futures; we are not buying toothpaste.

Senator SHERRY—I am glad you reject that supermarket analogy; it is a favourite analogy of another operator.

Senator MURRAY—It is an anticompetitive device in supermarkets, too.

CHAIRMAN—I think the same principle applies.

Senator MURRAY—I think it is highly suspect. The fact that it goes on does not make it desirable.

Mr Tucker—So your question is: are we being damaged by the position? I think in the short term, possibly; in the long term, I do not think so.

Senator MURRAY—You are big enough not to be.

Senator SHERRY—Doesn't that raise an issue, though, with respect to your position that you have outlined on the long-term future of commissions and where the industry has to be, which I accept is a position that is more advanced than many others. Don't you perhaps pay a penalty for that approach and the shelf-space fee issue when others are not prepared to move? Therefore there is a legitimate argument about ensuring a regulation to phase it out over time so that you are not placed at a disadvantage and it is a level playing field.

Mr Tucker—We believe in the industry and that it is fundamentally going to get there on these issues around transparency. The difficulty, as with any structural change—and that is what this is: people say that the industry has structural shifts; 127½ per cent to five is pretty structural, but it can get there and these businesses are resilient—is that it does take some time.

Senator SHERRY—I accept the argument of time.

Mr Tucker—A regulated outcome will force a point-in-time outcome which may well be to the detriment of many customers because it will force some people out of business.

Senator SHERRY—Sure, but at the same time the entire industry has been underpinned by force and compulsion implemented over time, beautifully phased in to the point where it is worth about $1 trillion today. I want to move to another issue of competitive disadvantage, and that is the self-managed super funds. I mentioned to you earlier that the Institute of Chartered Accountants appear to be taking a different attitude to the carve-out. According to the submission—I think you are right with your attention to the fact: and it was not the headline of the shadow shopping exercise; that was mentioned by others—of the 22 cases of advisers misselling on SMSFs, which I think is probably the tip of the iceberg, 18 of them were accountants. Should we have a transition period for ending this exemption or should the exemption, the carve-out, be ended as soon as possible?

Mr Tucker—Yes. We believe it should be in as soon as possible. Simply, it is misunderstood. I can understand why accountants can give advice to a point and then can no longer go any further. It is very difficult to understand. It is very difficult, if you think about the real world conversation with a client, as to where that stops and starts. What that is showing is that there is no question about the honesty and the integrity of these people. I think it is confusion as to what they are allowed to do and what they are not allowed to do. I just think over time you will see convergence between what many accountants and financial planners are doing and you will see a need for a level playing field in terms of regulation and financial advice.

Senator MURRAY—I have a question on consolidation of accounts. I would like to pass on a compliment to your company. I have heard it said that your company facilitates consolidation of accounts and is helpful and swift in the process, in contrast to others who make sure they hang

on to other people's money as long as possible before transferring the accounts to consolidate them. Do you have a system of sampling, exit interviews almost and entry interviews, to find out how well regarded you are versus your competitors on an issue like consolidation? Bear in mind this is particularly important now with the simple super regime coming in which will tax people at 46½ per cent if they do not provide their TFNs, and some of those that need consolidation sit in that basket.

Mr Tucker—We survey our customers on a range of satisfaction measures. We like to see where money is going when it leaves and we like to know where money is coming from as it arrives. Our view has been that we will try to facilitate as efficient a transfer of moneys as we can in the industry. There is no point in hanging on to money. I am not sure whether people do that deliberately or whether they just have complex systems. It is complex at times to get money out from some of the older products and so on. We offer a service that will collect moneys for people, through transfer protocol, to try to help to consolidate their different accounts. But when it comes to paying out, we have service standards that we try to meet and we meet them as often as we can.

Senator MURRAY—The feedback to me is that you are particularly good at both ends—receiving and sending—

Mr Tucker—Thank you.

Senator MURRAY—in complete contrast to another major, who takes twice as long, is twice as difficult and is obstructive in the process. My little nose tells me there is a suspicious element to that. I wondered if that had reached your ears as a strategy in the industry?

Mr Tucker—No. I have no strong view on that.

Senator SHERRY—I want to address one last point: the issue of constant change. We have seen another series of major changes as a consequence of the budget and we have anti money laundering measures coming up, although they are not perhaps as significant for superannuation and the life industry as for other financial institutions. Is all this constant changing of your systems coming at a cost? Is it time for a bit of a breather?

Mr Tucker—It is a complex and very changeable world, so we need to make sure that we keep up to date with current regulation, legislation and so on. That is not going to go away, we do not believe. We now budget for these things rather than not budgeting for them. The changes to some of these things cost, in our case, many millions of dollars. MLC is Australian Eagle, Capita, National Australia Funds Management and so on. There are a number of companies there that need to have systems that are interacting all the time, so the changes are onerous. We would like to see more rigour around cost-benefit work when it comes to change, to ensure that what can be a significant cost to the industry is of real benefit to the customer. Through my work on the Regulatory Affairs Committee I know that IFSA is advocating more rigorous work around cost-benefit analysis of regulatory change. But we also accept that there will be fairly constant requirements of us to change as regulation changes. A break would be nice, but I am not sure that is possible.

Senator SHERRY—It must be a fairly challenging environment. For example, take the new pension product from 1 July. We just had the introduction of TAPs two years ago. Frankly, that is going to be largely irrelevant going forward. That is just an example of a system with significant cost in IT which was largely made redundant a few years later.

Mr Tucker—There is significant cost in these things. I think that, whilst there is a cost to this round of superannuation changes, the benefits are terrific. Customers will benefit greatly from those changes, so, as a cost of business, we wear those costs. I think we need a practical approach to the implementation of some of these changes—for example, AML. That is a big cost for industry. The time frames and phasing of these things are important because you simply cannot deliver the outcomes in the times and with the controls—

Senator MURRAY—Do you need special tax treatment, a special tax concession? It is essentially an exogenous IT shop which results from an international change which governments then carry on through into business. It is not a natural regulatory trend. It is a consequence of a major shift in international demands for higher regulation in this area. In other cases where governments have had to address that sort of thing they have provided a special tax regime to give business a financial breather.

Mr Tucker—It is a significant cost and any relief, of course, would be welcomed.

Senator MURRAY—The precedent is there. I think there was a special tax regime that came through for the millennium bug. There was a $2 billion cost imposed on business—I think there was a special tax advantage provided there.

Mr Tucker—As I said, any relief would be welcomed.

