

SUBMISSION

ON

THE ISSUES PAPER, *OPTIONS FOR IMPROVING THE SAFETY OF SUPERANNUATION*, ISSUED BY JOE HOCKEY, THEN MINISTER FOR FINANCIAL SERVICES AND REGULATION, ON 2 OCTOBER 2001

TO

THE SUPERANNUATION WORKING GROUP, C/O THE TREASURY

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1. Background

The Corporate Super Association is Australia's dedicated representative body for major Not For Profit corporate superannuation funds and their corporate sponsors.

The assets of Association members amount to approximately \$60 billion, representing about 75% of total corporate superannuation sector assets in Australia and some 750,000 individual employee fund members. The dominant position of the Association in the corporate Not For Profit superannuation sector is indicated by the fact that Association member funds total only 2% by number of the total number of funds in the sector, but hold 75% of the assets.

1.1 Terms used in this submission

In this submission reference is made to:

- *Not For Profit employer sponsored superannuation funds.* In Not For Profit funds, the trustee body does not obtain profit, nor is there a dividend payable to shareholders of the trustee bodies. The main reason for the existence of the funds is a concern on the part of the employer sponsor to provide for the welfare of employees and their dependants through appropriate incentive and benefit structures. There is no profit motive or commercial interest in bringing funds under management. The governing trustee bodies represent the interests of members and sponsoring employers. Consumer protection in these entities is, to a major extent "built in" through the extensive cooperative involvement of employers and members in the governance of the funds.
- *For Profit entities.* These may be:
 - superannuation funds, master trusts, pooled superannuation trusts or unit trusts;
 - fund administrators, investment managers, or professional trustees;
 - any combination of the above.

The prime characteristic is the offering and issuing of financial products in order primarily to realise profit for the issuer's shareholders. These service providers and their agents have a financial interest in drawing additional funds under management. They have no connection, other than commercial, with either the sponsor or the members. It is essential that the very different nature of these two broad categories continue to be recognised in separate regulatory and supervisory requirements.

1.2 Abbreviations used in this submission

The Issues Paper	Issues Paper, <i>Options for Improving the Safety of Superannuation</i> , issued by Joe Hockey, then Minister for Financial Services and Regulation, on 2 October 2001.
The Association	The Corporate Super Association
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
SIS Act, SIS legislation	Superannuation Industry (Supervision) Act 1993, and related legislation
Productivity Commission Draft Report	Productivity Commission 2001, <i>Superannuation Industry (Supervision) Act 1993 and certain other Superannuation Legislation</i> , Draft Report, Canberra, September 2001.
AFSL	Australian Financial Services Licence
SWG	Superannuation Working Group, chaired by Mr Don Mercer, established to conduct public consultation on the Issues Paper and to develop legislative options to be put to Government

2. Summary of position

- The Issues Paper starts from an over-generalisation, hence exaggeration, of the problems affecting the safety of superannuation. There is no broad-based threat to the safety of retirement savings and no need for a radical overhaul of the entire supervisory system.
- Senate Select Committee case study reports surveying the major recent losses through mismanagement of superannuation assets document losses of between \$35 and \$40 million from regulated superannuation funds over the last two years, while the fate of a further \$20 million invested in Tasmanian solicitors' mortgage schemes, substantially at the instigation of financial advisers, and not subject to SIS Act regulation, was uncertain^{1[1]}. A total of some \$300 billion was invested in APRA supervised superannuation funds as at 30 June 2001^{2[2]}. In absolute terms \$40 million dollars lost in superannuation is a large sum, and disastrous for those affected, but in percentage terms this represents merely 0.01% of assets currently invested in the sector, leaving 99.99% of assets well protected under the current SIS Act regulatory regime.
- The problems facing the regulators are highly specific and restricted to two distinct areas:
 - disproportionate resources required for regulation of small Not For Profit funds; and
 - difficulty in regulating certain operators in the For Profit sector.

Within these two areas, risks are specifically identified by APRA as

- investment risk; and
 - administration risk.
- Proposed options for solutions should be re-assessed and directed towards the specific problems identified.
 - Further compliance complexity and cost cannot be justified as cost effective in light of the current high level of security of funds achieved under the SIS Act. Significant expense would be incurred, to be met from members' retirement assets, with no guarantee of increasing security from 99.99% to 100%, and the cost of covering the 0.01% exposure could exceed the risk itself.
 - Further compliance complexity and cost would:
 - be anti-competitive;
 - discourage or bar current players from continuing in the current market;

^{1[1]} Second Report of the Senate Select Committee on Superannuation and Financial Services, tabled on 30 August 2001.

^{2[2]} Table 1 at section 1.3 of the Issues Paper.

