SUPER SYSTEM REVIEW
FINAL REPORT

PART TWO

Recommendation Packages

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SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 1

MySuper and choice architecture

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KEY THEMES

Issue

The current superannuation system assumes that all members want to make choices about their superannuation and are interested in receiving a variety of superannuation-related services. 'Default' members are not adequately protected and can find themselves paying for services that they do not need or request and, on some occasions that they do not receive. Trustees are not always focussed on acting for the benefit of members and maximising members' retirement incomes in an efficient and cost-effective way.

Proposed solution

The Panel proposes measures, including:

- a new architecture for the superannuation industry, designed from a member — not an industry or product — perspective;
- the creation of MySuper, a simple, cost-effective product intended to better serve the interests of members who want the trustee to be responsible for making decisions about their super;
- a requirement that only MySuper is eligible to be a 'default' fund under the SG Act nominated by an employer or under Fair Work Australia awards; and
- a renewed emphasis on duties for MySuper trustees, with the trustee explicitly responsible for a single, diversified investment strategy and controlling costs.

Benefits for members

Members will benefit from the new choice architecture as:

- they would have the confidence to be engaged as much or as little with their super as they want;
- MySuper trustees would have to design and give effect to an investment strategy aimed at optimising members' financial interests; and
- the effect of commissions (and like payments) would be contained and fees would not be charged for advice that is not requested or received.

1 A NEW ARCHITECTURE FOR SUPER

Treasury projections show that the superannuation system is expected to grow to $6.1T (in nominal dollars) by 2035.[1] The Panel believes that now is the time to position the superannuation system for the challenges of the future under an 'architecture' that would re-affirm the primacy of the best interests of members and the rationale of the system as optimising the contribution of superannuation to members' retirement income.

1.1 A member-focussed 'choice architecture'

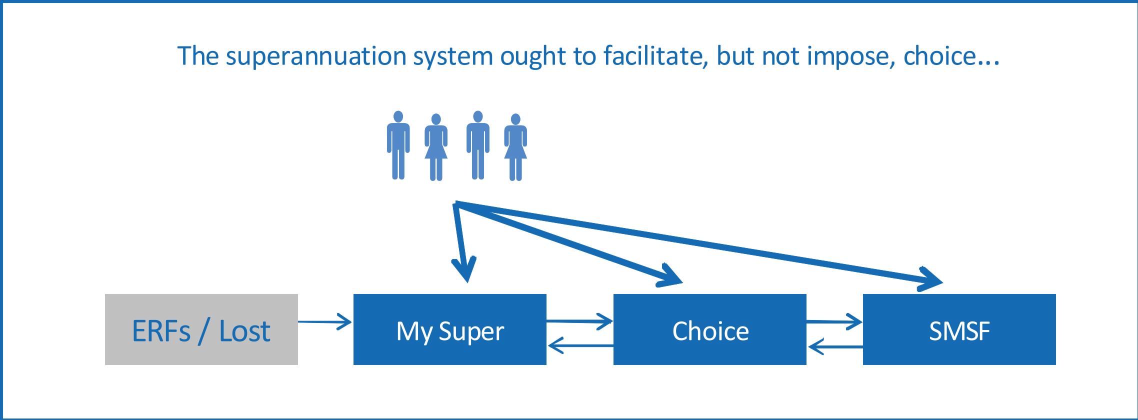
The current regulatory infrastructure supporting the superannuation industry distinguishes between different types of fund to some extent. At the margin, there are different rules applied to public offer funds as opposed to standard-employer-sponsored funds, to defined benefit plans and to SMSFs. For the most part, though, the SIS Act assumes that there can be a single model of superannuation fund governance.

The Panel believes that industry developments since the enactment of the SIS Act make this approach inadequate. More importantly, although the one-size-fits-all approach appears equitable, in practice it can result in the illusion of protection or the primacy of member interests in certain situations and in unnecessary complexity and cost in others.

The Panel believes that there has to be room in a system, where there are compulsory contributions, for a governance model that addresses not only the disengaged member, but also the member who exercises choice about the fund (or investment option in the fund) to which they belong. There also needs to be more clarity for members about the differences between the various models and what those differences mean regarding the trustee's duties to the member.

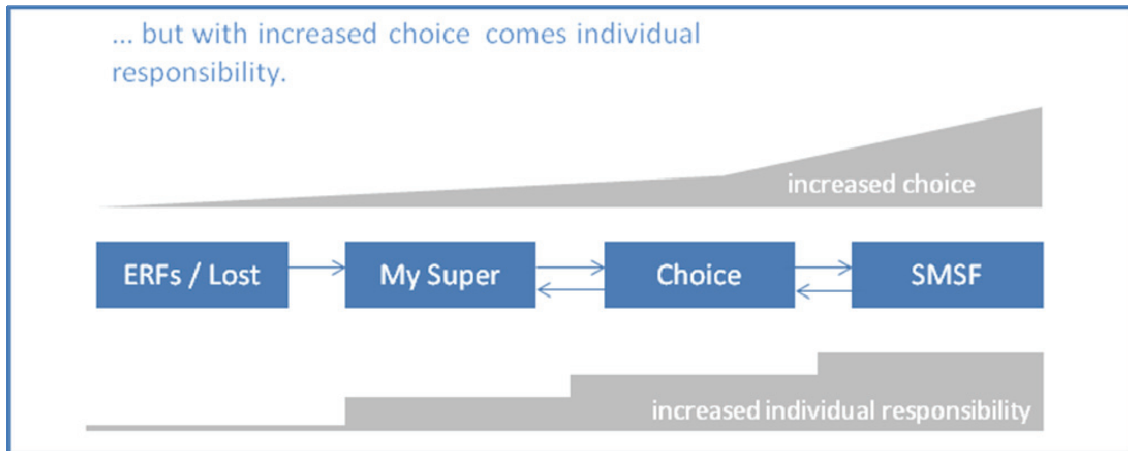
Figure 1.1 below sets out an approach which starts from a member, rather than a product or industry sector, perspective. In behavioural economics terms, this is a 'choice architecture' model.[2]

Figure 1.1: A choice architecture model for Australia's superannuation system



The model classifies members into three main types — MySuper, choice and SMSFs — on the basis of whether or not they have made a choice about their superannuation and the nature of the choice made. A number of submissions indicated a desire to see differentiation along these lines.[3]

Figure 1.2: Increased choice, increased member responsibility



Those who do not make an express choice would be in MySuper. This recognises that direct engagement in superannuation decision-making is not currently a priority for a large portion of the population (and leaves open the question whether it could or should be).

However, the model also recognises the value of choice, with the greater responsibility that choice entails for the member. MySuper would be available to those who actively choose to be there and the choice sector caters for those who wish to tailor their super. SMSFs recognise that some people have the desire and capacity to manage their own retirement savings and choose to assume full responsibility and control.

The ERF/lost member sector recognises the practical reality that some people are currently disconnected from some or all of their superannuation. If a member loses connection with their account, that account would be transferred to an eligible rollover fund (**ERF**). The SuperStream recommendations in chapter 9 seek to address the factors contributing to this disconnection. The Panel would not expect the ERF/lost member sector to continue as a material part of the system following the implementation of SuperStream, although the existing stock of lost members would remain large for some time.

Members who want to exercise choice outside MySuper would be able to have their contributions made into non-MySuper products through an active 'opt-in' decision. Employers and others would not be permitted to 'opt-in' on behalf of their employees or clients, as applicable. People could have interests in both MySuper and choice products at the same time, though this would be by active choice, and not by poor record-keeping or because they were unable to consolidate multiple superannuation accounts.

1.2 Implications of the choice architecture model

There are several important implications for the industry arising from the choice architecture model, including:

First, the model orients attention towards members and away from 'products' and industry sectors.

Second, the model uses the conscious choices and choice-related outcomes of individuals to calibrate the levels of governance, regulation and member protection applicable. Accordingly:

- ERF members, disconnected from their super, would receive a high level of protection while they remain in the super system. There would be minimal information or disclosure, but importantly also a low cost facility to aid member identification so as to expedite consolidation of any lost amounts and, ultimately, transfer from the ERF to other sectors. ERFs are discussed further in chapter 10;

- MySuper members would receive the protection afforded by the duties imposed on a traditional trustee who is a fiduciary acting single-mindedly in the best financial interests of members. They would be in a product with a single, diversified investment strategy, insurance would be offered, but few other product features. There would be a limited role for external advice because intra-fund advice would be 'embedded' in the product and there would be limited choices to be made by the member;

- choice members would bear substantial responsibility for the investment choices or fund choices that they made. They would be in a product with potentially an unlimited menu of investment options, but with trustee responsibility for reasonable due diligence on investment options offered, with some limitation of liability for investment choices made by individual members. Effective disclosure would therefore be of paramount importance. Members would be likely to rely on advice or disclosure and other information about their options; and

- SMSF members would, subject to conformity with certain minimum standards, be self-reliant.

Third, different governance (and regulatory) models would be appropriate for the different types of members. Prudential regulation would be more relevant to the MySuper and choice sectors than the SMSF sector. Likewise, a traditional trustee role is more relevant to the MySuper sector than the choice sector.

Fourth, the model facilitates more precise allocation of costs to members. The costs of the compendious disclosure documents, advertising and transactional infrastructure required to facilitate member investment choices in the choice sector would be borne only by those members in the choice sector.

Fifth, the model accommodates movement of members between the sectors, albeit with some regulation. The potential for moral hazard and the removal of layers of protection mean that movement towards sectors offering increasing choice (that is, to the right in the choice architecture model in Figure 1.2) cannot be allowed to be inadvertent. Participants moving in that direction must signal their intention expressly and unambiguously. Having done so, they should be allowed to move with minimal friction and cost. On the other hand, no special restrictions need to be placed on member movement in the other direction (for example, a move from an SMSF to MySuper).

Lastly, one segment of the industry is not specifically captured in this model: defined benefit plans. These plans remain an important, but declining, part of the industry. More importantly, the allocation of investment and other risks in defined benefit plans are quite different from those in accumulation plans, which have implications for the governance and administration challenges they face. The Panel believes these plans should be subject to a regulatory environment tailored to their unique requirements. Defined benefit plans are discussed in chapter 6.