Senator MURRAY—I am not suggesting this in an idle sense. I think business is obliged to accept regulatory shifts as they occur; they are part of the normal pattern of the social contract, if you like. But where you have an exogenous shock arising—in this case from the Basel and other agreements—it does seem to be an impost which deserves some relief.

Mr Tucker—If you take AML, it is a very significant multimillion-dollar program. The costs will be borne by the shareholders in some regards and by investors in others. We live in a world where these things come along fairly regularly, so you do plan for them. But, as I said before, I can only agree: any relief or support to business to reduce the burden would be seriously welcomed.

CHAIRMAN—Thank you for your appearance before the committee. It has been very useful for our inquiry.

Senator SHERRY—They were the only retail fund to front.

CHAIRMAN—This is true. They are to be commended for that.

Mr Tucker—Thank you. Good luck with your inquiry.

[4.33 pm]

CHAPMAN, Mr Keith, General Manager, Policy Development, Australian Prudential Regulation Authority

HENNESSY, Ms Merrie, Adviser, Policy Development, Australian Prudential Regulation Authority

JONES, Mr Ross, Deputy Chairman, Australian Prudential Regulation Authority

VENKATRAMANI, Mr Senthamangalam Ganesan, General Manager (Central), Specialised Institutions Division, Australian Prudential Regulation Authority

CHAIRMAN—Welcome. We have before us your submission, which we numbered 51. Are there any alterations or additions with you wish to make to the written submission?

Mr Jones—No.

CHAIRMAN—I invite you to make an opening statement, after which I am sure we will have some questions.

Mr Jones—I will just make a couple of quick comments focusing on the main points in our submission. As we noted in our submission, the two-year transitional licensing period for trustees ended on 30 June 2006. During this time, the long-term trend of consolidation continued. We have now issued just over 300 trustee licences and, as at 30 June 2006, trustees granted licences have combined assets of around $560 billion out of the total of $900 billion, the remainder being the exempt public sector schemes and the self-managed super funds. The main point for us now is that the APRA-regulated sector of the superannuation industry is licensed in a way which is broadly similar to banking and insurance and is consistent, I think, with the increased levels of complexity in the industry and the policy objective of giving fund members a much higher level of prudential oversight that existed before. The industry is far more sophisticated than it was in the past, and the consequence of this is that the rigour of prudential supervision has increased post the licensing period.

I will quickly turn to some aspects of our forward supervision program in granting a licence and registering the licensee’s funds. APRA has relied very much on the trustee’s documented business plans, the structures and controls that ensure the risk management framework exists. As a consequence, to embed the increased security of the new regime, in the next 12 months we are going to assess whether what was put to us in written policies during the licensing period actually reflects the practice, and is adequate in light of emerging market conditions.

We have also embarked on a review of guidance material issued in the licensing period and we are continuing to revise our superannuation circulars to ensure they remain relevant to the changes. I think in the next 12 months also we are going to be expanding supervisory practices to cover operations of the service providers. We will look particularly at the risks to which they expose fund members. The other element I would like to refer to briefly, also in our submission

and linked to one of the terms of reference, is the cost of complying with regulatory requirements. This is one of the themes that emerged during the process. I note that several submissions refer to costs incurred in establishing policies and processes to meet licensing requirements that were additional to the application fee and the levy. Others referred in particular to the costs of dual reporting to us and to ASIC.

We put in our submission that our approach to regulation is very much principles based. It is based on what we consider to be good practice for the industry. I think in approaching the cost of regulation we would consider that the only costs that would be extra to the entity's own management requirements in operating an environment would be the ones that you considered. The ongoing supervision cost as represented by APRA's share of the levy represents less than 3c per week per member account compared to the industry costs of fees administration of about $1.85 per week per member account last year.

In terms of the other regulatory elements, we are working with the government and other agencies to reduce the incidence of reporting without compromising the rigour of the regulatory scrutiny. While this project is underway, APRA has recently made available web-based mechanisms to facilitate breach reporting by superannuation entities. The other theme that emerged in the written submissions and during the public hearing process relates to the guidance material which is provided by APRA with regard to trustee responsibilities and investment choice. It has been put by some of the submissions that our interpretation of the act undermines member investment choice to the point where trustees are unable to rely upon financial planning advice given to members.

Our revised investment management circular, which was released in March of last year, had very extensive consultation with industry and the relevant government agencies. The issue that received a lot of attention during that process was the role of the trustee in formulating investment strategies. Whilst the SI(S) Act does not expressly prevent a trustee from considering financial planning advice, a trustee must consider all the circumstances of an entity when formulating and implementing an investment strategy. Consequently, our approach has been to take the view that the extent to which a trustee recognises financial planning advice would be incidental. We also note that the trustee does not have the ability to take into account the individual's circumstances outside the fund itself.

In summary we see the separate role of financial planner as providing advice to individual members about the allocation of the member's interest in the fund between the choices offered by the trustee and within the parameters set independently by the trustee. As I stated in our submission, we believe that the trustee deliberation and involvement in offering investment options is in fact the core of a robust superannuation system. They are really the main comments I want to put on the record at this stage. We are quite happy to take questions.

CHAIRMAN—Thank you very much. One of the issues that has been raised consistently during the hearings we have conducted is in relation to APRA's guidance note on the trustee's role in member investment choice and where the responsibility of the trustee lies in determining investment as against the role of a member and perhaps the advice the member is receiving from an adviser. Are you aware of that issue that has been raised and the concern about it? What is your response?

Mr Jones—Absolutely. It is an issue that was raised during the consultation period with regard to the investment circular. The essential view that we have taken all along is that the trustee has the primary responsibility and it is up to the trustee to determine the appropriate extended investment choices that a trustee makes available for the individual to choose from. The trustee has an obligation to ensure that there is an appropriate level of choice being made. But, more importantly, the trustee has an obligation to ensure that the options that are made available are consistent with the operations of the trust.

CHAIRMAN—Isn't that limiting member choice?

Mr Jones—The member does not have individual and endless choice. The choice comes from the options that are provided by the trustee. The requirement of the legislation is that the trustee determines a set of choices and the member can choose from those various choices.

CHAIRMAN—Another issue we have just discussed is unit pricing. I have been discussing that at some length. A witness put the view that he thinks the industry is moving more to unit pricing. Do you regard unit pricing as important?