- increase monopolistic tendencies in the market to the advantage of the For Profit players;
 - increase the costs of providing superannuation;
 - erode the benefits to Australian consumers; and
 - ultimately aggravate Australia's problems of providing for the support of an aging population.
-
- The Association would support moves to require small Not For Profit funds (with membership under a key number, or with assets falling below a specific benchmark) to move to pooled investment and administration arrangements. This would have the effect of reducing the regulatory requirements. In addition, tightening of in-house asset rules would assist in controlling investment risk through removal of a potential source of mismatch in the incidence of liabilities and the availability of realisable assets.
 - With administration and investment risks concentrated into a manageable number of service providers regulatory resources would then be freed up to address genuine problems of competency and integrity in the For Profit sector, and to assess the real effectiveness of the Not For Profit sector.

3. Detailed review

3.1 Identification of problems

3.1.1 The nature of superannuation

The Issues Paper starts from the mistaken premise that “superannuation is essentially a managed investment with special characteristics.....” (opening of 1.2). The special characteristics identified are listed as compulsion, restrictions on access to capital by members, and members’ lack of access to information sufficient to assess or manage “financial risks associated with their superannuation investment”.

The assumption that superannuation shares the characteristics of bank deposits and managed investments is at the root of some highly inappropriate suggestions for the “reform” of the superannuation system.

Superannuation funds fulfil a very different role from that of discretionary investments entered into by individuals. Provision of superannuation benefits on retirement is an occupational or employment issue, involving a long-term commitment to continue to provide income at a time when the flow of employment income has ceased. Where the superannuation obligation is linked to employment, the employer should retain an interest in and commitment to the security and performance of the funds supporting the obligation. Assets are held in trust, and their safekeeping and performance are the responsibility of the trustees. Delivery to the individual does not occur until a trigger event, such as retirement, occurs. In the particular case of defined benefits, it is simply not possible to quantify an amount accumulating for the benefit of any particular member, until the event which causes the benefit to be defined, occurs.

Certainly there have been developments in the area of superannuation which have increased the apparent similarities between superannuation and discretionary managed investments. There is an increased focus on superannuation as an entitlement (arising from the compulsory nature of the Superannuation Guarantee minimum support and other contractual aspects), giving rise to a stronger feeling of member ownership during the accumulation phase. Further, the increase in popularity of accumulation schemes (as opposed to defined benefits) has given rise to increased interest on the part of members in the performance of the fund. Consequently, investment choice has been almost invariably introduced by the large corporate superannuation funds.

The distinguishing features of superannuation remain:

- superannuation is a collective investment undertaken on a fiduciary basis;
- in certain cases, notably in defined benefit schemes, individual interests are not separately identified, because they cannot be quantified until particular circumstances occur;
- responsibility for the security of the funds is the collective responsibility of the trustees, representing the interests of all members as a group, and not that of each

member on his or her own account. In the special case of a defined benefit scheme, the trustees must also take into account the role of the employer, because the capacity to pay benefits is linked to the employer's continuing viability; and

- the long-term nature of the funding process requires specialist investment expertise, in order to ensure that liabilities are appropriately matched by assets in terms of risk and in terms of relative liquidity.

These characteristics set superannuation apart from discretionary individual savings plans, where the interests of individuals are clearly defined, the source of the money is their own funds, the time of withdrawal is their own affair, and there is no other party with employment or fiduciary obligations standing between them and their investments.

3.1.2 Issues raised in the Issues Paper

The Issues Paper opens with the broad proposition that there are general and widespread concerns regarding the safe and prudent management of superannuation. The options proposed in the Issues Paper are a response to a perceived general threat to the safety of superannuation arising from implied lack of competence and integrity in the Not For Profit trustee system: see sections 1.2 and 1.3 in the Issues Paper.

However, the concerns that emerge from the Issues Paper are more specific and confined and may be summarised as follows. (References are to sections in the Issues Paper.)

- Currently the corporate superannuation funds in Australia (numbering 2862 at 30 June 2001: APRA statistics) are highly diverse, in terms of size, benefit design, sponsorship and membership: 1.3.
- Large funds, of which the Association members represent approximately 75% in terms of dollar funds under management in the corporate superannuation sector, tend to have significant resources available, and are well managed, often with specialist assistance. These funds have an excellent governance record, a matter not overtly acknowledged in the Issues Paper, although implied at 1.3.
- There is a disproportionately large number of smaller corporate sponsored stand-alone Not For Profit funds: discussed at 1.3. Many of these are well managed, although at the smaller end it may be that economies, efficiency and greater overall benefits would result from entry into master trusts or other rationalisation: this issue is not discussed in the Issues Paper.
- A minority of small corporate sponsored stand alone Not For Profit funds are attracting adverse attention because of practices such as:
 - inappropriate investment strategies;
 - inappropriate use of funds; and
 - failure to meet reporting deadlines and requirements – a possible symptom of lack of administrative integrity: 1.3,1.5.