The choice architecture model does not represent a complete break from the current structure of the industry by any means. The ERF/lost member and SMSF sectors essentially exist today. The Panel discusses ERFs in chapter 10 and SMSFs in chapter 8. Similarly, there are today both MySuper and choice products available in the market; they might have different names and details, but they are essentially recognisable.

This chapter outlines the MySuper component of the choice architecture model in more detail.

Recommendation 1.1

The 'choice architecture model' should be adopted as the structure for Australia's superannuation industry.

2 PURPOSE OF MYSUPER

2.1 A product for a core demographic

The MySuper component of the choice architecture model is predicated on providing a simple, cost-effective product with a diversified portfolio of investments for the vast majority of Australian workers who are invested in the default option of their current fund.[4] A significant portion of those members have not exercised choice to be where they are, but there are some members who have actively chosen the default investment option.

MySuper does not just cater for disengaged members — it is also designed for members who choose actively to participate in this product.

Recent data show that the average member account balance across a wide range of super funds is below $25,000.[5] In fact, APRA data show that retail and industry fund accounts had average balances of $18,400 and $16,600, respectively, at 30 June 2009. Rice Warner estimate the June 2008 average balance per member (not per account) at $32,895 for industry funds, $46,710 for retail, $100,302 for public sector and $133,492 for corporate funds.[6] Roughly 80 per cent of members are in the default strategy.[7]

These figures illustrate a core member demographic for which the Australian superannuation system should be able to cater simply and efficiently. It is particularly at these member account sizes that the Panel finds MySuper compelling; account sizes where costs and inefficiencies can make a real impact on whether a member has a comfortable retirement. But even as the system matures, and account balances grow, the Australian superannuation system should be able to ensure that there is a value for money, simple and effective product for members to rely on — whether that reliance is preferred by the member or is due to an inability or disinclination to choose.

2.2 Leveraging off a well-known existing product

Generally speaking, existing default investment options have delivered good outcomes for members. The Panel sees the MySuper proposal as based in and around the existing widely offered and well-understood default investment options. Indeed, MySuper has been designed to sit within the

existing structures currently offered by many superannuation funds. However, MySuper also aims to focus trustees' attention more sharply on the types of member advantages afforded by those default options.

Also, as noted, MySuper is not just for people who are disengaged. With the lower costs and traditional trustee obligations, the Panel believes that many engaged investors will actively choose to have their superannuation in MySuper. MySuper includes a range of additional regulatory requirements which are designed to ensure that the trustee is truly accountable to members, that the trustee is unfettered in its pursuit of the best interests of members and that the costs of delivering MySuper are contained. Together, these safeguards are designed to emphasise the true fiduciary oversight — 'trusteeship' — that MySuper members ought to expect from their product providers. They also ensure that members do not inadvertently pay for services they do not need and sometimes do not receive.

The MySuper product is intended to provide a simple superannuation option for members. It will be treated, for some purposes, as separate from other types of superannuation products, and operated so that member interests are transparently paramount and there will be an enhanced focus on optimising net investment returns and reducing overall costs. The Panel believes that by imposing some degree of homogeneity on the product, price competition might reasonably be expected to produce more positive outcomes for members and to help trustees contain costs. It would also be easier for engaged members and their advisers to make comparisons between MySuper products offered by different funds. Regulatory changes will put pressure on MySuper (and choice) trustees to be more transparent and accountable about their investment objectives, efficiency and member outcomes. This is discussed in chapter 4.

2.3 MySuper as the new 'default'

2.3.1 Superannuation Guarantee

Only MySuper products should be able to be nominated by an employer as a 'default'.

However, MySuper is also for members who choose to rely on an investment strategy developed, in their interests, by a fund trustee. Employees would therefore also be able to select MySuper products as a 'choice of fund' for SG Act purposes.

Recommendation 1.2

The SG Act should be amended so only a MySuper product is eligible to be a 'default' fund nominated by an employer.

2.3.2 The award system

The Panel also believes that only a MySuper product should be a 'default fund' for the purposes of awards and other industrial instruments. Currently, modern awards nominate a number of funds to which an employer must pay superannuation contributions on behalf of employees who do not actively choose their superannuation fund. Some submissions to the Review argued that this system is uncompetitive because employers are unable to select their preferred superannuation fund as a default if it is not nominated in the award. For example:

- IFSA maintained that competition drives improvements in superannuation fund offerings as well as efficiency and puts downward pressure on fees.[8]

- Mercer's submission noted that awards do not have the capacity to monitor the ongoing performance of funds. As a result, underperforming funds can continue to be the default fund for award-respondent employers. Employers who have actively chosen a fund, on the other hand, are able to change their default fund if circumstances require. Mercer also pointed out that the wording of modern awards with respect to the nominated default fund can prevent employers from contributing to an award-nominated fund if it ceases to exist due to a successor fund transfer or merger with another fund.[9]

Other submissions endorsed the modern award approach:

- The Australian Industry Group (**AIG**) supported the process on the basis that it is simple and reduces costs and complexity that employers would have to bear in selecting default funds. The AIG submissions said, in response to the concern that the award process lacks transparency and a competitive element, that this could equally be the case for employer-nominated default funds.[10]

- Generally, the ACTU agreed with AIG's views, but also supported the idea that award-nominated funds should satisfy certain governance, cost and performance criteria to be eligible for nomination as a default fund.[11] The Panel believes that its MySuper proposal addresses those issues.

Naming a particular fund in an award when there has been no transparent, formal selection process would appear to inhibit competition and delivers a significant advantage to the fund named. However, one cannot overlook the fact that the selection of the fund named in modern awards has been the subject of negotiation between employee and employer representatives.[12] Also, the selection of default funds by employers outside the industrial relations system is not perfectly competitive and transparent either.

As it is logical that there be a reasonable transition period before MySuper would apply generally, there seems to be no reason why the default funds in modern awards should not continue for the time being. They are due for comprehensive review in 2014. In order to prepare for the 2014 review, the Panel considers that, in 2012, the Productivity Commission should examine the way default (MySuper) funds are nominated under the awards system, with a focus on whether the procedures are the most open, transparent and competitive means by which members are given access to the most favourable default (MySuper) offerings.

Recommendation 1.3

The relevant legislation should be amended so:

(a) only MySuper products are eligible to be nominated; and

(b) all MySuper products are able to be nominated,

for 'default fund' purposes in awards approved by Fair Work Australia.

Recommendation 1.4

In 2012, the Productivity Commission should conduct a review of the processes by which default funds are nominated in awards to assess whether the processes are sufficiently open and competitive.

Recommendation 1.5

Any fund that is a 'successor fund' (as defined in the SIS Act) to a fund currently nominated as a default fund under an award should, where the successor fund is a MySuper product, be accepted automatically as a default fund under the award, so that there is no impediment to consolidation for those funds that wish to do so.

Following the implementation of these measures, the Panel intends that MySuper would replace the current concept of 'defaults' and that the regulatory structure and industry cease referring the term 'default'.

2.4 Open to all providers

There is no reason why any industry sector should be excluded from offering a MySuper product, and so be considered for nomination as a modern award default fund. It is not intended that only not-for-profit entities should be able to participate in the MySuper category, nor that only retail financial institutions should be able to participate in the choice category. The Panel's view is that greater competition should result in due course.

The Panel believes that members of current default funds or default investment options that a trustee flags for conversion into a MySuper product will not need to move out of these funds because of this transformation. Funds would be able to offer either MySuper or choice products (or both) but the requirements pertinent to each of the types of product would need to be met.

3 QUALIFYING AS A MYSUPER PRODUCT

A MySuper product would be formally established by demonstrating compliance with objective criteria to which any trustee would have to conform in order to qualify as a MySuper product. There would also be principles-based duties in relation to MySuper products that trustees would be legally obliged to meet, addressing financial performance, reporting and disclosure. APRA would be empowered to work with the trustee to resolve any non-conformity with the principles depending on the circumstances.

3.1 Principles-based trustee duties

The Panel considers that MySuper trustees should operate under new high level, principles-based, duties that could not be diluted in a fund's governing rules. These are set out below. The overall duties of MySuper trustees would also include the types of governance duties discussed in chapter 2.

However, for the purposes of articulating MySuper as a stand-alone concept, the Panel has kept the two discussions (that is, MySuper in chapter 1 and trustee governance in chapter 2) separate.

3.1.1 Optimising investment performance and overall cost to members

The trustee would have to formulate and give effect to a single, diversified investment strategy at an overall cost aimed at optimising fund members' financial best interests, as reflected in the net investment return over the longer term. This does not mean that a trustee would have to provide the lowest possible cost investment strategy. While there is an emphasis on low costs, this would not be at the expense of investment returns. The Panel recognises the importance of asset allocation and that some investment strategies would be more costly to provide than others.

Although there would not be an overall fee cap or other regulation of the cost of a MySuper product, a MySuper trustee would be required to operate with a clear and transparent justification for the investment strategy it formulates and the overall cost and net return to members.

3.1.2 MySuper trustees and investments

A touchstone of MySuper is that its members would defer to the trustee generally in relation to all aspects of their superannuation. The Panel believes that offering investment choices in MySuper would, in essence, be delegating what some regard as the most important activity of the trustee to members who are generally not well-equipped to perform that activity or who have specifically chosen to minimise their own decision-making by adopting the MySuper product. The Panel therefore believes that decisions about investment strategy in a MySuper product would be the sole responsibility of the trustee.

There is a clear consensus that people should ideally have a suitably diversified investment strategy. This is common practice within default investment options of funds at present. The Panel has also recommended a mandatory system for explaining investment aims, volatility and costs, which is discussed further in chapter 4.

It should also be stressed that while MySuper must have a single investment strategy from the perspective of the member (that is, no choices) it is very much open to the trustee to change the investment profile over time to reflect certain characteristics of members, including movement according to defined age bands and/or proximity to a target retirement date.