Mr Jones—I guess we are a bit agnostic. With unit pricing or crediting rates, both have potential risks, benefits and downsides. We do not take a strong view one way or the other. I think it is the case, though, that more and more are moving towards unit pricing. Our view is that depending on which approach you have taken you then need to ensure that you have fairly robust mechanisms around it to ensure that you are doing it properly. We and ASIC put out the unit pricing guidelines 12 months ago which pretty much says that, regardless of whether you are using unit pricing or doing a crediting rate, there are certain things you need to be careful of. One of the things I would say, of course, is that, since the guideline has come out, the frequency and size of unit pricing errors that we are finding is decreasing. That is a fairly positive thing.

CHAIRMAN—Another issue is the security in terms of capital adequacy—whether there should be uniform capital requirements or whether the custodian system is adequate to provide protection or insurance.

Mr Jones—Once again, we are fairly agnostic on this. There are processes that are designed to ensure the robustness of the arrangements. We would be concerned if the process was not robust. In terms of whether or not there is one preferred mechanism, I do not think we have a strong view either way.

Mr Chapman—No.

Senator SHERRY—You mentioned an examination of risk levels for the service providers. To me there are some obvious ones. Which service providers are you looking at—which areas of service provision?

Mr Jones—We would probably be looking at a variety of them. But up until quite recently we just did not have the ability to look at any outsourced services—even the nature of the investment provisions or auditors or anything else. None of these things were easy enough for us to get access to.

Mr Chapman—That is a new process for APRA but it is not a new process in the regulatory regime.

Mr Jones—Yes.

Mr Chapman—Previously the ISC carried out an extensive custodian assessment and administrative assessment.

Senator SHERRY—It obviously involves some reallocation of resources to do that work. Presumably you would move the licensing resource there and have some reallocation towards the service providers.

Mr Jones—Yes. Even though the end of the licensing was 30 June last year, as at about 30 June there were still about 800 wind-ups. So there was still a lot of cleaning up. We actually did not disband our super licensing team until 31 December. You are quite correct—we now have the ability to start shifting resources. The main thing we are doing at the moment, actually, is the first reviews post licensing and seeing the degree of compliance with—

Senator SHERRY—With the business plans.

Mr Jones—Yes—with the plans and the RMSs and so on.

Mr Chapman—One of the other reasons for looking at the outsourced providers is to also to get some efficiencies out of the process. We now have a much greater concentration on small numbers of providers than we did in the prelicensing regime. And while we found over time it is important to look at the interface between fund X and provider Y, if you have a high degree of confidence that provider Y is doing the right thing, you then only have to check the interfaces. You do not have to check the substance of the actual function for every fund that you supervise.

Senator SHERRY—In terms of the service provision, let us take administration providers. Do you keep a list? Are the admin providers licensed?

Ms Hennessy—Not by us. They are licensed by ASIC.

Senator SHERRY—So you will look at the connection; you are not going to look at the internals of the service provider, an admin provider, for example.

Mr Venkatramani—We would intend to look at it. For example, administration, as Keith points out, is a fairly concentrated industry; there are only a handful. We are interested in risk, given the preponderance of operational risk in superannuation, and most of that risk does get filtered through administration arrangements. It looks at the manner in which administrators operate, whether it is bank accounts or contribution receipts or benefit payments or insurance arrangements or liaison with employer sponsors. We want to understand those processes and hopefully they meet the outsourcing arrangements which individual or overseas licensees have in turning to these administrators, and manifest that appropriate risks have been considered by the trustee and built into the risk management plans. Yes, it is our intention to work through them. As Keith points out, once we have done that, we can extrapolate those lessons into all of the funds which they service so that we do not have to redo that work.

Senator SHERRY—Given the small number of admin providers, for example, if the worst happened and their entire system crashed, the impact would be enormous in terms of the number of funds that—

Mr Jones—It could well be, because of their concentration.

Senator SHERRY—Yes. Are there any other service providers with a similar level of concentration?

Mr Venkatramani—Custodians.

Mr Jones—Custodians in Australia would be major ones.

Senator SHERRY—You gave me some information in an answer to a question on notice where you provided the compensation made under Part 23 of the SI(S) Act—a running list of the funds and the quantum. I have a couple of follow-up questions. Did Commercial Nominees involve some element of compensation for the self-managed super fund structures? There were many of those involved in Commercial Nominees and I am interested in that because—I mean, my understanding is self-managed super funds are not compensatable under Part 23, but did they get some sort of indirect compensation as a consequence of Commercial Nominees holding operations for the wrong group, if you like. There were quite a number of grants given.

Mr Jones—I think the answer is no, isn't it?

Ms Hennessy—There were some small funds that were APRA- regulated at the time and then they broke up and became self-managed funds later on. I think the fact that they participated in the eligible loss, if you like, meant they were entitled to some compensation.

Senator SHERRY—Could you clarify that for me? I was not sure how you had drawn the line in that case.

Mr Jones—If they were small APRA funds, if they were SAFs, they would be covered. But if, at the time, they were self-managed funds, I do not think they would—

Ms Hennessy—No, but if they were, say, five-member funds, for example—

Mr Chapman—And the self-managed funds should not have been covered, because the redress was the investment losses of the funds, not the losses of the underlying investment. That would be where there is a potential indirect effect, but that was not the case.

Senator SHERRY—Perhaps you could take this on notice: the number of people who received for each fund—you gave me the number of payments and the number of grants and the total figure—if it is readily available. I do not want you to have to go through the files.

Mr Jones—We will do what we can. I am not quite sure if we can go back and get the total number of people.

Senator SHERRY—The total number of members of each fund. Presumably they would have all been—if you can get the data.

Mr Jones—Yes, we might be able to do that.

Mr Chapman—Ballpark figures.

Senator SHERRY—The other question I had on the answer in this area is on the table you gave me on investment losses outside part 23 of the SI(S) Act—obviously they are not compensatable—where there was a 'serious breach' of the prudent person principle. How did you determine that definition 'serious breach'?

Ms Hennessy—We looked at the enforcement cases. That was the only way we could do it. All these were examples where we took enforcement action, there was an outcome and it was quantifiable.

Senator SHERRY—Okay. This is the first time I have seen a consolidated list of these published. I know it was an answer to a question on notice.

Mr Jones—We would publish these things in our annual report each year but, as you say, that is an aggregate list.

Senator SHERRY—Yes, it is consolidated.

Ms Hennessy—I think all of these were on our website as media releases.

Senator SHERRY—We had a fair discussion with Mr Brigden of the Law Council. Did you read their submission?

Mr Jones—Yes.

Mr Chapman—We have read their submission. The bit that sticks in my mind is the comments about APRA effectively having the ability to set legislation through using conditions. Is that the area you discussed?