It has been suggested in the Issues Paper that there have been investment failures, but the only major identifiable case in the Not For Profit sector appears to be the Corrections Corporation of Australia Staff Superannuation Fund, which sustained losses on winding up due to inadequate diversification in its choice of assets. No fraud or impropriety was found to have occurred.

- Some of the more spectacular and public failures have occurred, not with the smaller corporate sponsored Not For Profit funds without specialist assistance, but with entities with For Profit approved trustees. This is not acknowledged in the Issues Paper, but examples are:
 - Commercial Nominees Australia Limited, which acted as approved trustee for corporate and small APRA funds, three public offer superannuation funds and a master trust, and was also trustee of two investment trusts. Funds under management totalled about \$300 million. Commercial Nominees collapsed amid allegations of non arms length investments, inappropriate investment decisions, administrative incompetence and breaches of reporting requirements; and
 - The Employees Productivity Award Superannuation Fund, a public offer fund with an approved trustee, which lost 51% of members' entitlements through imprudent and non-arms length investment strategies. SIS Act investment strategy requirements as well as specific regulations were breached. The trustee also breached the law in failure to respond to complaints and requests for information.

The above cases are reviewed in the Second Report of the Senate Select Committee on Superannuation and Financial Services, tabled on 30 August 2001^{3[3]}.

- The failure of HIH Insurance Group in March 2001 has also been cited in the Issues Paper (1.4) as an event which has had an impact on public perceptions of the safety of superannuation. Given that HIH was a general insurer with no superannuation involvement, it is hard to see the relevance for the safety of superannuation, other than that the common regulator was APRA. Certainly, it should not be suggested that HIH was managed by amateur trustees or that the regulator was handicapped in its task of regulation by defects in the SIS regulatory regime (which did not apply).

It is clear, however, that the regulators, in particular APRA, feel that the supervision of the range of superannuation entities currently in existence is a challenge to their resources: 1.5. The major issue, then, is that the regulator's task needs to be facilitated. This is a far cry from the contention that the superannuation savings of Australians are under universal threat.

^{3[3]} "Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services: Second Report – Some Case Studies", August 2001.

3.1.3 Issues identified by the Association

The regulators face two quite distinct problems, which do not amount to a generalised problem with the trustee system, but which are highly specific, requiring quite specific remedies.

1. Supervision of a large number of small corporate sponsored stand alone Not For Profit superannuation funds, where expertise and resources are not always sufficient for effective stand-alone operation. APRA's statistics reported in the Issues Paper (Table 1, at section 1.3) reveal that, of the 2862 corporate Not For Profit funds at 30 June 2001, there were 2109 with assets under \$10 million, and 1070 with assets less than \$1 million. APRA has reported that disproportionate resources are occupied dealing with issues with small funds, notably:
 - concerns regarding appropriateness of investment decisions; and
 - breaches of reporting requirements and concerns with the robustness of reporting and administration systems.

The Senate Select Committee on Superannuation and Financial Services^{4[4]}, cites evidence provided to it by APRA indicating that the above issues were commonly reported in funds reviewed by APRA with assets under \$1 million. It was particularly in relation to “small funds with between 5 and 20, 50 or 100 members (many of which are company based)” that Mr Ian Macfarlane, Governor of the Reserve Bank of Australia, also expressed concerns regarding “irresponsible financial transactions and related-party transactions”^{5[5]}.

2. Supervision of “professional” service providers operating For Profit in the fields of fund administration, trusteeship and investment services, who have failed to meet the necessary challenges through lack of competence or through lack of integrity. It may be that the problem entities are operating at the smaller end of the market, but nevertheless they are supposedly specialists, operating For Profit and *already* subject to enhanced licensing and scrutiny by the regulators.

Many of the publicised “failures” have resulted from the second problem, not the first. However, issues associated with the first problem, including lack of prudence in investment strategy and failure to provide due reports to the regulators and other parties, have created regulatory resource problems and may directly and indirectly increase the costs of providing retirement incomes to Australians.

3.2 Remedies proposed in the Issues Paper

A number of the proposals in the Issues Paper are misdirected because of exaggeration of the problem discussed above at 3.1. Solutions should be directed not to the radical re-

^{4[4]} Paragraph 3.25 in “Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services: First Report”, issued in August 2001.

^{5[5]} House of Representatives Standing Committee on Economics, Finance and Public Administration, Hansard, Friday 11 May 2001, p. 85; also cited in the Senate Select Committee's First Report at 3.36.

design of the trustee governance system, but to remedying certain specific and confined problems.

Comment follows on the options proposed in the Issues Paper. References in parentheses are to sections in the Issues Paper.