3.1.3 Scale

Scale is central to a trustee optimising operating costs in the best interest of fund members. A report prepared for the Review by independent consultant, Deloitte Actuaries & Consultants Limited, describes the power of economies of scale in reducing per member investment, advice and operating costs, and so the scope to reduce total member fees.[13] A copy of the Deloitte report, dated 19 April 2010, is appendix D to Part 1 of this report.

As part of the grant of a MySuper registrable superannuation entity (**RSE**) licence, a MySuper trustee would have to demonstrate to APRA that the product had sufficient scale or, if a new entrant, there was a credible path to building the necessary scale. Also, on an annual basis, a trustee would have to ask itself and determine whether it would continue to have sufficient scale in relation to its MySuper product (with respect to both assets and number of members) to deliver optimal benefits to members.

Further, scale would be part of APRA's ongoing review of MySuper products. The way the scale concept is administered would, of course, need to deal with a fund's individual circumstances, features particular to certain occupations and to allowing competition from new entrants to the market. The interaction between the trustee's duty and APRA's regulatory role in relation to scale is discussed further in chapter 10.

Recommendation 1.6

The SIS Act should be amended to apply statutory duties to MySuper trustees to:

(a) formulate and give effect to a single, diversified investment strategy at an overall cost aimed at optimising fund members' financial best interests, as reflected in the net investment return over the longer term; and

(b) actively examine and conclude whether, on an annual basis, its MySuper product has sufficient scale on its own (with respect to both assets and number of members) to continue providing optimal benefits to members.

3.2 Objective criteria for MySuper products

Set out below are some of the criteria with which trustees offering MySuper products would have to comply and the features which a MySuper product would have to contain.

APRA licensing

A trustee who wants to offer a MySuper product would be required to hold a 'MySuper' class of RSE licence granted by APRA. This would most likely be through a variation to an existing licence.

Contributions

The trustee would have to accept all types of contributions (except where prevented by law).

Single investment strategy/diversified asset allocation

The trustee must formulate and give effect to a single, diversified investment strategy for the MySuper product.

No costs cross-subsidisation

The Panel recognises that there is always some degree of cost cross-subsidisation between members in any pooled investment. However, it would be a clear feature of MySuper that there should be no direct or indirect cross-subsidisation of costs between MySuper products and other products offered by a fund trustee, whether within the same RSE or not. The outcomes reporting standard to be developed by APRA in consultation with ASIC and the industry, as discussed in chapter 4, would cover cost cross-subsidisation issues in MySuper products.

Buy and sell spreads

Buy and sell spreads could be charged to MySuper members so long as the charge is closely linked to demonstrable costs incurred by the fund (that is, actual transaction costs in investing contributions and paying benefits) and provided that the charges are paid to the fund and not to the trustee in its personal capacity or to any other party.

Switching fees

Fees payable on switching into or out of a MySuper product, whether chargeable on the first switch in any given period or only after a certain limit has been reached, would be able to be charged in MySuper provided that those fees are paid to the fund (as in the case of the buy and sell spread) and not the trustee in its personal capacity or to any other party.

Fee schedules and discounts

All fee schedules and discounts (if any) for MySuper products are to be explicit and not subject to negotiation or rebates.

Performance-based investment management fees

No performance-based investment management fees could be paid to or by a MySuper trustee unless they comply with the performance fee standard, discussed in chapter 3.

E-super disclosures

Because of the simplicity of a MySuper product and the central role of the trustee in overseeing the product, there would be reduced member disclosure obligations to assist with cost reduction. Entry to a MySuper product would not depend on notions of informed choice reliant on trustee disclosures and trustees would not be required to provide disclosure to members in the form of Product Disclosure Statements. Joining a MySuper product would generally occur online. People choosing to enter a MySuper product would not be treated differently from those entering through 'default' processes. Comprehensive information, at a variety of levels of detail, would be made generally available by the trustee online, and any person without internet access would be able get hard copy information on request. Member benefit statements would continue to be sent out as they currently are, including by email, because this is one of a fund's primary forms of engagement with members. However, the legislation would make it clear that MySuper members could elect to have member account information available to them online instead of in hard copy.

Retirement product

MySuper would not just cover accumulation to retirement, but ultimately must also offer a retirement income stream product, either on its own or in conjunction with another provider. The Panel views MySuper, in its fully-developed form, as a 'whole of life' product. This would need extensive consultation and development with industry, but is a key part of the MySuper concept. Options include a range of account-based pension products, annuity products and other longevity risk hedging products. This is discussed in more detail in chapter 7.

Entry and exit fees

There would be no entry (contribution) fees charged for a MySuper product, including on rollovers. Exit fees could only be charged on a cost recovery basis.

Benchmarking

To drive the advantages of MySuper, the Panel believes that MySuper products should be regularly benchmarked against each other according to a transparent methodology, approved by APRA and applied on a consistent and objective basis. This is discussed further in chapter 4.

Intra-fund advice

Trustees offering MySuper products would be required to maintain a facility for providing 'intra-fund' advice to members. Under current ASIC arrangements, the trustee of a superannuation fund that holds an Australian financial services licence to provide personal financial product advice is able to give advice to fund members about certain aspects of their existing interest in the fund, with the level of inquiry and consideration in relation to that advice set by the trustee's fiduciary duty to members, rather than the Corporations Act. ASIC has also provided guidance in relation to giving personal advice to fund members only in relation to specific fund features under the generic standards in the Corporations Act.[14] The Panel notes the Government's announcement in the Future of Financial Advice reform package to expand the current intra-fund advice regime to new topics, and considers this will be particularly appropriate for MySuper.[15]

The cost of intra-fund advice to fund members could either be shared across the MySuper membership (like an administration expense) or charged to those who use the service. Any payment for superannuation advice from a member's superannuation account must comply with the 'sole purpose test' in the SIS Act and payment for advice about superannuation has been accepted as meeting this test. The 'price point' at which intra-fund advice must be charged to the member, rather than shared across the fund, is a matter to be determined under the trustee's optimisation duties.

As well as making intra-fund advice available to members, the Panel also sees a role for a pro-active offering of the trustee's intra-fund advice service in relation to specific member needs or life stages. This could be in relation to the role and value of death and total and permanent disability (**TPD**) insurance, especially to members with families and mortgages, and this is discussed further in chapter 5. A pro-active approach to the offering of intra-fund advice services would also be appropriate as members approach retirement and during retirement, and this is discussed further in chapter 7.

The Panel also notes that, in providing intra-fund advice, the trustee would be required to act in the best interest of members. This will be important in relation to any potential for trustee advice to be used to direct MySuper members into choice products. The Panel envisages monitoring by the regulators to ensure appropriate advice is given consistent with the trustee's fiduciary duty. In addition, the Panel envisages that such monitoring will include ensuring that expensive and non-transparent advice arrangements are not reintroduced with the expansion of the intra-fund advice arrangements.

Payment for external or non-intra-fund advice is discussed in section 4.3 below.

Other criteria

Other objective criteria for MySuper products are also part of the specific detailed sections later in this chapter in relation to advice, insurance, member movement and engagement in MySuper products. Other aspects of MySuper products are also covered in later chapters of this report.

Recommendation 1.7

The SIS Act should be amended to require trustees of MySuper products to satisfy objective criteria relating to:

(a) APRA licensing;

(b) Acceptance of contributions;

(c) Single, diversified investment strategy;

(d) Absence of costs cross-subsidisation;

(e) Buy and sell spreads;

(f) Switching fees;

(g) Fee discounts;

(h) Performance-based investment management fees;

(i) E-super disclosures;

(j) Retirement income stream product;

(k) Entry and exit fees;

(l) Benchmarking;

(m) Intra-fund advice;

(n) Insurance;

(o) Absence of commissions and like payments; and

(p) Member engagement.

3.3 MySuper structures

3.3.1 Legal

The integrity of the MySuper concept requires that trustees would generally not be able to present a prospective member with choice between different MySuper products. Choices can be made outside the MySuper environment. Generally, there would be only one MySuper product in each RSE.

However, the Panel recognises that there would be situations where a trustee would have multiple distinctly-branded products within a single RSE legal structure. In those circumstances, one MySuper would be permitted under each brand name.

The Panel also recognises that there might be situations where a master trust could have multiple MySuper sub-funds to reflect the fact that it is serving a range of different employers. An employee

of any particular employer could, however, only be offered the one MySuper product and not a range of them. Similarly, an employee could only be defaulted into a single MySuper product. In some structures, the same MySuper product could be offered at different price points reflecting differences in the scale of employer participation. The over-arching principle is that a member is only presented with, or defaulted into, the one MySuper product.

3.3.2 Operational

The Panel does not seek a complete separation of a MySuper product from other aspects of a fund's operations (for example, any other superannuation products and any investment options). The Panel would not envisage that a trustee would be required to undertake separate mandates for MySuper investments as opposed to investments for choice products. The Panel wants trustees to keep the synergies available from treating MySuper and choice members as a single pool for administration and investment purposes, where appropriate. This would allow trustees to get the benefits of economies of scale and bulk purchasing power. It would also not prevent trustees from using pooled vehicles. Of course, a trustee would be free to operate MySuper as a separate, stand-alone asset pool if it chose, subject to being able to obtain the scale required to deliver a cost-effective product. All these matters would be for trustees to assess under their optimisation duty.

3.3.3 MySuper separately audited accounts

It its second Phase One Preliminary Report on MySuper, the Panel articulated a view that MySuper would require separate audited financial statements. The Panel's concluded view is that the outcomes reporting standards (as discussed in chapter 4) could produce a better outcome for all stakeholders, but that a level of assurance by way of audit would still be required. The mechanism by which this would occur should be specifically addressed in the outcomes reporting standard which will follow extensive industry consultation.

3.3.4 Unit prices and crediting rates

The Panel has decided not to intervene in the debate about whether unit pricing or crediting rates is a superior method of crediting and valuing interests in a super fund. The Panel does not see that MySuper necessarily calls for one approach or the other. Both methods seek to serve the same purpose. This is more of an operational issue better left to the trustees under the existing regulatory framework.