Senator SHERRY—Yes. I drew their attention to it. One of the issues they were critical of was guidance notes and your licensing process—that effectively de facto you are setting the rules beyond that which you can do in the legislation. Do you have a response to that?

Mr Jones—We do not think that is correct. The other element to this is that my impression is that the consequence of what they wanted would have been greater precision and greater regulation.

Senator SHERRY—They are arguing that guidance notes should effectively be replaced by clear regulation. I think that was the point.

Mr Chapman—As we read it—and Merrie has just reminded me of the words—they were talking about us imposing conditions on licences as opposed to guidance notes per se. We have

the same power in all the legislation. We have had that power for limited numbers of trustees ever since the SI(S) Act came in in 1994. We actually see that as being a very powerful way of recognising the circumstances of individual funds. From one point of view, yes, I think it is a legitimate to argue that all those things could be put in law, but we would then have to have some process where we can say that these things do not apply, because it is not a one size fits all, particularly in the market we are now in where we have a small number of very large funds with individual idiosyncrasies.

Mr Jones—You certainly finish up with very prescriptive and endless regulation to try to cover every set of circumstances. There is flexibility in this. On the counter side, of course, you could always go to the Federal Court.

Senator SHERRY—I am glad you raised that, because we then got onto the practicalities of a fund taking you on.

Mr Jones—Come on—funds taking us on!

Senator SHERRY—Yes, that is right. Put aside the AXA issue, which we also discussed.

Mr Jones—No, we did not mention it.

Senator SHERRY—No, you didn't. Under the sole purpose test, if a fund believes that they need to take legal action—and not just against yourselves—there are difficulties that trustees could face, which we discussed, because it could be seen as them not protecting their members' interests in taking legal action and objecting to an APRA view of the world. This was because of (1) the practical issue of resources, the size of the funds and taking on APRA—this great regulator with limitless resources, deep legal expertise and experience et cetera—

Mr Jones—Keep going!

Senator SHERRY—It would be tough to win a fight. Can they do that within the sole purpose test, if they want to challenge you legally? You would effectively determine that, actually.

Mr Jones—A simple answer is yes, they could legally challenge us. But I think probably the better approach is to think that, from our point of view, it actually provides a greater degree of flexibility. That is why with the imposition of licence conditions we are able to say, 'Yes, we will grant you a licence and, in return for granting the licence, we expect you to do the following things over the next six months,' and we can put those as licence conditions. In the absence of that, it may well have been simply saying, 'No, you don't meet the circumstances and we're not going to give you a licence.'

Ms Hennessy—And the specific conditions for that institution are reviewable, so they can be challenged at that point.

Mr Chapman—It is not only a super issue: we apply the same process to the other industries. Fair enough, lots of the conditions might not be as lengthy as they are in the super industry, but we have conditions for all the other industries we supervise as well.

Senator SHERRY—I think in this case at least part of the argument was that for the trustees, certainly in a so-called not-for-profit for members, there was a question mark about the degree to which they could effectively exercise any legal remedy.

Mr Chapman—One of the reasons I was drawing the analogy with the other industries is that we apply conditions across the board and the number that have been challenged and overturned is fairly low. Only quite a small number have been challenged, so we do not make capricious decisions to impose conditions in the first place. And of the ones that have been challenged—I am not sure we have had formal challenges in other industries—we have had changes. So, again, we are open to: 'Well, this does not work for us. We need it done differently.' That is precisely the reason we think we should have the power in the first place, because otherwise those conditions would be set in law and we could not change them.

Senator SHERRY—Have there been any formal legal challenges as a consequence of the licensing process?

Mr Jones—As a result of the super licensing process?

Senator SHERRY—Yes.

Mr Jones—No.

Senator SHERRY—In the context of related party transactions and entities, which we have had a fair old discussion about, when you carry out the licensing process how would you treat a retail fund, for example, because most of them do their own administration, they have planner entities and planner connections and their own in-house asset consultants? A lot of their people are in-house related parties. How far did you drill down beyond the trustee and the board level?

Mr Jones—In the first instance, for any of those sorts of arrangements, the trustees are expected to be able to show that they had formal arrangements in place, that there were termination dates, how they chose particular service providers and so on. So the process was no different between a retail, an industry or a corporate in that sense.

Senator SHERRY—Sure, but with a corporate and an industry fund, don't you have guidelines that require competitive tendering for the various service provisions?

Mr Venkatramani—We have not mandated competitive tendering anywhere.

Senator SHERRY—I know you have not.

Mr Venkatramani—We have not said, 'If you do not do it, you are in trouble.' All that we have said is that it would be good practice. But the more fundamental tests are: how are you able to determine, given your fiduciary obligations, that whatever you are proposing is in the best interests of the members; having chosen a service provider, what kind of arrangements are you putting into place; what kind of pricing have you obtained and should things go wrong—and we are talking about operational risks here—which will happen from time to time, what are your remediation control measures? We even ask, 'What would be your termination arrangements

and, should termination occur, how would you make sure that ongoing service to the members takes place?' Those tests are common across the industry.

Senator SHERRY—I was going to get to the point of how practically that is applied to the retail section of the industry. Where you have done that, haven't you also—not mandated—suggested—

Mr Venkatramani—Strongly suggested.

Senator SHERRY—'Strongly suggested'? I will accept that as a compromise. Let us take the issue of where it is done in-house at the moment, and some funds do have some operational aspects in-house. Again, you have strongly suggested some sort of benchmarking exercise against other operators. That is true, isn't it?

Mr Venkatramani—Yes.

Senator SHERRY—How have you applied that approach in the case of a retail fund? Are they benchmarking and contracting out their admin services, their planner services and their funds management services? I do not see how practically they could be doing that.

Mr Venkatramani—To the extent it immediately impacts a super fund, which is our focus—whether it is an administration service, an investment service or an asset allocation service—we do go through the processes which the trustee has taken into account. Sometimes, the bigger the entity, there are actual beauty parades taking place with the help of external consultants. An external consultant is assigned, and we go through those processes because—

Senator SHERRY—But I cannot believe that, say, AMP do this or MLC or Colonial. They have got their own structures internally. Why would they contract out those areas of their service?

Mr Venkatramani—They contract those areas out with those internal parties. Whether they are internal parties or external parties, the outsourcing standard applies regardless.

Senator SHERRY—So you would strongly suggest that they go through a competitive tendering process for those sorts of service provision.

Mr Venkatramani—Or, alternatively, demonstrate how they have met their obligations to the members in terms of getting the best deal available.

Mr Jones—You would expect that they would have service level agreements, for example.