3.2.1 Universal licensing regime (1.6.1)

Comment is sought on proposals to require all superannuation funds to hold either or both of:

- an Australian Financial Services Licence (“AFSL”) to offer and issue interests in a fund, and
- an APRA licence similar to that required of other prudentially regulated financial institutions. The Issues Paper raises the proposal that the issue of such a licence be conditional on the satisfaction of certain entry and operating standards by the trustee, such as capital adequacy and indemnity insurance conditions.

COMMENT

Australian Financial Services Licence

The requirement for the trustee of a non-public offer superannuation fund to hold an AFSL, in respect of the issue of fund interests, has been waived under the new Corporations Regulations (Reg. 7.6.01). This exemption was a considered response to detailed submissions by the superannuation sector regarding the inappropriateness of requiring Not For Profit entities to conform to a licensing regime in respect of the admission of members.

The arguments for exemption remain. There is a radical difference between:

- the offering and issue of financial products by entities in order to make a profit by the process, and
- the admission of employees to membership, and the continuing support of members, in employer sponsored not for profit superannuation funds. In Not For Profit funds, there is no motive of obtaining profit from commission and funds management fees, nor is any dividend payable to stakeholders. Trustees of Not For Profit funds do not actively promote membership of the funds. Their role is a fiduciary one, administering the funds with which they are entrusted. Employers facilitating the admission of members to the funds they sponsor are fulfilling employment obligations, and their obligations under the Superannuation Guarantee (Administration) Act 1992. Again, they have no profit motive in bringing funds under management.

The exemption of Not For Profit funds is entirely appropriate and soundly based and should be maintained.

APRA prudential licensing, with entry and operational standards

The Issues Paper proposes a review of the current APRA process for trustee approval. This is currently required in certain restricted circumstances, where the trustee is at arm's length from the members and the trustee is generally providing services for profit. The Issues Paper canvasses revision of the process into a full prudential licensing regime encompassing revised minimum entry conditions and operating standards. The Issues Paper also notes and invites comment on the Productivity Commission's recommendation in its Draft Report, that such a regime be extended to the trustees of all superannuation funds.

COMMENT

Review of the approval and regulation of approved trustees, encompassing reconsideration of entry and operating requirements, may be justified in view of recent compliance issues with such bodies. However, the Association as stated in its submission to the Productivity Commission on that body's Draft Report, opposes the extension of such a regime to Not For Profit superannuation trustees.

The Issues Paper raises concerns regarding the lack of barriers to entry for (non-professional) trustees of For Profit superannuation funds, who need only make an election to be regulated under the SIS Act, without need for prior assessment by APRA of the trustee's capacity. It is argued in the Issues Paper that the licensing process provides the regulator with an opportunity to impose conditions when it has concerns about the operation of the fund, and provides a franchise value that is at risk if the institution fails to comply with prudential requirements.

COMMENT

It is not the lack of barriers to entry to the function of trustee that allows incompetent or dishonest trustees to operate. The existence of entry barriers, including satisfaction of entry requirements and the application of operating standards, has not proved a guarantee of integrity in the case of highly regulated bodies, for example HIH Insurance, and certain For Profit entities in the superannuation sector. There is no lack of skill and integrity in the trustee bodies of Not For Profit funds of any significant size. The track record of such bodies is extremely good, with no significant breaches of standards reported in the large Not For Profit sector. In fact, the track record of the Not For Profit sector has been eminently superior to that of the For Profit sector.

However, APRA has reported problems (cited in the Senate Select Committee Report as discussed at 3.1.3 of this submission, and in the Draft Report of the Productivity Commission, at section 6.3) relating to the management of smaller employer-sponsored funds, notably those with assets of less than \$5 million. APRA has reported typical problems as including:

- inappropriate investment decisions;
- insufficient diversification of investment risk;
- use of funds for the benefit of related parties;
- problems with systems capacity and capability; and
- delay in remitting contributions to the fund.

APRA itself acknowledges that the problem funds are in a small minority of the small corporate funds. The issues noted above are very specific to the interaction between small business and entities closely related to small businesses. These issues are certainly matters for concern, but do not justify application of the same solution across the whole range of employer sponsored superannuation funds.

Core problems reported above relate to the investment approach adopted by the trustees, and to the arm's length relationship, or absence thereof, between employer and trustee. These problems lend themselves to remedies more specific than the imposition of a licensing regime. A combination of exclusion of the smaller players, and enforcement of existing legislation, is all that is required.

Any new regime of universal prudential licensing should be restricted to the For Profit superannuation sector. Extension to Not For Profit funds would ultimately increase costs of providing income in retirement without bringing any corresponding benefits, to the detriment of the Australian consumer.