4 ADVICE

4.1 Concerns with current arrangements

The Panel is fundamentally opposed to the 'bundling' of advice with superannuation products, other than intra-fund advice. By bundling the cost of advice into the price of the product, and by having that cost incurred on an ongoing basis, members do not appreciate the true cost of the advice and may pay much more for the advice than it is worth. Also, members' choices in this regard are limited; they generally cannot opt-out.

Conceptually, given that there are relatively low barriers to entry in the advice market, any excessive advice fees should be driven down through competition. However, there are concerns that the

advice market is imperfect such that this does not occur. This is most pronounced where a component of a member's fees may be distributed to a financial adviser even though the member has not met the adviser or received any advice.

Further, the adviser has an incentive to recommend products that pay commissions, or pay higher commissions, rather than products that do not. Some advisers also receive other incentive payments based on the volume of products they recommend to clients. This is often compounded in the sense that members might not be aware of the relationship between their adviser and the product provider. Many of the larger corporate groups use various 'brands' to target different market segments or adviser types. While large financial institutions have both product-making and distribution by financial advisers in the single corporate group, the financial adviser group often has a different branding from the institution itself. Consequently, these interrelationships, and the associated potential for conflicts of interest, are often not readily apparent to members. This makes it difficult for members to assess the impact of these conflicts on the advice they receive.

The Panel is also concerned where members receive information and advice in a collective fashion, rather than individually.[16] As an example, fund members might be invited to attend a workplace seminar. In these circumstances, members might pay for the cost of this information and advice, whether or not they want it and whether or not they attend.

Lastly, there are circumstances where advisers help employers choose a default fund or default insurance settings and the like. These services and their cost is typically bundled into the overall fee a member pays, raising concerns over whether the benefits the members receive from these services exceed the costs. There is also a more fundamental problem being that members should not pay for services provided to an employer (as opposed to the trustee) under any circumstances. Such arrangements need to dissect more transparently what costs are properly payable by the employer and which ones are payable by the trustee, and then ultimately by the members through administration fees.

4.2 No 'bundled' advice

Reflecting these concerns, the following aspects concerning advice would be objective criteria for a MySuper product.

MySuper trustees would have a duty to optimise overall costs to members. Accountability and transparency in costs would therefore be paramount. Accordingly, advice (other than intra-fund advice) should not be bundled with MySuper products. The costs of providing superannuation advice services (and other services) provided to employers also should not be bundled into member charges or paid from member accounts in MySuper products under any circumstances. An employer should pay for advice services provided to it (which would be tax deductible as a business expense), rather than the fund members. Services provided to the trustee can, of course, be passed on to members as part of explicit fees such as the administration fee.

This is also an area in which the Panel is concerned not to create regulatory imbalances or opportunities for arbitrage between MySuper and choice products, including SMSFs. The Panel therefore considers that there should also be no bundling of advice in relation to any choice sector products and including products offered to SMSFs. The Panel notes that removal of the capacity to bundle advice services with superannuation products will not affect a fund trustee's intra-fund advice facility.

Outside the intra-fund advice model, it should be up to members to ask for advice. Employers would still be able to arrange for advice services to be offered to members, but members would have to opt-in to this arrangement. For advice about superannuation, the member would have to agree in writing for any fee to be deducted from their account and the payment would have to relate solely to advice about superannuation.

Recommendation 1.8

Neither advice to members (other than intra-fund advice), nor advice to employers should be 'bundled' with MySuper products.

Recommendation 1.9

Advice to members of a MySuper product (other than intra-fund advice) should only be provided on request and trustees should only be able to deduct the costs of advice about superannuation from a member's account with the member's written agreement.

Recommendation 1.10

The cost of advice or services provided to employers should not be borne in any way, directly or indirectly, by MySuper members.

Recommendations relating to advice in the choice sector are in section 9 of this chapter.

4.3 No up-front or trailing commission or ongoing payments

Payments for advice to fund members in the form of product-based up-front or trailing commissions or other like payments raise real and potential conflicts of interest that could have no place in relation to a MySuper trustee's fully member-focussed duties. The Panel notes the Government has decided to ban commissions more widely in the *Future of Financial Advice* reform package. This package outlined the Government's decision to remove conflicted remuneration structures generally from financial services. Although those reforms would extend to superannuation, the Panel is particularly of the view that a ban on payments of these kinds would be necessary to be consistent with the duties of a MySuper trustee.

Recommendation 1.11

Trustees of MySuper products should not:

(a) pay or fund any product-based up-front or trailing commission or other similar payment; or

(b) make or fund any payment that relates to volume,

in respect of superannuation advice or other products or services provided to members.

4.4 Annual renewal of advice contract

The ability of a fund trustee to permit the cost of superannuation advice to be paid from the member's fund account under the sole purpose test helps to ensure that advice remains accessible to those who cannot afford to pay for it from other sources.

However, the Panel believes that there should be an opt-in regime so that MySuper members are in control. Under this regime, any arrangement for superannuation advice to the member could only operate for a period of no longer than 12 months, after which time it would lapse if not expressly renewed. Anti-avoidance rules would be necessary to prevent arrangements designed to have clients committing to payments over a longer period.

Any arrangement by a member for ongoing advice about their superannuation would have to be renewed in a standard form, akin to an annual insurance renewal, with full disclosure of the estimated cost to the member of continuing the arrangement for up to another year. Where possible, the renewal notice should be provided electronically. There should always be the option of paying for the advice on a fee-for-service basis and from sources outside the member's super account, and the same renewal requirements would apply in those cases. It would not be permitted for the standard form to be incorporated with any other information.

The Panel notes the *Future of Financial Advice* reform package requires that if an adviser is to provide an ongoing service, the adviser must send an annual renewal notice to the client. Although those reforms are intended to apply in relation to any financial services, including superannuation, the Panel is particularly of the view that an annual renewal regime would be necessary in MySuper.

Recommendation 1.12

Members of MySuper products should only be provided with advice about superannuation (other than intra-fund advice) under arrangements that require the member to renew the advice service each year on a renewal notice from the adviser.

Recommendation 1.13

ASIC should, in consultation with industry, devise a standard form which requires clear identification of the advice service to be provided where a fund member renews an ongoing advice service.

5 INSURANCE

The following aspects concerning insurance would also be objective criteria for a MySuper product. A further discussion of insurance in superannuation is in chapter 5.

5.1 No up-front or trailing commission or ongoing payments

In a MySuper product, the premium paid for insured member benefits would not be allowed to include or fund up-front or trailing commissions or like payments in connection with any group

insurance arrangement. This would not prevent a trustee paying brokerage for services rendered to the trustee by a broker or agent on a fee-for-service basis.

The Panel notes that, in the *Future of Financial Advice* reform package, the Government has announced its intention to remove conflicted remuneration structures generally from financial services, including superannuation, but not, at this stage, in relation to risk insurance (including group insurance). The Government noted that policy concerns in relation to affordability of insurance and under-insurance of the population would need to be explored and further consultations undertaken.

As with commissions for financial advice, commissions on group insurance policies raise real and potential conflicts of interest that have no place in relation to a MySuper trustee's duties. The Panel, for its part, is of the view that concerns in relation to affordability and under-insurance are less relevant in the specific context of MySuper products and the duties under which MySuper trustees would be required to operate. The removal of commissions in relation to insurance is also consistent with the removal of commissions for advice in MySuper products, and forms an integrated approach to removing unwarranted costs that adversely affect the financial outcomes delivered to members. On this basis, the Panel maintains its view that in a MySuper product group risk insurance premiums should not be allowed to include or fund an up-front or trailing commission or like payment.

Recommendation 1.14

Trustees of MySuper products should not pay premiums for insured member benefits that include or fund an up-front or trailing commission or like payment.

5.2 Death and TPD insurance

Death and TPD insurance (subject to availability of cover) would have to be offered on an opt-out basis in MySuper products: that is, cover would be automatic unless the member chose to opt-out. The member could opt out at any time. Cover would also be able to be increased above the default level of cover at member election. There would not be a minimum specified level of cover; trustees would retain their traditional responsibility to set an appropriate minimum default and maximum optional level of cover to suit its member demographic and balance that against the impact of premiums on the accrual of member's final retirement benefits.

5.3 Income protection insurance

The Panel believes that MySuper trustees should have the option, but not the obligation, of offering income protection (salary continuance) insurance in support of temporary disability benefits on an opt-out or opt-in basis, if they believe that it is in their members' interests to do so.

5.4 Other types of insurance

The Panel believes that there should be limits on a MySuper trustee providing insurance that is not directly related to building retirement savings out of a member's superannuation. Therefore, a MySuper trustee should not be able to offer trauma insurance and other types of cover.

5.5 Risk pool

Consistent with the Panel's view that MySuper is aimed at transparency of outcomes and not physical barriers, it should be possible for MySuper members to be in the same pool as other members for the purposes of pricing the risk attaching to group life or other types of insurance.

5.6 Aim of uniform coverage

The Panel's aspiration is that insurance coverage in MySuper products be provided on an automatic acceptance basis. Preferably, coverage would also be generic, in that there would be no difference in coverage whether a member were to join a MySuper product through a 'default' process or by virtue of the member's own decision. However, the Panel recognises the scope for cross-subsidisation where people can benefit from there being no requirement to demonstrate health, as currently occurs in default arrangements, and that this may require further industry consultation.

6 MOVEMENT OF MYSUPER MEMBERS

The Panel expects that some MySuper members might wish to make investment choices through some level of participation in the choice sector. MySuper is not 'all or nothing'. It would be possible for a member to have part of their superannuation in a MySuper product and the rest in, for example, an international equities investment option in a choice product offered by the same trustee or in another fund altogether.

Of course, a MySuper trustee would always comply with legislative obligations to transfer a member's benefits, such as those in relation to the payment to the ATO of the benefits of certain former temporary residents and lost members. MySuper products would also operate consistently with the wider family law and super arrangements. Otherwise, the Panel believes that, in general, a member should not be moved from a MySuper product other then by way of the member's active choice. The aspects below in relation to the involuntary movement of MySuper members would also be objective criteria for a MySuper product.