Senator SHERRY—Yes, I understand that.

Mr Chapman—It is different, and it applies not only in the AMP-MLC style sector. Some of the industry fund sector also now have their own tied service providers.

Senator SHERRY—That is right, and the larger they have got, some of them have actually brought the service back in—

Mr Chapman—That is right. It all comes down to demonstrating the process you have gone through to ensure members get an appropriate outcome.

Senator SHERRY—I am just interested in how you have been able to apply that practically.

Mr Chapman—But also, some of those retail funds you mentioned—or some of the players in that retail sector—do use the providers for parts of their business.

Senator SHERRY—Yes, I know.

Mr Chapman—Some of it also comes down to the types of products they do. For example, if I were a trustee of a fund associated with a life office that was only invested in life products issued by that life office, effectively the life office, as part of the investment contract, is also providing the admin service.

Senator SHERRY—In your opening comments you mentioned $560 billion. Was the difference in the total assets the life component?

Mr Jones—No. Firstly, that was at 30 June 2006, and that was our percentage. Out of the $900 billion, the other $250 billion or so would be the public sector and self-managed. We look after about two-thirds of the total.

Senator SHERRY—You mentioned 800, I think it was, being run out. That is a fair number, and I know we touched on this at estimates; but for the purposes of our committee, where are we up to with the run-out of those 800?

Mr Jones—It is pretty much all done. There are a few bits and pieces that are uncontactable—the usual sorts of administrative things.

Senator SHERRY—I am assuming that some of them, at least, were DB. How do you handle the run-out of a DB? What entity is managing the administration—

Mr Jones—Those ones are actually easier, because generally speaking they are fairly well managed and they met the deadline of 30 June. Some of them might have rolled into master trusts, some of them went into subfunds, and so they maintained their DB characteristics but effectively they were outsourced.

Senator SHERRY—Where they are outsourced, does there have to be an agreement by the new provider, presumably, who is carrying out the run-out? Does there have to be a formal agreement that you are able to access to make sure that the DB will be continued?

Mr Jones—Yes. They would have been transferred over. When we use the words ‘run-off’ and ‘run-out’, it is effectively the level of wind-ups. There are a whole lot of transfers. The transfers were relatively easy. What was left over were the things where most of the money had already been moved out but, for a variety of reasons—say, an outstanding legal claim or something like that—the fund had not been able to wind up completely by 30 June. For much of the last six months we were cleaning those up.

Senator SHERRY—The chair touched on this a bit earlier: the overlapping issues with ASIC. There have been a number of reports recently on red tape. The last one was the Productivity Commission report last week. I have not been able to read that. I am not sure if that went to this issue. Presumably there will be a formal response from APRA and ASIC to these issues.

Mr Jones—Out of the Banks inquiry, there was a chapter specifically on APRA and ASIC. There was only one APRA-specific recommendation. There were a number of APRA-ASIC recommendations. We have already established a joint working group. The single most significant issue was breach reporting and the difference in breach reporting between APRA and ASIC. That requires a legislative change. My understanding is that that is going through. We have set up electronic processes to try to simplify the breach reporting. Ours works with all breach reporting, in contrast to ASIC.

Mr Chapman—It becomes quite complex to solve that particular issue. One of the options we talked about with ASIC is that all breaches come to APRA. But then, of course, we have the problem that some of those breaches are not APRA responsibilities; so can we collect them? And, if we do collect them, can we give them to ASIC? We are trying to work through those practical issues.

Senator SHERRY—Would you like all the planner breaches?

Mr Jones—Not particularly. I think one of our favourite responses to that is, ‘Isn’t that ASIC’s issue?’

Senator SHERRY—I am sure. What about the interaction with the ATO?

Mr Jones—The ATO has the responsibility for the self-managed funds. That is pretty much their responsibility. The philosophy is significantly different. For the SMSFs, every member has got to be a trustee. We are out there protecting members while, in the case of the SMSFs, the members are the trustees.

Senator SHERRY—Are they trustees?

Mr Jones—They are supposed to be trustees.

Senator SHERRY—I know they are supposed to be.

Mr Jones—Legally they are.

Senator SHERRY—I know they are legally trustees—but anyway, that is not your responsibility at the moment.

Mr Jones—And hopefully no other day.

Senator SHERRY—It depends on the terms and provisions and the definition of a trustee for a self-managed fund that you may end up regulating. You distinguish between the cost of regulation and the cost that might be incurred for commercial reasons. Can you elaborate on that distinction?

Mr Jones—The reason I mentioned it is because it is a bit frustrating when we hear people talking about the high cost of regulation. Quite often they include all of their costs. We believe that they would, in the absence of a regulator, still have substantial amounts of internal regulations that you would hope they would want to comply with. When we look at what the externally imposed additional costs of APRA are on the institutions, they are actually extremely minor. As I mentioned, if the typical fund is charging about $1.85 per member, per account, per week, we are 3c per member, per account, per week.

Senator SHERRY—We could compare it with an annoying mosquito, fluttering around and buzzing.

Mr Jones—Just about. I did not realise that we work so cheap: 3c a week.

Senator SHERRY—The $5 million figure: we have had discussions with providers about the issue of capital adequacy. Where does the $5 million figure come from? How is it determined?

Mr Chapman—It came from parliament in 1993 when the SI(S) Act was put into place. It was the capital that a life company was required to have.

Senator SHERRY—It has never been changed since?

Mr Chapman—The view was taken that that was a reasonable surrogate—and don't forget it only applied to the approved trustees in those days, the public offer retail trustees—because if it was good enough for a life company, it was basically good enough for a retail public offer trustee. My recollection is that at that stage there were a couple of players who, in the consultation process on the bill, felt that they should be able to be in the market, and therefore the $5 million for the custodian was put in there as a surrogate, rather than the trustee having to have it themselves. The $5 million was there as some sort of asset protection. Therefore, if a custodian was holding the asset the $5 million should apply there.

Senator SHERRY—But it seems to me that in the reality of today and in a practical sense it is relatively irrelevant.

Mr Chapman—It is similar to what we have in the other industries in terms of base capital, but of course all the other industries then have a risk based incremental process, if I can put it that way. General insurers currently need to have five, life companies need to have $10 million and a bank needs to have $50 million, but, obviously, as their business builds their risk-based capital requirement increases in those industries.

Senator SHERRY—It was suggested to us by a couple of witnesses that a percentage of assets under management, either as a reserve or as a form of insurance equivalent, would be a better approach than the arbitrary $5 million figure.