Minimum entry and operating standards

The proposal to introduce minimum entry and operating requirements for Not For Profit trustee bodies is linked to the proposed universal licensing regime discussed above. As indicated above, the Association is opposed to the extension of a prudential licensing regime to Not For Profit funds. This would involve inappropriately treating of Not For Profit funds as though they were For Profit, the tightening of barriers to entry, unnecessarily increasing costs, reducing competition in the market and reducing benefit to employees.

Even in the event that such a licensing regime should be introduced, the proposal to introduce a minimum capital requirement, as currently formulated, should be abandoned. The proposal brings no clear practical benefits and would impose very particular practical problems. As discussed later in this paper, it may be practical instead to introduce a hurdle based on number of members or on assets under management, in order to facilitate effective regulation.

The Draft Report of the Productivity Commission supports the introduction of a minimum capital requirement across the board on the grounds that the capital provides a cushion against certain operational risks or systems failure. The Issues Paper (1.6) states that the proposal has Government support as an extension of approved trustee conditions.

Support for minimum capital requirements is entirely inappropriate and represents an attempt to adopt a “one size fits all” approach to regulation of institutions by APRA. APRA regulates banks and insurers as well as superannuation funds, and capital plays a very different role in each of these types of entity.

Practical purposes for establishing capital pools and reserves

Set out at 3.1.1 of this submission are some fundamental differences in the nature and function of superannuation, as compared with individuals’ discretionary savings vehicles. The function which is performed by reserve capital, as opposed to liabilities, in various financial institutions, is considered below. It does not appear that reserve capital would play a comparable role in a superannuation fund. Superannuation funds do not share the particular operational risks which give rise to the need for capital and reserving requirements in banks and insurers.

Capital requirements for banks, credit unions and other deposit taking institutions

The nature of banking business is that of taking deposits, and then lending and otherwise investing the proceeds. Risks which arise involve:

- difficulty in matching timing of assets and liabilities. Liabilities include many short term and “at call” deposits. Long term capital commitment to certain assets, e.g. long term loans, means that liquidity needs to be carefully managed;
- loss of invested capital. Certain types of high risk investments, such as mortgages, cause particular exposure; and
- unpredictability of volume of withdrawals of deposits.

The capital requirements for banks are in place for the above reasons. A cushion is needed to ensure that liquidity is available when required.

Contrasts between the capital situations of banks and superannuation funds

- Most superannuation funds, with the exception of short term institutions such as RSAs and ERFs, are long term by nature and do not operate an “at call” deposit taking function. Instead:
 - Access to entitlements follows a statistically predictable pattern, in view of the age retirement function of the funds.
 - Statutory preservation entitlements also restrict withdrawals and make their timing more predictable.
- In the particular circumstances of defined benefit schemes, the comparison to a deposit taking institution fails altogether. Liabilities are not set out in the form of members’ accumulation accounts, but as obligations to pay specified benefits as and when specified events occur. The entity primarily at risk in funding the benefits is not so much the fund’s trustee as the sponsoring employer, who is responsible for

supporting the fund. In the defined benefit context, it is particularly difficult to support an argument for a minimum capital requirement in the fund.

- It is practical, and a legal requirement under paragraph 52(2)(f) of the SIS Act, to tailor the investment strategy so that long term and short term liabilities are substantially matched.
- Certain strategies which can result in higher investment risk exposure are not adopted by superannuation funds.
 - Gearing is not permitted.
 - Derivative transactions are restricted.
 - Because of diversification requirements, trustees are obliged to avoid a high level of exposure to the high-risk end of the lending market (this is less avoidable by banks because it is their business to lend to businesses and to provide property finance).

Capital requirements for insurers

The primary risks for insurers are:

- as for banks, that the timing and incidence of calls on capital, e.g. claims and investment policy exits, will be out of phase with the availability of liquid funds; and
- the particular risks associated with underwriting. These require specialist assessment and reserving policies.

Distinctions between insurers and superannuation funds

- As discussed above in the banking context, calls on capital for super funds are statistically more predictable, because of the age retirement function of the funds and statutory access restrictions.
- No significant underwriting risk arises, except in the highly restricted situation where funds self insure death cover.

Reserve against losses arising from systems failure

Superannuation funds do not share the requirement for reserve capital arising from fluctuating and partly unpredictable demands for liquid assets.

However, in the Draft Report of the Productivity Commission, a case was put forward for reserving to provide a cushion of capital from which losses could be met arising from systems failure.

Systems failure is a specific risk faced by superannuation funds. However, in many cases the risk is carried by external service providers. In others, it may be appropriate and practical to carry insurance against the risk of such losses. The level of such insurance will vary depending on the potential losses arising from such failure.

Practical aspects of capital reserving

In a “Not For Profit” fund, there would be significant difficulty in establishing an operational reserve in an entity where there is no pool of profits separate from members’ benefits. Setting aside a capital reserve for the first time would have a detrimental impact on current members’ entitlements and would be inequitable.