6.1 Member choice

There should be very few barriers to a trustee giving effect to a member's choice to move some or their entire super out of a MySuper product, if that is what they want to do. This should be treated as just another piece of fund administration to be done efficiently. The Panel is very keen to see an end to efforts by trustees to delay (or frustrate) the wishes of members to move to another fund.

6.1.1 Recommendations by advisers and trustees

There would, however, be some important protections for members making a decision to move out of MySuper. Where a financial adviser recommends that a member switch out of a MySuper product into an alternative superannuation product, the Panel believes that requirements at least as robust as those in section 947D of the Corporations Act would be required. These would ensure the advice covers such aspects as charges the member would incur, pecuniary or other benefits the member would lose and other significant consequences. This would be required whether the alternative

product is within a suite of products offered by the same trustee under a single RSE umbrella or is a completely separate product offered by a competitor.

Switching advice requirements would also apply to a trustee's recommendation. In providing advice, the trustee would be under a range of obligations directed at the member's best financial interests in MySuper. The purpose of MySuper would be quickly defeated if trustees could induce members to switch to other choice products offered by the trustee that were either equivalent to MySuper, but carried higher fees or were inferior or unsuitable for some reason.

The Panel notes that the measures announced by the Government in the *Future of Financial Advice* reform package also move in this direction. Under those reforms, financial advisers would be under a duty to act in the best interests of their clients.

Recommendation 1.15

Legislation should apply specific and thorough conduct and enquiry duties on persons (including trustees) providing switching advice to a MySuper member built on the current requirements of section 947D of the Corporations Act.

6.1.2 Moving back to MySuper

A member might also decide to switch those benefits back to MySuper. The Panel sees this occurring in much the same way as it does now. The move back to MySuper should involve even less administration and would not call for the member being treated in any way differently from other MySuper members merely because the member had made a 'choice' to move or had made a 'choice' to return.

6.2 Transfer to an ERF

A MySuper trustee would be able to transfer members to an ERF without the members' active choice. This is consistent with current provisions in the SIS Act in relation to all super funds.[17] All ERFs would be required to operate under standards very similar to those proposed for MySuper. ERFs are discussed further in chapter 10.

6.3 Flipping

'Fund flipping' describes the practice of a member being automatically moved from one division of a fund to another (generally to a 'personal' division or plan) on cessation by the member of the particular employment to which the original fund division related. Generally, the personal division will have higher fees and may involve a decrease in insurance cover or an increase in the premium charged.

Fees in a corporate division can often be lower than in a personal division in the same fund because the employer usually subsidises costs for its active employees and, when in a retail fund, the employer can use its purchasing power to negotiate discounted fees for its employees. On ceasing employment, the member no longer enjoys those benefits and is 'flipped'.

Some unsatisfactory practices have arisen from flipping. Members often have no 'grace period' after termination of employment in which to provide the trustee with instructions concerning transfer of their benefit and thereby avoid the higher fee. Also, disclosure about this practice is often inadequate and members do not know it will happen or has happened.

However, the Panel recognises there would be scope for flipping in MySuper products in master trusts. The Panel believes that a member could be moved from a MySuper product without the member's active choice where the member is flipped to another MySuper product in the personal division of the corporate master trust.

The inbuilt criteria of a MySuper product, at both ends of this member movement, would remove many of the concerns identified with flipping. The Panel believes that this would be a matter for the trustee whether a MySuper corporate master trust product engages in such flipping; the trustee could decide to retain the member and accumulated balance in the original MySuper corporate master fund product.

6.4 SuperStream auto-consolidation

Arrangements for the auto-consolidation of accounts within the same fund, without prior reference to the member, are recommended in chapter 9. To the extent multiple accounts for the same member are found in a MySuper product, such auto-consolidation would be highly appropriate. Chapter 9 also canvasses arrangements for account consolidation, on an opt-out or opt-in basis, across all large APRA funds to the fund with the latest contribution. These arrangements would ensure any member could keep their MySuper membership if they were to move part of their balance into the choice sector and, if desired, retain a previous MySuper membership after a change of employment and a decision to enter a choice sector product.

The Panel does not see much potential for the misuse of auto-consolidation in advice to MySuper members (that is, the possibility that an adviser recommends the creation of a new account without regard to other accounts, knowing that auto-consolidation will sweep them up), particularly if an opt-out model is ultimately adopted. The advice could not properly ignore the possibility of the client having existing super accounts. In the *Future of Financial Advice* reform package, the Government has announced that financial advisers would come under a duty to act in the best interests of clients, and chapter 9 recommends that the ATO develop a mechanism to display all funds of which a person is a member. The Panel therefore believes that these regulatory settings should provide sufficient protection.

Recommendation 1.16

Members should only be able to be moved involuntarily out of a MySuper product if they are:

(a) transferred to an ERF;

(b) flipped from a MySuper product in a master trust to another MySuper product in another division of that trust; or

(c) transferred under legislative requirements such as auto-consolidation of accounts or temporary resident arrangements.

7 MEMBER ENGAGEMENT

The aspects below illustrate a feature of a MySuper trustee's duty in relation to the optimisation of costs and performance, and describe another objective criterion for a MySuper product.

7.1 Trustees' focus on engagement

Currently, there is a range of approaches to encouraging members to be more engaged with their superannuation. Some trustees offer intra-fund advice (which has only been available since mid-2009) and will now be specifically required in MySuper. Other communications by trustees to members are closer to advertising and less obviously in member interests. Some trustees engage in a substantial amount of outright advertising. The Panel believes that, in MySuper, trustees need to be more focused on the intent of engagement with members and its tangible benefit to them.

The Panel certainly does not intend to deny members access to information or to enforce a level of disengagement in an effort to reduce costs. This is not to say that the Panel is opposed to efforts to get members to take more responsibility for their retirement; far from it. The point is that these initiatives cost money and trustees need to be accountable for their effectiveness. The Panel is seeking to make trustees accountable for overall costs to members with the result that some practices carried out in the name of member engagement might be more difficult for trustees to justify.

The Panel envisages that MySuper would result in a greatly enhanced environment for those members who are engaged or want to engage with their superannuation, arising from a combination of the following:

(a) the e-super disclosure measures mentioned above would make comprehensive information about the MySuper product readily available;

(b) the MySuper trustee's intra-fund advice facility, as expanded by the *Future of Financial Advice* package, would mean that all MySuper members would have access to information and advice direct from their trustee, and the Panel envisages this being offered pro-actively in some cases;

(c) the mandatory provision of forecasts about likely retirement benefits, discussed in section 7.2 below; and

(d) greater transparency imposed on all funds by other measures recommended by the Panel in chapter 4, including performance measurement and information about the wider fund, including the fund's trustee.

These measures would reduce the need for other, less relevant, engagement with a corresponding reduction in costs to members.

7.2 Forecasts of retirement benefits

The Panel believes that possibly the biggest engagement hurdle is getting members to understand whether their current contribution strategy is likely to provide them with an adequate income in retirement. This involves the multi-tiered challenges of focusing them on future events, current

savings habits and the conversion of their lump-sum thinking into 'replacement rate' thinking; what proportion of their current income will they need to live on in retirement?

Forecasts of retirement benefits (also variously described as 'end benefit projections', 'retirement projections' or 'superannuation forecasts') aim to provide super fund members with an indication of the value of their ultimate retirement benefits. The Panel agrees with widely held sentiments in the industry that these projections can help educate fund members about the adequacy of their current super savings and can help members make choices that will help them achieve financial security in retirement.[18] However, forecasts of retirement benefits are not about comparing the potential performance of different funds and should not be structured to suggest this. Comparing funds is a separate endeavour and is discussed in chapter 4.

The Panel considers that the relative simplicity of a MySuper product would support a single standardised system for retirement projections for use by all MySuper trustees. A forecast of retirement benefits would also have a natural synergy with the intra-fund advice facility. There would also be clear value in a forecast being actively presented to members, as a routine part of a MySuper members' annual statement. This is a key member communication and the important purpose and message of these forecasts would be far less likely to be achieved through indirect means, such as a link to a calculator. For this reason, in chapter 7, the Panel also recommends that a MySuper trustee must pro-actively offer intra-fund advice to members when they get close to retirement and at intervals in retirement.

Many features appropriate for MySuper forecasts of retirement benefits have been identified in ASIC's consultations in respect of benefit projections.[19] The Panel is aware of submissions to ASIC from sections of the industry critical of some of these aspects. However, the Panel firmly believes standardised retirement projections are the best way to seek to raise members' awareness of their likely financial position at retirement and prompt them to seek out other information, consider their options and make informed choices about their contribution rate and length of time in employment. On this basis, a MySuper retirement projection would:

- be provided in relation to a member's account balance and a set uniform retirement date;
- not consider any entitlement to the age pension or any other superannuation account;
- assume no change to current salary for SG contributions outside set assumptions for inflation, and assume no change to current personal contribution levels;
- assume current taxation and other legal conditions remain unchanged;
- utilise a single set of annual assumptions for investment earnings, insurance premiums, fees and costs across all MySuper funds, developed by government in consultation with the industry and the actuarial profession;
- be accompanied by suitable standard warnings and disclosures including, for example, in relation to how the age pension and other assets also determine final retirement income; and
- present the projection as an amount in current-day dollars.

Retirement projection would also be best presented in the form of both a final account balance and an annual income stream, to assist members to understand their superannuation savings in terms of

the 'replacement rate' in relation to current employment income. However, this would need to be developed further in conjunction with the development of the MySuper retirement product.

Recommendation 1.17

The presentation of retirement forecasts should be mandatory for MySuper products, and should be developed in consultation with industry in accordance with the approach identified by the Panel.

8 IMPLEMENTATION

The Panel expects many existing funds would wish to offer MySuper products to continue to participate in the SG and award 'default' framework. The kinds of issues that arise in the transition to the new choice architecture model and, in particular, in relation to the implementation of MySuper will inevitably give rise to a number of issues arising from individual circumstances. While the Panel acknowledges this is ultimately a matter for Government and further consultation, in this section the Panel outlines its thinking on some of those issues.