Mr Venkatramani—This is a deep philosophical discussion point. There are several ways of doing it. But, ultimately, who provides that funding, having in mind that eventually the members will pay for that cost over time? When the original discussions took place prior to the reform, we made clear our position to move to some form of risk based approach. But once the government made the decision that the current scheme would continue, we are working within the system to

make sure through the risk management process that the risk controls and identification were appropriate. That is the current state of it.

Senator SHERRY—We discussed this earlier with other witnesses. Do you examine the reserving policy of a fund where they have a reserve?

Mr Venkatramani—Yes. It is a SIS requirement to have a reserving strategy. If they do have reserves, then we ask them: 'What is your strategy? Under what conditions do you put money into the reserve and under what conditions do you take it out?'

Senator SHERRY—It seems to me that there is a valid argument for a fund not having a reserve at all.

Mr Venkatramani—That is common too. Lots of funds do not have reserves.

Senator SHERRY—What I am trying to get at is this. In some cases funds do not have a $5 million requirement. They do not have a reserve. Are they adequately insured if there is a serious event?

Mr Venkatramani—We would be asking them those kinds of questions. Do you recognise the risks you are facing? If there is fraud or if there is an operational risk what would you do? How would you go about it? It could be an outsourced service provider who has got some insurance. It could be that service agreement is properly tightly drafted, it could be that there are make-good clauses in service agreements or insurance of the service provider as to adequacy and all those things, spreading it amongst members.

Senator SHERRY—I refer to the way of spreading it amongst members. In terms of theft and fraud we have part 23, so I think that is largely covered or at least to 90 per cent. But if an administrator collapsed and therefore the fund literally could not function or had to function under great difficulty, practically how would you insure against something like that or have a reserve against something like that?

Mr Venkatramani—With great difficulty. But given that there is a small number of administrators and that they are supported by fairly large organisations, we believe that the trustees themselves would, and we would, get signals in time if things were happening.

Senator SHERRY—Have you identified any incorrect use of reserves that you regard as being outside the sole purpose test?

Mr Venkatramani—I would not characterise it as a sole purpose test breach, but there are other mechanisms as to reserves where the maintenance and the monitoring do not quite adhere to the explicit reserving policy, in which case we do have issues which we work with trustees on administratively and remediate.

Senator SHERRY—Is the use of reserves for smoothing the rate of return still allowed?

Mr Venkatramani—It is allowed.

Senator SHERRY—So they can do that?

Mr Venkatramani—Yes.

Senator SHERRY—Even in a public offer fund where an industry fund has become public offer?

Mr Venkatramani—It is theoretically allowed. But, given the competition for funds and the intergenerational inequity which the reserving would inevitably involve, you would need to have some very strong reasons as to why you would have reserving in a public offer fund when the pressure is on you to declare the highest rate this year and to publicise that rate and to get more members.

Senator SHERRY—Sure, but I can see a situation where, let us say, you did do very well this year, so you try to hedge your bets. You say, 'Okay, well, I've done very well this year; I'll put aside a quarter or half per cent to add to a year when I don't do so well.'

Mr Venkatramani—That is possible. You can do that.

Mr Jones—It is perfectly legal.

Senator SHERRY—That is legitimate, is it?

Mr Jones—Yes.

Ms Hennessy—Provided it is for a trustee too.

Senator SHERRY—Yes.

Mr Chapman—It is very underused at the moment. One of the other things to look at too, when we are talking about reserves and comparing them to the other industries, is that the other industries have a solvency test, whereas in superannuation, other than for DB funds, there is no solvency promise. So the capital for superannuation is tied much more to operational risk than it probably is for the banking or insurance industries. In a lot of cases as we have already discussed, most of the operational risks tie back to the administrator. If an administrator fails, they tend to use systems which you can buy. So the actual cost of someone picking it up is buying the licence to the same administration system and taking the tape and doing the transition, rather than having to build something from scratch. To buy a new IT system now, to get something that would run a large fund, would probably cost you $10,000 in terms of the hardware; the software licence would probably cost you $200,000 or $300,000. But in the case of a failure that is a valid option.

Senator SHERRY—The reserving issue just made me think about DBs. We have had a very good run in the market for the last three to four years. Are we seeing any signs of DBs seeking to take some of the surplus out of the funds, because presumably some of the DBs are in surplus now?

Mr Jones—No, we are not seeing any of that.

Mr Venkatramani—There is no need for them to apply to us. There is a process prescribed. Repatriation to employers has to go through a process, including an actuarial report, and ongoing solvency and notification to members.

Senator SHERRY—Not even a notification to APRA?

Mr Venkatramani—Not immediately, not on an automatic basis. We would probably pick it up in the annual returns, because there would be a question about any repatriation to employers. But there is no prior approval or notification required. We would pick it up in the annual return process.

Senator SHERRY—Given the way the markets have been, it seems logical to me that some DBs would now be overfunded in this peak time. There might be some temptation to move out a surplus.

Mr Jones—Or simply take a contributions holiday.

Senator SHERRY—Yes, that is right; that is the other option.

Mr Chapman—I am not an expert on the accounting standards, but now the surplus in a DB fund gets added into the employer's accounts from the point of view of the accounting standards. So, from the point of view of company X with a DB fund for its employees, it would already have that in an accounting sense. So I am not sure there are the same incentives that there might have been in the past in order to inflate the parent company accounts.

Mr Venkatramani—Unless of course the employer also suffers a cash flow problem, in which case you need to actually take the cash out.

Senator SHERRY—Yes, that is right.

Mr Chapman—Or they will be tempted to take the cash out.

Senator SHERRY—Okay. Thank you. I don't think I have any more questions, Chairman.

CHAIRMAN—We had a comment earlier today that, in the view of one of the witnesses, APRA was micromanaging some aspects of superannuation businesses.

Mr Jones—Micromanaging?

CHAIRMAN—Yes. This may be in relation to some of the conditions you put on licences. Can you give us some examples of the sorts of conditions you put on licences that might be interpreted as micromanaging the business?

Mr Jones—The licence conditions would not have been micromanaging. Most of the licensing—I cannot think, off the top of my head—

CHAIRMAN—I am not sure it was licensing conditions they were referring to, or other aspects of APRA's intervention.

Mr Jones—More often than not, it is related to elements of our supervision and requests for information when they say it is micromanaging. Because it is essentially risk based, from our perspective we would say that we do not micromanage; however, if there is a problem we will go back and ask for more and more. We will probably ask for more and more detail; we may ask for some very specific detail. And I guess, from their perspective, they then say we are micromanaging. We are not micromanaging across the aggregate. But we might even agree to the language that we 'micromanage' a fund where we think there is a problem.