3.2.2 Prudential standards (1.6.2)

Standards making power for APRA

The Issues Paper raises the suggestion that APRA be given the power to make prudential standards for superannuation funds, including capital and risk management standards. Such powers already exist in relation to banking and insurance.

Currently, there is a power for the regulator to make operating standards under regulations under the SIS Act. The Issues Paper raises concerns that the procedure under the current arrangements is time-consuming and inflexible and relies on access to scarce Parliamentary drafting resources. It also may not permit coverage of the full area of prudential concern such as outsourcing and capital adequacy.

COMMENT

The Association opposes this suggestion. The setting of standards should be a considered process, but the Issues Paper suggests that the regulator needs to set standards which are “capable of evolving quickly to keep pace with evolution in the financial markets and with community expectations” (1.6.2 page 14). The number of players in the banking and insurance sectors is small, and detailed consultation with all representatives within a relatively short period is practicable. By contrast, in the superannuation sector, there is a large number of participants with disparate interests. The regulator may find itself unable to achieve consensus through consultation and may find itself without sufficient internal resources or external support to make appropriate decisions. The superannuation sector could find itself operating in a world even more uncertain than at present.

Amendment to the structure of the SIS Act

The Issues Paper invites comment on a suggestion that the SIS Act be re-modelled to a three-tier structure consisting of high order principles, subordinate prudential standards and guidance notes.

This idea, although criticised by the Productivity Commission in its Draft Report, is still proposed in the Issues Paper as a route to a more responsive and flexible regulatory regime.

COMMENT

The idea should be abandoned. The SIS Act and its regulations currently are easy to interpret and have been highly successful and effective. The proposal for amendment would require the regulator to perform an extensive task of interpretation. This would increase uncertainty and costs. Despite arguments in the Issues Paper that an increase in flexibility and an ability to act rapidly in response to changes in financial markets is needed, change does not occur in the superannuation sector so rapidly that the legislation cannot keep pace. On the contrary, the superannuation sector requires stability in legislation in order to plan for the security of long term savings vehicles.

Prudential standards governing investment activities

The Issues Paper proposes the development of investment standards governing investment objectives and strategy, diversification of risk, management and oversight of delegated activities, and general overview of appropriateness of investments and their risk/return profile.

COMMENT

- There are already extensive rules in the legislation dealing with investment strategy.
- Where investment problems have been clearly identified, these have generally been associated with clear breaches of the existing SIS Act and regulations. Further regulation would not remedy the situation.
- The regulators have the power to pursue trustees and others who act recklessly or criminally.
- The regulators have had difficulties in detecting criminal and reckless behaviour at an early stage, but they have also been slow in reacting even when such behaviour has been detected: action was only taken over the Commercial Nominees problems after the Senate Select Committee recommended immediate action.
- No amount of legislation will prevent cyclical or intermittent poor investment performance. Investment performance is linked to world economic conditions, which fluctuate. It is impossible to produce brilliant results all the time.
- However, investment is a specialist field where expertise and judgment are required, and specialist advice should be sought.
- Trustees should remain in control of management of outsourced activities and should monitor the activities of the investment experts. This is a process which already works well with large funds.

For the above reasons, further development of regulations in the investment area is not required. However, there are arguments in favour of supporting and if necessary providing further training to trustees to assist in their management and monitoring of expert resources. Where funds are too small to seek expert support, their real viability must be called into question.

The final report of the Myners Review of Institutional Investment, commissioned by the UK Government and published in March 2001, contains a list of proposed principles to be followed by trustees in their task of institutional investment^{6[6]}. These principles provide a useful reference point, should it be considered necessary to provide further guidance for trustees in managing the investment function.

Capital adequacy

The Issues Paper has invited comment on

1. the appropriate level of capital for Approved Trustees;
2. the role of capital in funds without Approved Trustees; and
3. the substitution of capital held in custodians.

The Association does not comment on the first or the third item, but it is clear that no useful role would be played by capital in funds without Approved Trustees. Reasons for this view are set out above at 3.2.1.

Outsourcing

The Issues Paper has invited comment on the appropriateness of setting prudential standards on outsourcing for superannuation funds, and on whether the proposed standard on outsourcing for ADIs sets an appropriate model.

The main concern raised by the Government on outsourcing is the absence of regulatory control over the entities to which trustees may delegate functions related to the administration and management of their superannuation funds.