8.1 Some key implementation issues

8.1.1 Conversion

It is a core aim of the MySuper proposal to ensure that an existing default fund or default investment option can be modified to conform with MySuper product requirements with minimal disruption and transition cost.[20] It is therefore not the Panel's intention that MySuper could be achieved only through setting up a new MySuper RSE.

The Panel does not consider that implementation should be thought of as a single 'big bang' conversion that could potentially take the fund off-line for weeks or months. There are synergies between MySuper features that mean that movement towards 'conversion' can involve several interconnected aspects at once. Similarly, systems changes that relate to MySuper would be made in conjunction with those required by the Panel's SuperStream recommendations in chapter 9.

An initial step for trustees would be whether the fund's existing default investment option could be the basis of conversion into a MySuper product. Some default investment options would not be able to convert immediately to MySuper because of existing contractual arrangements which cannot be overridden, such as commissions (whether for advice or on insurance products) and certain insurance policies. The Panel expects that funds that currently have investment options would want to retain them and the transition could involve the conversion of a fund into both MySuper and choice products.[21] Depending on scale, the trustee may need to consider whether the MySuper product needs to merge with other funds and, if so, explore options as to how that might happen.

If a trustee decides to have MySuper and choice products in the same fund, there will be necessary alterations of the trust deed (with prospective effect) to reflect multiple products. The governing rules would need to ensure that the interests of members of one product are separately identifiable from the interests of members of the other product. While some of this might be achieved at

generic level by legislation, trustees would still determine what, if any, consequential changes might be required.

8.1.2 Initial member placement

Although new employees would be in a MySuper product unless they made an active choice in favour of a choice product, trustees would need placement strategies for existing fund members until otherwise directed by the member. These would include:

(a) members with benefits wholly in the default investment option could be placed into the MySuper product;

(b) members with benefits spread over a default option and other investment options could be placed in both the MySuper product and the choice product, with the trustee obliged to give effect to any existing arrangement to split future employer SG contributions between the products; and

(c) members with no benefits in the default investment option could be placed into a choice product based on their selected investment option.

8.1.3 Timing

Implementation would involve at least a two-year transition period from passage of legislation to establish the new choice architecture. Trustees intending to offer a MySuper product would need to develop or enhance the fund’s website, e-communications and intra-fund advice capabilities. APRA licensing and the finalisation of APRA prudential guidance would also be required. Time for transition should also mean that current insurance policies can expire and be re-negotiated on terms consistent with MySuper, including that a member can withdraw from cover at any time and that no commissions are involved.

Modern awards are set to be reviewed in 2014 and the date from which SG Act and award defaults funds would have to be a MySuper product could be an effective 'deadline'. This also means industry would be able to pre-position aspects of funds before the end of any formal legislative timeframe.

8.2 Supervision of implementation

The Panel also considers it would be appropriate for there to be close regulatory oversight of the transition to the new choice architecture and MySuper. It would be important to reduce the possibility of groups of members to which MySuper is directed being inadvertently overlooked. There might be potential for APRA licence conditions that aim to ensure the transition into MySuper products is as easy as possible.

The Panel also believes that ASIC should conduct an information and surveillance campaign aimed at trustee and adviser behaviour in the period leading up to the implementation of MySuper.

Recommendation 1.18

The superannuation industry should have at least two years to transition to MySuper and the new choice architecture.

Recommendation 1.19

Both APRA and ASIC should oversee the transition referred to in Recommendation 1.18.

9 CHOICE PRODUCTS

9.1 The new choice architecture

The major difference in the choice architecture model is the clear distinction to be made between MySuper and choice products, as either may be offered by large APRA funds. The Panel's broad starting point in relation to the choice architecture model is that, as far as is reasonably possible, if the trustee of a large APRA fund does not wish for a product to comply with MySuper or ERF criteria, the product should continue to operate much as it currently does.

A choice product trustee would be able to determine the extent to which it differs from a MySuper product in relation to the offer of investment choices, intra-fund advice or retirement products, among other features. This is appropriate and will allow the creation of a competitive choice sector. Of course, this must be read alongside the Panel's recommendations in this and later chapters that relate to wider systemic features that cross product sectors. Recommendations in relation to trustee governance, transparency and insurance, among other things, would also clearly affect choice products and MySuper products.

9.2 Entry and exit fees

The Panel has recommended above that, for MySuper products, there should be no entry (contribution) fees, including on rollovers, and exit fees could only be charged on a cost recovery basis. These are areas in which the Panel is concerned not to create regulatory imbalances or opportunities for arbitrage between MySuper and other products. Accordingly, the Panel also considers these should also be features of choice sector products.

Recommendation 1.20

Trustees of choice sector products should also not be able to charge entry fees and should only charge exit fees on a cost recovery basis.

9.3 Advice

The Panel's concerns with the bundling of advice apply as much to products in other sectors of the choice architecture model as to MySuper products. The Panel especially considers that in any type of product an employer should pay for advice or other services provided to it and not the member.

This is also an area in which the Panel is also concerned not to create regulatory imbalances or opportunities for arbitrage between MySuper and other products, including SMSFs. Accordingly, the Panel considers its recommendations with respect to bundling, provision of advice, up-front or trailing commission and advice service renewal should also apply to products in all sectors of the choice architecture model.

Recommendation 1.21

Neither advice to members (other than intra-fund advice), nor advice to employers should be bundled with choice products or with any other product in the choice architecture model, including products offered to SMSFs.

Recommendation 1.22

Advice to members of a choice product or of any other product in the choice architecture model (other than intra-fund advice) should only be provided on request and trustees should only be able to deduct the costs of advice about superannuation from a member's account with the members' written agreement.

Recommendation 1.23

The costs of advice to employers should not be borne in any way, directly or indirectly, by members of choice products or by members of any other products in the choice architecture model.

Recommendation 1.24

Trustees of choice products or of any other product in the choice architecture model should not:

(a) pay or fund any product-based up-front or trailing commission or other similar payment; or

(b) make or fund any payment that relates to volume,

in respect of superannuation advice or other products or services provided to members.

Recommendation 1.25

Members of choice products or of any other product in the choice architecture model should only be provided with advice about superannuation (other than intra-fund advice) under arrangements that require the member to renew the advice service each year on a renewal notice from the adviser.

The Panel notes that the *Future of Financial Advice* reform package announced by the Government would reduce the extent of differences between MySuper and choice products in areas such as commission-based remuneration practices and advice service renewals.

9.4 Insurance

Similarly, the Panel considers that its recommendations in relation to up-front payments or trailing commissions should also apply to products in other sectors of the choice architecture model.

Recommendation 1.26

Trustees of choice products or of any other product in the choice architecture model should not pay premiums for insured member benefits that include or fund an up-front or trailing commission or like payment.

9.5 Forecasts of retirement benefits

Although recommending these forecasts be mandatory for MySuper products, in the longer term the Panel would also like to see retirement projections as a feature of choice products, and so across all large APRA funds. The introduction of retirement projections into MySuper products would be the start of this process. The Panel agrees that as account balances increase, the provision of information of this type will become increasingly important.[22]

Presumably also, as some of the measures recommended in chapter 4 become well-established, there could be some scope for funds to move to projections that are specific to the investment objectives and other characteristics of individual MySuper products and choice investment options, but the Panel sees that as some way off at the moment.

9.6 Investment option duties and protections

The new duties the Panel proposes for trustees of MySuper products are explained in this chapter 1, and chapter 2 deals with trustee governance generally. This section deals with different investment governance settings proposed for trustees in the 'choice' environment where members are making decisions about where to invest their retirement savings.

Currently, trustees are required to formulate and give effect to an investment strategy that takes into account the entire circumstances of the entity, including the risk and likely investment return from investments of the fund, the diversification of those investments, liquidity requirements and the ability of the fund to discharge its liabilities. These considerations are directed at ensuring that

fund assets are not placed at excessive risk from asset concentration and that there is sufficient liquidity for outgoing funds.

While trustees are responsible for formulating an investment strategy for the fund, members can direct the trustee to follow an individual investment strategy, by selecting from one or more of the investment options made available by the trustee. This has led to some uncertainty as to whether the trustee is responsible for the appropriateness of the investment or investment mix chosen by the member. The new choice architecture model, and the very clear requirement for diversification in MySuper products, offers a new framework to consider a different scope for the role of trustees that offer investment choices.

9.6.1 Trustees and diversification

In seeking to establish suitable policy settings, three challenges exist.

First, there needs to be a balance between the ability of members to choose investments and the responsibility of trustees to ensure that investment options are appropriate for members. Secondly, for some people, maximisation of retirement income involves consideration of investments across their entire asset portfolio, rather than just across their superannuation assets alone.

Lastly, diversification needs to be defined in a way that takes risk into consideration, rather than just a mix of assets.

The Panel has considered three broad options along a spectrum of weaker to stronger constraints on members making undiversified investment choices.

Option 1: Choice trustees required to offer a suite of investment options that allow members to diversify across asset classes, but members can choose to be undiversified

In formulating the fund level investment strategy, trustees would decide the type and number of options to offer to members. The range of options must be sufficient to allow members to obtain a diversified asset mix if they choose. The trustee must be satisfied that each option is ‘fit for purpose’, that it is suitable to be offered as part or the whole of an individual’s retirement saving strategy. Members could then direct the trustee to follow any strategy selected or constructed by the member from the options offered by the trustee. The trustee would have no obligation to assess the appropriateness of the investment strategy for the member.

Having a range of investment options would allow well-advised members to optimise their portfolio across all their assets, in and outside superannuation. Members could adopt an investment strategy that changes their investments over time in line with changes in their needs and tolerance for risk over their life cycle.

However, undiversified investments are, in themselves, riskier. There is also the risk that some members might end up in the wrong investment strategy through poorly informed or advised choices.

Option 2: Choice trustees could offer undiversified investment options, however members must give written acknowledgement before investing

Members who wish to choose an undiversified investment strategy would be able to do so by giving a written acknowledgement. This would place greater emphasis on the importance of the decision and the risks involved.

This approach would not impair a member's control over their superannuation investments, while protecting those members who prefer to choose from investment options that satisfy the investment strategy requirements.