CHAIRMAN—Okay.

Mr Venkatramani—One example would be where we have concerns about, say, a particular service provider or the agreement with a service provider and we have decided that on the whole we are happy to license them, but we might say, 'Within an agreed period we want you to address your service provider agreement and strengthen the agreement in the following factors, and give us a copy.' That could be a licence condition that within six months of being granted a licence we want them to revisit that and make sure that adequate measures are put in place to best look after member interests. That would be an example.

Mr Jones—Other examples could be with regard to individuals. Suppose you had some concerns about the fitness and propriety of an individual. You may then ask for very specific information about that individual—for example, the extent to which that individual has had adequate training; things that you would not ask in general from anybody else. You may go back and say: 'I want to know whether person X actually did complete this training. Did they do this? Can you show us that they did complete training?' And I guess from their perspective they would say, 'Gee, that's real micromanagement.'

CHAIRMAN—Can I go back to the issue I addressed earlier on the relationship between the trustee and the member in terms of investment choice. Your response was that the trustee sets basically a range of options. Some of our witnesses have interpreted your circular as meaning that the trustee can override the investment decision a member has made which may be a result of professional advice.

Mr Venkatramani—It is the other way around, actually. As Ross pointed out, how the process is supposed to work is that SIS imposes an obligation on the trustee to set the investment strategy. Within that, it does allow investment choice. But in order to facilitate investment choice the trustee has to determine the menu of options. Once they have allowed the menu of options and told the members, 'This is how you can exercise it,' then at that point in time that menu applies to the members. The way you framed the question it appears that the member does something and the trustee goes and overrides that. It is the other way around. The trustee facilitates member choice and once that menu is allowed within the constraints imposed by the trustee—which is where APRA says the trustee needs to exercise some diligence—it is up to the member to decide.

CHAIRMAN—So if they want to go outside that menu they would have to go to another trustee.

Mr Jones—Exactly.

Ms Hennessy—Or invest outside superannuation.

Mr Jones—Yes. If a particular individual said, ‘I want this particular type of investment,’ and their trustee said, ‘Well, that is not one of the 350 options that we make available,’ the answer would be that the member can take his or her money and move somewhere else.

CHAIRMAN—So would that be a factor in the growth of self-managed funds, do you think?

Mr Jones—I am not convinced that that is the case. I suppose that from some people’s perspective, given that they are the trustee in a self-managed fund, they can set a range of strategies for themselves. So certainly they get more freedom under that approach. I guess that is correct.

CHAIRMAN—How do you believe the industry has responded to your guidance letter with regard to promotional advertising?

Mr Jones—We have had a couple of instances where we have looked at particular examples whereby things that were new in terms of the type of advertising may have been adopted. Generally speaking, though, we did not get a great deal of response. It was simply that in the lead-up to choice we recognised that in all probability we may get increased advertising and we were needed to remind trustees of their obligations. I think it has gone reasonably well.

Senator SHERRY—What about promotion? We have had the Melbourne Storm-HOSTPLUS example, which is a promotional exercise. I suppose in one sense it is advertising, or sponsorship.

Mr Jones—We do not distinguish in the sense that it is advertising or promotion. If it is shown to be in the interests of the members—so it is not breaching the sole purpose test—and in the interests of current members, in that it is designed to provide information or whatever to current members, it is not necessarily in breach.

CHAIRMAN—On this issue, a number of witnesses have argued that advertising costs should be specifically disclosed to members.

Mr Jones—I guess you are almost asking me for an opinion. If I am a shareholder in Coles Myer I do not think I can pick up the Coles Myer accounts and find the amount of money they spend on Channel 7. These things just get thrown in in accounting rules.

Senator SHERRY—Yes, but I think the issue more went to the fact that realistically most members never look at the accounts. One out of 10, if we are lucky, is looking at the annual report. At least it should be shifted to the annual report. It is the same with executive and trustee remuneration. It should be shifted from the annual accounts to the annual report. It is a real mixed bag. If you look at some funds you get the general manager’s and the CEO’s remuneration and the trustee remuneration. In others you get nothing—there is no information.

Mr Jones—I guess it is largely a disclosure issue.

Senator SHERRY—Yes, it is a disclosure issue.

Mr Jones—We do not have strong views one way or the other. I guess it is a matter of to what extent you are going to make disclosures available and to what level you are going to subdivide the various costs. Some of them may simply say, 'These are all parts of the cost of running the fund,' and lump them all in together—you do not see them.

CHAIRMAN—Can you elaborate on the distinction you draw on page 9 of your submission between the cost of regulation and costs that you say might be incurred for commercial reasons?

Mr Jones—Any well-run superannuation entity or any other financial institution should have various internal costs of compliance. Independently of whether you had a regulator or anything else, you would like to think they had all sorts of systems in place. Those costs should not be seen as a regulatory burden. Those costs should be seen as simply good process. What should be looked at as a regulatory cost is the additional cost imposed as a consequence of the regulatory agency. It is very important to distinguish them. Quite often when firms say, 'We have had a substantial increase in our compliance costs in the past two years,' I think the reasonable answer is: 'So you should have. Your fund has grown sevenfold in the past two years. If there has been no increase in your compliance costs, you should be concerned about your business.' So I think there is a need for that separation.

Mr Venkatramani—An example would be internal audit costs, for instance. A well-run fund with or without a regulator, even if you are not a regulated industry, needs to have a reasonable amount of internal audit to ensure the integrity of the system. To try to attribute such an essential business cost to regulation merely because regulators think that is a great idea or ask whether you are going to have an internal audit I think would be putting it in the wrong box.

Mr Jones—All of the major banks would spend a lot of money on various types of compliance, risk assessment and so on. These are things they would do whether or not they had a regulator looking over their shoulder.

Mr Chapman—I think the important thing from our perspective, which we try to do now with other industries that are a bit more involved than super is, is to recognise a weakness, put a requirement in place that says, 'You must address this weakness,' and then recognise when the industry has adopted it. In the general insurance industry, for example, we put a lot of requirements in place in 2002. The industry said, 'These are horrible and they are costing the clients—they should not be imposed on us.' Things like risk management frameworks are now fundamental. No general insurer would say that they want to get rid of their risk management framework.

It is important for us to then recognise that the industry has moved. We should reduce the prescription because the base is there and allow them to put in place what they need to run the business properly. I am hoping that, in a couple of years time, once we have bedded down the risk management framework for super, we will be in the same position with super to be able to recommend that we change some of those things back to a broader form and then customise where we need to for the individual funds.