COMMENT

To extend to superannuation funds a similar standard to the proposed standard on outsourcing for ADIs would be inadvisable because:

^{6[6]} http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2001/press_myners_01.cfm

- the proposed standard would require notification to the regulator of every significant proposed contract by the trustee. The notification process would involve the provision of a substantial array of information about risk assessment and management by the trustees. This process would increase costs for the superannuation fund.
- Such a process would also delay finalisation of contracts.
- For the regulator to perform a useful and timely review of each such contract for every superannuation fund, significant additional resources would be needed. In turn, increased regulatory costs would result in increased regulatory levies – increasing costs for the employer or members and reducing benefits to the consumer.
- It is not clear from the proposed standard and the guidance notes, what action the regulator would propose to take after review of proposed contracts.
- If the processes adopted and choices made by the trustee are overturned by the regulator, there would be serious implications for the trustee system and the powers of the trustee under the SIS Act. It is unlikely that the community would gain, and costs would increase.
- Proposals requiring access to the service provider and the provision of detailed information by the service provider are likely to result in increased costs levied by the service provider on the fund

If APRA is concerned about standards in external service providers, the approach proposed in the ADI standard appears inefficient, involving the superannuation fund in significant expense, as well as duplication of effort. This duplication would result from separate scrutiny by APRA of contracts affecting each separate fund. A more economical and efficient approach would be (subject to legal and constitutional constraints) for APRA to perform bulk vetting/risk management reviews of the service providers themselves, with the costs of performing such reviews being met by those service providers. As well as increasing efficiency, this approach would enable the service providers to provide to their existing and potential clients assurances of a clean bill of health from the regulator.

Governance requirements

The Issues Paper seeks comment on a proposed reassessment of existing governance requirements for superannuation trustees and funds.

In particular, concerns are raised in the Issues Paper (1.6.2) regarding the operational risk exposure of superannuation funds. Operational risks faced by superannuation funds are listed as including:

- error or failure in administrative procedures;
- error or failure of technology;
- risk of fraud;
- compliance risk and risk of failure to meet legislative requirements; and

- legal risks associated with contractual arrangements.

The Issues Paper raises concerns regarding the limited scope of statutory audit requirements.

COMMENT

These risks are not new, and superannuation funds have been operating in the context of such risks for many years without a statistically significant failure rate in these areas. It is noted that reliance on sophisticated technology is increasing, along with the size of funds and the complexity of legislative requirements. As previously indicated (at 3.2.1 above) many functions involving systems are outsourced, and many risks can be insured against. The management of operational risk is an important function of the fund trustee, but there has not been significant adverse experience in this area such that any change in regulatory approach is required.

In the area of risk management, as with the management of funds in general, the trustees' role is increasingly one of management of resources and monitoring. Again, the challenges in this area are best met by ensuring that trustees are aware of the nature of their role and are well trained to answer the challenges. There is no evidence in the governance experience of large funds to suggest that trustees boards are not responding to these challenges.

3.2.3 Annual meetings (item 1.6.3)

The suggestion that members be admitted to and have the power to vote at Annual General Meetings should be abandoned.

The cost of running public company AGMs is significant and is justifiable only in terms of the potential benefit to company shareholders of general input into the macro direction of company resources. Whereas in a company directed towards profit for the shareholders, the range of potential activities and policies is extremely wide, the direction of superannuation fund resources is specific and restricted. Superannuation funds must be directed towards providing benefits to members. The main activities are not subject to change or discretion. These are the receipt and investment of capital, the administration of member accounts and interests and the payment of benefits to members.

It is clear that for shareholders and stakeholders in general to become involved in the minutiae of management process would be counter productive. AGMs for superannuation funds are necessarily concerned with such minutiae.

Where major changes are proposed to the structure of the fund, or to benefit structures, or where the fate of fund surplus is concerned, there are provisions in the SIS Act which require consultation with the members.

Further, there are ongoing accountability mechanisms already present in the SIS Act which are not present in the law relating to companies, such as the requirement for member representation on trustee boards. Representation on the trustee board provides members with greater involvement than would attendance and voting at an AGM.

There is no requirement for banks to hold annual meetings for their depositors or for insurance companies to admit policyholders to their AGMs. The managed investment template is unique to those entities which fall under the Managed Investments Act, and is not extended to banks or insurance companies. The suggestion that superannuation funds should be singled out for this requirement is inappropriate – particularly given that superannuation fund members’ interests are arguably already better protected, through member representation, than those of depositors and policyholders.

To sum up, there would be enormous costs and no benefit associated with attendance by members at AGM.

3.2.4 Publication of Annual Returns (item 1.6.4)

No further benefit would be gained from this requirement, since all interested parties already receive all relevant information about the fund under the disclosure requirements of the SIS Act and the Corporations Act.

3.2.5 Compliance plans and approval of benefits to related parties (item 1.7)

A requirement for a compliance plan akin to that required for entities regulated under the Managed Investments Act should not be introduced, because such a requirement would be redundant. The deeds of superannuation funds already explicitly or implicitly require compliance with the provisions of the SIS Act.