Option 3: Choice trustees and members would have to comply with mandatory diversification requirements

Under this option, choice trustees would need to ensure members' investment choices are appropriately diversified. This would reduce the risk of financial loss from poorly informed choices, but would limit the ability of members to choose how to invest their superannuation in the choice environment.

Some people would be unable to optimise their retirement income because they would have less scope to tailor their superannuation investments in light of their overall financial position (for example, substantial savings outside super). This would limit the choices available in the choice sector. It is also inconsistent with current industry practice and would therefore result in significant compliance costs.

On balance, the Panel prefers option 1 on the basis that it is appropriate to allow members of choice funds to select undiversified investment options, subject to certain safeguards that are discussed below.

9.6.2 Trustees and due diligence 'safe harbour'

Given the Panel's view above, it also considers that, generally, a choice trustee should be able to operate in an environment that gives it protection in relation to the consequences for the member of any lack of diversification in the option(s) selected by the member or in the event that the chosen option itself causes the member to suffer loss.

However, the Panel considers that such protection should only be available where the choice trustee has complied with an appropriate standard of due diligence in making investment options available for selection by fund members and in monitoring them. This duty would include aspects such as:

- a requirement for initial due diligence to understand the nature of the underlying investments involved with the option and continued monitoring of the suitability of the option. This duty is likely to be magnified where the option is a managed investment scheme or other product designed and managed by others;
- obligations in relation to the liquidity of the underlying investments and structures, including to match the liquidity/maturity terms of the underlying products with the disclosed benefit portability regime; and
- a requirement for due diligence in relation to the legal structures of underlying investments and especially foreign-domiciled entities with no legal presence in Australia.

The Panel envisages that APRA would detail the trustee's due diligence obligations through a prudential standard and/or prudential practice guide.

9.6.3 What would the safe harbour look like?

APRA and ASIC could develop, in consultation with the industry, guidance on what steps would be reasonable in the circumstances for a trustee to carry out in placing an investment option on a menu and in carrying out ongoing monitoring of the investment option. This could then be developed to form part of the new package of trustee duties recommend in chapter 2, together with an appropriate safe harbour from civil liability.

Recommendation 1.27

Choice trustees must offer a range of options sufficient to allow members to obtain a diversified asset mix if they choose, but members can choose to be undiversified and the trustee would have no obligation to assess the appropriateness of the investment strategy chosen by the member. Trustees would be subject to new express duties in selecting and monitoring options.

Recommendation 1.28

A choice trustee that discharges its duties in selecting and monitoring investment options should not be exposed to civil liability in the event that a member suffers damage by reason of illiquidity or other circumstances affecting the investment option, including diminution in value or failure.

ENDNOTES

1 Part 1 of this report, Overview and recommendations, explains the basis of this projection.

2 Thaler R and Sunstein C, (2008) Nudge - Improving decisions about health, wealth and happiness, Yale University Press.

3 For example: Australian Institute of Superannuation Trustees, Submission no. 62, pp 24-25; AMP, Submission no. 59, pp 6-7; AXA, Submission no. 34, p 13.

4 It has been estimated by a number of research providers, academics and industry professionals that on average 80 per cent of members are in the default option: (i) SuperRatings: "some 82% of Australians accept the default position within their funds." SuperRatings, Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Structure and Operation of the Superannuation Industry, September 2006; (ii) Choice: "Nine out of 10 super fund members are invested in their fund's 'default' option." Choice, 'Super in a volatile environment,' 12 May 2008 <www.choice.com.au>; (iii) PricewaterhouseCoopers: "80 per cent of members are in the default investment option." PricewaterhouseCoopers (Tubman. W), 'The Australian Wealth Management Industry: Global gold standard, or fool's gold?' April 2009 ; (iv) Gallery & McDougall: "Over 80 percent of members do not exercise choice and consequently, their superannuation assets are automatically invested in their fund's default option" Gallery G., Gallery N., McDougall L., 'Don't Judge a Superannuation Default Investment Option by Its Name,' 19 April 2010;

5 SuperRatings 2009 SR All Fund Median average member account balance was $24,855.

6 Rice Warner Actuaries, Superannuation Fees Report 2008.

7 Part 1 of this report, Overview and recommendations, discusses the composition of default fund membership and the level of engagement in super generally.

8 IFSA, Submission no. 226, p 5.

9 Mercer (Australia) Pty Ltd, Submission no. 296, p 106.

10 Australian Industry Group, Submission no. 321, p 1.

11 ACTU, Submission no. 218, p 4.

12 There are also processes if an employer, employee or organisation covered by a modern award, or that is entitled to represent one or more of the employers or employees covered by the award, wants to apply to Fair Work Australia to vary a modern award to include a different default fund.

13 Survey of Superannuation Costs: To understand further the impact of fund size on superannuation costs, the Review commissioned Deloitte, assisted by Chant West, to undertake an independent survey of superannuation costs. The survey was influenced by the number and representativeness of funds that responded to the survey and the difficulties in adjusting for outlying results and other factors such as asset allocation or investment style. In light of this, the Panel has decided not to rely on this analysis in forming its conclusions. That said, the results are consistent with other evidence of substantial economies of scale for fund administration. The survey showed that the smallest funds had the greatest potential economies of scale that could be experienced from increasing size. In other words, the results showed economies of scale were persistent, but at a decreasing rate. For the funds surveyed, there was no evidence of diseconomies of scale in terms of assets or members. For a member with an account balance of $25,000, administration costs can be up to two-thirds of the fees that are paid from their account. Therefore, lower balance members are the most likely group to benefit from capturing the potential economies of scale, which would lower the cost of administration as funds become larger. Based on the average account balance size in the industry fund and retail fund sectors, the administration costs represent around half of the total cost of an account. It was not possible to adjust the results of the survey in relation to investment costs to account for different asset allocations and investment style.

14 See ASIC MR 09-119 Improved access to simple advice for superannuation fund members 9 July 2009 and ASIC Regulatory Guide 200 Advice to super fund members July 2009

15 Minister for Financial Services, Superannuation & Corporate Law & Minister for Human Services, Media Release No. 36 26 April 2010.

16 The provision of services in this manner is described generally the following submissions: Centric Wealth Limited, Submission no. 220; Capital Partners, Submission no. 115.

17 SIS Act Part 24.

18 For example: ASFA Submission no. 32, p 22 of Appendix 1; Institute of Actuaries of Australia, Submission no. 162, p 24; QSuper, Submission no. 86, p 7; Mercer (Australia) Pty Ltd, Submission no. 170, p 64; SPAA, Submission no. 205, p 26; ABA, Submission no. 238, p 22.

19 ASIC Consultation Paper 122, Superannuation forecasts, October 2009.

20 Funds that offer only investment choices will determine the extent to which they wish to participate in the SG and award 'default' framework.

21 While it is possible for a fund with investment options to convert wholly to a MySuper product, this is considered less likely.

22 Melbourne Centre for Financial Studies, Submission no. 169.

SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 2
Trustee governance

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KEY THEMES

Issue

Trustee governance structures have not kept up with developments in the industry. There have also been difficulties for trustees and their trustee-directors in understanding what is expected of them and, as the industry consolidates, conflicts of interest and conflicts of duty arise regularly. Good trustee governance is fundamental to enhancing members' retirement incomes.

Proposed solution

The Panel proposes measures, including:

- creation of a new office of 'trustee-director' with all statutory duties set out in the SIS Act;
- equal representation would not be mandatory and all boards would be required to have some 'non-associated' trustee-directors;
- a detailed, specifically-tailored conflicts policy would be required for all trustees; and
- development of a Code of Trustee Governance which would set out 'best practice' principles for trustees and trustee-directors.

Benefits for members

Members will benefit from better trustee governance as:

- it will help ensure that the appropriately qualified people are running the fund and that they are aware of their duties toward members;
- conflicts will be better managed so that members can be confident that all trustee-directors are acting solely for the benefit of members; and
- accountability to members will be improved.

1 INTRODUCTION

The Panel's Phase One — Preliminary Report 'Clearer Super Choices: Matching Governance Solutions' (14 December 2009) expressed concern that the current approach to superannuation fund governance under the SIS Act was no longer adequate. This was primarily due to the fact that the 'one size fits all' model was not sufficiently flexible to take into account industry developments since the SIS Act was enacted and because the current approach gave the 'illusion' that members' interests were protected and paramount. The Panel has further considered these significant governance issues. It sets out its final conclusions and recommendations on the subject of governance in this chapter and in chapter 3. This chapter addresses the governance of trustees of all APRA-regulated funds (including small APRA funds). Investment governance (which covers both MySuper and choice sector) is dealt with in chapter 3. This chapter does not address the trustee governance issues for SMSFs. All SMSF issues are addressed in chapter 8.

The Phase One Report also set out the Panel's preliminary conclusions concerning an enhanced architecture for superannuation which became the 'MySuper' proposals in the Panel's Second Phase One — Preliminary Report (20 April 2010). MySuper is specifically covered in chapter 1, so it is not addressed in a detailed way in this chapter.

Collectively, the purpose of trustees and trustee-directors is to deliver the public policy goal of enhancing the retirement incomes of members. It is sometimes overlooked that the superannuation industry is quite different from other businesses. It owes its existence to government policy and is underpinned by a social purpose that runs alongside many other economic and stakeholder considerations. Recognising this special purpose, the Panel believes that all those involved in the system need to have — and be seen to have — high standards of governance. In superannuation, just as in other areas of corporate activity, good governance plays a major role in promoting better decisions, greater accountability and in reducing unintended operational and investment risks.

The Panel believes that the governance standards that apply to major listed entities are a reasonable starting point for the requirements that should apply to trustees and their trustee-directors, given the profound impact the latter have on the retirement incomes of members. This is particularly so in light of the growing influence that super funds have in advocating corporate governance practices for entities forming part of their investment portfolios that are not necessarily matched in their own practices. Turning the governance spotlight on trustees' own operations is, in the Panel's view, critical to the long-term sustainability of the superannuation system.

2 A FRAMEWORK FOR ACCOUNTABLE TRUSTEE GOVERNANCE

Because all APRA-regulated funds must be trusts, the conduct and skills of trustees are crucial to a fund's efficient and successful operation.