CHAIRMAN—There has also been some criticism raised in some of the hearings regarding the interaction between APRA and the tax office—there is some inconsistency in the way that

the two of you regulate or interpret the same legislation—and also regarding the level of consultation and communication between APRA and the tax office.

Mr Jones—It is hard to judge. There is regular consultation between APRA and the ATO at all sorts of levels—at operational levels and so on—but essentially we administer different populations in a totally different way. I should not talk about what the ATO's focus is, but our focus has been on protecting the beneficiaries, so our focus has been looking upon the way in which larger funds are run where the members are not making their own investment decisions. The ATO has a completely different model.

CHAIRMAN—With self-managed funds.

Mr Jones—Yes. I do not think that we deal with things inconsistently. We have the same views on most of the matters.

Mr Venkatramani—It would be incorrect to say that we administer legislation inconsistently, but the level of scrutiny and the rigour which we apply to someone managing somebody else's money should necessarily be different from that applied to someone managing his or her own money.

CHAIRMAN—There have been some similar issues raised with regard to APRA and ASIC overlapping in terms of licence requirements, breach reporting and disclosure in relation to advice.

Mr Jones—That was interesting, because when we began the superannuation licensing one of the very first things we did in establishing a process was to get in touch with ASIC to see the extent to which we could use all the information that they collected for their licensing regime. From memory, we found there was only an overlap of 15 to 20 per cent in our population, because many of our licensees are not public companies, so the licensing was different. So for starters we then had to devise our own licensing system. The biggest criticism, as I was saying before, in terms of the overlap is with regard to breach reporting. That is something that is being worked on at the moment. I am not aware of much else.

In terms of other examples, I mentioned that APRA and ASIC jointly developed the unit pricing guidelines, which seems to have had a big positive impact for the industry. You can always do better. You can always look at things. Where some of it comes out too is in terms of enforcement, because some entities have said, 'Well, we've got APRA and ASIC knocking on our door.' And the answer is, 'Yes, you do, because we deal with different pieces of legislation.' In an enforcement matter it may well be that we are looking at two different types of breaches of different laws. So, yes, APRA enforcement and ASIC enforcement may be there.

Senator SHERRY—In your submission you drew our attention to the annual super bulletin, the DB-DC change. DC in 1995 had 44 per cent of assets and was up to 50 per cent in 2005. Pure DB was down from 28 per cent to four per cent.

Mr Jones—In our submission?

Senator SHERRY—Yes, on page 8. It was just drawing the attention to the figures released. Do you have any more accurate breakdown of the hybrid? It has always struck me that it is such a big component hybrid, but we do not know the distinction between the assets in a DC in the hybrid versus the DB and the number of members.

Mr Jones—Hybrids automatically come under DB, by definition.

Mr Venkatramani—By definition, you need only one DB member to be classified as hybrid.

Senator SHERRY—That is why my question. Do you have any breakdown of the two components in a hybrid?

Mr Venkatramani—Not immediately.

Mr Jones—Not statistically. Individual supervisors would know for individual funds, but I do not think we have a statistical breakdown of that.

Senator SHERRY—It would be interesting to look at the conversion from DB to DC over time. I am sure it is happening, but we have never got any hard data on it other than that, and the hybrid can be—

Mr Jones—I see: because many of the hybrids are in the DBs you do not have an accurate number of pure DBs.

Senator SHERRY—Yes, that is right.

Mr Chapman—We do not have an accurate number of members who are DB members.

Ms Hennessy—And their DB assets.

Mr Chapman—With a broad-brush process, most hybrids have few DB members, but the average DB balance would be much higher than the DC balance.

Senator SHERRY—That is right—it is the number of members and the assets. It is just really hard, other than to know that DBs have been shut and DB obviously must be in gradual decline because they are shut off. In the international context, this is an issue that is a worldwide matter. The other interesting issue I was going to ask about is: is the Future Fund asset going to be classified as a superannuation asset?

Mr Venkatramani—Not to my thinking, no. It is not a regulated or complying fund.

Senator SHERRY—No, I understand that.

CHAIRMAN—It is under its own legislation.

Senator SHERRY—I understand it has its own legislation, but the asset is to pay out a superannuation defined benefit debt.

Mr Venkatramani—Yes, at that time the money will be available for discharging that, but it is not considered super.

Senator SHERRY—No, I understand that, but I was wondering for statistical purposes—

Ms Hennessy—It is a national asset, isn't it?

Senator SHERRY—Yes.

Mr Chapman—I think it is a national accounts question for Treasury or Finance.

Senator SHERRY—You collect the statistics, but you only collect them from a licensed superannuation fund.

Mr Jones—Correct.

Senator SHERRY—But if the assets had been placed in the licensed superannuation fund, in the PSS or the CSS, you would have included them in the stats, wouldn't you?

Mr Venkatramani—How would that be any different from the current or the pre-Future Fund situation where any unfunded balance effectively came out of the exchequer, the consolidated revenue? You can conceptually argue that all of that money should also be under APRA's scrutiny. That is one argument. But that is not what happens.

Mr Chapman—What that argument actually is, looking at it in a different way, is we should not report assets, we should report liabilities.

Mr Venkatramani—That is right.

Mr Jones—The other element to that is that, while we do have a PSS and a CSS, there are a lot of exempt public sector schemes that we do not—

Mr Chapman—Which we do collect on a best-endeavours basis, but they have no legal obligation to provide us—

Senator SHERRY—So you do include some of those stats in your overall stats?

Mr Chapman—In the trillion?

Senator SHERRY—Yes.

Mr Chapman—The trillion includes that plus self-managed funds.

Senator SHERRY—I am sure it has got to a trillion. When are those stats being released, by the way?

Mr Jones—I have a meeting tomorrow to go through the last things, so it is very soon. My guess is that we are over the trillion. My other guess is that they are also now over 100 per cent of GDP.

Senator SHERRY—That is what I would have thought too.

Mr Chapman—My recollection is that we are not the world leader in that regard.

Ms Hennessy—Canada beat us to it.

Mr Jones—There are a few others. The Netherlands are there as well.

Ms Hennessy—They are 125 per cent.

Senator SHERRY—There was Lichtenstein and there was one other. I cannot remember.

Mr Chapman—We are one of the few that is over 100.

CHAIRMAN—As there are no further questions, thank you all for your appearance before the committee and for your assistance with our inquiry.

Committee adjourned at 5.37 pm