There are no widespread practices involving benefits provided by superannuation funds to related parties. Closely related parties are generally the employer sponsor and the members. The SIS Act and the trust deed already regulate payments to sponsors and members, and further action appears redundant.

In general, the SIS Act provides a tested regime for the regulation of superannuation funds. Because of the distinct nature of superannuation as opposed to discretionary private savings, it is not true to say (as contended at 1.7) that superannuation funds bear a close similarity to managed investments. See further on this topic at 3.1.1. The Managed Investments Act has only recently been introduced for managed investments and has not yet fully established a track record for effectiveness. It would be inappropriate to extend its provisions to superannuation funds, which are already subject to sufficient regulation suited to their different nature and special purpose.

3.2.6 Funding financial assistance for failed superannuation funds (1.8)

A suggestion has already been raised in session with the SWG that any superannuation fund losses be funded from Consolidated Revenue. This approach should be favoured because the Government, as recipient of tax revenue from superannuation funds, is the largest beneficiary of the superannuation system. Funding of superannuation losses from an industry levy would increase the burden of subsidy on current membership of funds (or employers), a less equitable approach than seeking compensation from the largest and most long term beneficiary of the system – the Federal Government.

3.2.7 Separation of prudential and retirement income provisions of the SIS Act (1.9)

This suggestion, which would involve dismantling the current prudential framework under the SIS Act, is strongly opposed. The SIS Act has been purposely designed to regulate entities managed by trustees. The system has been tested and has a proven, excellent track record. There is no need to abandon it in favour of a fragmented regime involving several separate sets of regulatory legislation administered by contending regulatory bodies.

The Association has provided a number of submissions on this topic, the most recent being the submission to the Productivity Commission, clarifying the major differences between Not For Profit superannuation funds and For Profit funds and that these are so pronounced as to justify the continued regulation of Not For Profit entities under a separate regime of proven effectiveness^{7[7]}. The current SIS regime encompasses internal governance requirements, reporting and disclosure requirements, and provisions relating to the integrity of the superannuation system (ensuring that retirement income vehicles are used for appropriate purposes). It has the advantage of providing a specialist set of provisions directed and focussed to the regulation of a highly specialised type of entity which should NOT be confused with discretionary managed investments.

4. Recommended solutions

The two distinct problems identified at 3.1.2 should be addressed separately, and an appropriate and specific response be developed for each.

^{7[7]} Submission No 12 to the Productivity Commission on the National Competition Policy Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation: <http://www.pc.gov.au/inquiry/super/subs/sub012.pdf>.

4.1 Investment and administration risk in small corporate funds

It may be in the best interests of members of Not For Profit small corporate funds that advantage be taken of economies of scale via pooled investment and administration arrangements. Funds below a certain benchmark size (set either in terms of member numbers or in terms of funds under management) could be required to:

- participate in professionally managed investment pools; and
- make use of external approved administration bodies.

This approach would also eliminate problems identified in this group by APRA in the areas of investment strategy and reporting. Regulatory resources would be freed up because there would be fewer funds to regulate, and the time consuming compliance issues faced by the regulator in this group would no longer be an issue. If the burden of supervision of small funds is removed, it should become possible for APRA to turn its full attention to regulating the larger funds.

A further change which would assist with the management of investment risk, particularly in the smaller funds, would be a review of any in house asset investment (other than as a portfolio holding under arm's length management and custody). There are many risks associated with substantial in-house asset holdings. A major concern is that on any winding up of the employer or of the fund, the in-house asset may be subject to forced sale, resulting in losses at a time when liquidity is required. Prudent management of investment risk requires diversification of assets, diversification of investment risk and management of liquidity, such that any material in house assets should be carefully reviewed.

4.2 Effective regulation of licensed "For Profit" bodies

- Steps to improve the effective supervision of such bodies have been taken by changes to the Corporations Act.
- The SIS Act contains powers enabling APRA to act against offenders. The SIS Act also permits investigation by the regulator at times when concerns are raised; it is possible that these powers should be enhanced.
- If resource problems for APRA were reduced as suggested above, it should become possible for APRA use existing regulation to police major areas of concern with For Profit entities.

5. Conclusion

- The track record of Not For Profit corporate superannuation funds has been excellent, at 99.99% effectiveness (more effective than the record for the For Profit sector). There is no need for radical reform of an excellent system.

- There is, however, a need to provide for the 0.01% loss experience, and that would most equitably be provided through the main stakeholder (Government) setting aside a small percentage of its multi-billion dollar tax revenue.
 - There is also a need to facilitate more effective regulation of Not For Profit funds, and to minimise the key investment and administration risks as identified earlier.
 - The solutions proposed at 4.1 above are simple and would:
 - Address issues of security in superannuation;
 - Reduce the regulator's burden;
 - Benefit the members of the small funds; and
 - Minimise changes to the law.
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