While it is possible under the SIS Act for a trustee to be a natural person, the vast majority of trustees of APRA regulated funds are companies and it is the board of trustee-directors who are responsible for the trustee's decisions and actions. In this chapter of the report, when we refer to the 'trustee', in context it means the trustee company. When we say 'trustee-director', we mean the person who

serves as a director of a trustee company. There are so few large APRA funds where there are only natural person trustees (five in total) that we do not separately refer to them.

With the introduction of the SIS Act in 1993, the government chose to focus on the unique position of the trustee. This is because the SIS Act was specifically designed to regulate and influence the way in which trustees play their role. The SIS Act reinforces the common law's orientation of trustees towards the best interests of members and emphasises that the sole purpose of the superannuation system is generally to provide retirement benefits to members. Subsequent legislation (including licensing trustees) has reinforced the pivotal importance of trustees.

Although the term 'governance' can be used in different ways,[1] in this report, the Review uses the term 'trustee governance' in the same way that 'corporate governance' is used by the ASX:

> *"Corporate governance is 'the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations'. It encompasses the mechanisms by which companies, and those in control, are held to account. Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised."*[2]

There is no evidence of systemic failure of trustee governance in the superannuation system. However, the Panel believes that there are shortcomings in the governance model that need to be addressed and improvements that can be made.

2.1 Current governance model

There are different models of governance evident across the industry. The differences are generally based on the fund's historical origins and whether the trustee operates a fund that is in the not-for-profit sector (industry, public sector and corporate funds) or the commercial sector (retail funds). However, the regulatory regime does not make significant distinctions between different models. This reflects the role of the SIS Act in articulating a minimum set of duties to be imposed on all super fund trustees, irrespective of business or operating model.[3]

That said, the Panel is concerned that the regulatory scheme shaping the governance of superannuation funds is unnecessarily complicated. It currently operates at two levels: one for trustees and a second for trustee-directors. To further complicate matters, some obligations on the trustee (company) flow through directly to the individuals acting as trustee-directors of the trustee.

In summary, then:

1. The trustee is subject to the duties imposed by section 52(2) of the SIS Act and a variety of registrable superannuation entity (**RSE**) licensing requirements.
2. The trustee-directors are subject to:
   - (a) the 'fit and proper' requirements for an RSE licence;[4]
   - (b) section 52(8) of the SIS Act, which imposes the covenants set out in section 52(2) on the trustee-directors as though they were trustees personally; and
   - (c) those parts of the Corporations Act that apply to company directors.

Lack of coordination between the SIS Act, the Corporations Act and the regulatory regimes creates a range of governance problems.[5]

For example, the present system creates ambiguity and confusion for some trustee-directors as to whom their duty of loyalty is primarily owed: to the members of the fund or to the for-profit trustee company (and hence its owners and associated parties). Ordinarily, directors would owe their duties directly to the company, which would owe duties as a trustee to the members. Section 52(8) of the SIS Act attempts to address this by requiring the trustee-directors to:

> *"exercise a reasonable degree of care and diligence for the purposes of ensuring that the trustee carries out [its duties], and so operates as if the directors were [subject to the same duties]."*

However the list of duties in section 52(2) of the SIS Act contains some duties that appear more relevant to the trustee, and some that appear more relevant to the trustee-directors individually and collectively. The Panel believes that there ought to be unambiguous clarity about the duties owed by the trustee-directors, as well as the standard of competence that they should possess and exercise. These should be distinguished from those related to the trustee. Rules of a similar nature, such as those governing the standards of conduct and competency of trustee-directors, should be found in the one place wherever possible. Trustee-directors should not have to collate rules from multiple sources in order to understand their core duties.

Another example of a potential issue that arises from having dual statutes (each with authority on the same subject) can be illustrated by the different provisions that apply in determining when trustee-directors are entitled to be indemnified out of trust assets and when they are personally liable. This issue is created by the indemnity limitations under section 197 of the Corporations Act on the one hand and the indemnity requirements under section 56 of the SIS Act on the other. Section 5.2 of this chapter addresses this matter in more detail.

2.2 A new model for governance

The Panel believes that there is value in creating a distinct new office under statute, that of 'trustee-director'. The duties, powers and standards required of that office should be recorded clearly and cogently in one place, preferably the SIS Act. These duties, powers and standards would apply to the trustee-directors of all APRA-regulated funds, not just those offering MySuper products to members. Certain additional duties would be imposed in relation to MySuper products (these additional duties are explained more fully in chapter 1).

While establishing the trustee-director office would necessitate changes to current legislation that go beyond the insertion of a few new provisions and would require wide consultation with industry, the Panel is of the view that there would be significant benefits in equipping trustee-directors to understand completely their role and responsibilities.

The Panel is conscious of the consequences in terms of delay, cost and disruption, that legislative change such as this cause. However, it believes that these changes are important steps towards a more accountable and efficient trustee governance regime for the future.

2.2.1 Enhanced statutory duties for trustee-directors

Enhanced statutory duties would be articulated for trustee-directors to address these governance issues. The statutory duties would enhance, expand and clarify the duties in section 52(2) of the SIS Act. The Corporations Act would no longer have any relevance to trustee-director duties, but ASIC would continue its regulatory responsibilities for trustee-directors; those duties would simply be found in the SIS Act, rather than the Corporations Act. There is no intention that these statutory duties would codify common law principles.[6]

The Panel's intent is that these duties would focus trustees and trustee-directors on the issues that, as a matter of policy, the Panel believes are of utmost importance for superannuation fund governance.

Key among these is the trustee's duty of loyalty to the members of the fund. Despite the apparent simplicity of the reference in section 52(2)(c) of the SIS Act to the 'best interests' of members, there is considerable uncertainty in practice about what that provision actually means. A diversity of views has been expressed in the courts[7] and the AAT,[8] and in commentators' analysis of the provision.[9] IFSA, focusing on one dimension of the confusion, noted in its submission to Phase One:

> *"Codification has arguably resulted in the misunderstanding of the 'best interests' test ... misunderstanding of the test (together with the breadth of when it is applied) has lead to much of the confusion arising in the governance of superannuation funds."*[10]

The Law Council of Australia also directly alluded to the uncertainty. It noted:

> *"A recent challenge faced by the industry is the meaning of the best interests duty set out in section 52(2)(c) of the SIS Act ... Moreover at times the regulator's interpretation (with its apparent focus on 'outcomes') is arguably at odds with the historical and general law interpretation of various duties and general industry understanding of those duties."*[11]

The Panel believes that the SIS Act would benefit from a clearer articulation of what appears to be two important elements of that duty: the requirement that trustees place member interests ahead of the interests of all others, and the requirement that trustees should actively endeavour to achieve the best outcome for members and not to be content to accept merely an adequate, reasonable, or peer-comparable outcome. To that end, the Panel is recommending a more precise set of 'conflict' duties and also recommending that the standard applied to the requirement that trustees act with care, skill and diligence be raised from that of the 'prudent person' to that of the prudent 'person of business'. That heightened standard has the additional attraction of reflecting the increasing challenges now facing trustees as funds grow and become more complex. It is also the standard that currently applies in all Australian states for professional trustees of funds in other circumstances.[12]

The Panel believes that the SIS Act ought to articulate a consolidated list of duties to apply to *all* trustee-directors that addresses directly the quality of the decision-making process. Chapter 1 discusses additional duties specifically for trustees who offer MySuper products.

Recommendation 2.1

The SIS Act should be amended to create a distinct new office of 'trustee-director' with all statutory duties (including those which would otherwise be in the Corporations Act) to be fully set out in the SIS Act, along with re-focussed duties for trustees. The duties for trustee-directors should include:

(a) To act solely for the benefit of members, including and in particular:

- **i. to avoid putting themselves in a position where their interests conflict with members' interests;**
- **ii. to give priority to the duty to members when that duty conflicts with the trustee-director's duty to the trustee company, its shareholders or any other person;**
- **iii. to avoid putting themselves in a position where their duty to any other person (such as another super fund or a service provider) conflicts with their duty to members;**
- **iv. to avoid putting themselves in a position where their duty to any other person (other than members) conflicts with their duty to the trustee company;**
- **v. not to obtain any unauthorised benefit from the position of trustee or trustee-director; and**
- **vi. not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the trustee's functions and powers.**

(b) To act honestly.

(c) To exercise independent judgment.

(d) To exercise the degree of care, skill and diligence as an ordinary prudent person of business would exercise in dealing with the property of another for whom the person felt morally bound to provide.

(e) To have specific regard to (among other matters) the likely long term consequences of any decision, including the impact of the decision on the community and the environment and on the entity's reputation for high standards of conduct.

The duties for trustees should include:

(a) To keep the money and other assets of the entity separate from any money and assets, respectively:

- **i. that are held by the trustee personally; or**
- **ii. that are money or assets, as the case may be, of a standard employer-sponsor or an associate of a standard employer-sponsor, of the entity.**

Recommendation 2.1 (continued)

(b) To formulate and give effect to an investment strategy in respect of the fund as a whole and each investment choice option, that has regard to the whole of the circumstances of the entity including, but not limited to, the following:

- **i. the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements;**
- **ii. the composition of the entity's investments as a whole, including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;**
- **iii. the liquidity of the entity's investments having regard to its expected cash flow requirements;**
- **iv. the ability of the entity to discharge its existing and prospective liabilities;**
- **v. the expected costs of the strategy, including those at different levels of any interposed legal structures and under a variety of market conditions; and**
- **vi. the taxation consequences of the strategy, in light of the circumstances of the fund.**

(c) To formulate and give effect to an insurance strategy which includes, but is not limited to, the types of insurance to be offered and the default minimum and permissible maximum levels of cover to be offered as well as the cost and value for money to members.

(d) If there are any reserves of the entity, to formulate and to give effect to a strategy for their prudential management, consistent with the entity's investment strategy and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due.

(e) To allow a beneficiary access to any prescribed information or any prescribed documents.

(f) To act fairly between all beneficiaries of the fund and to act impartially between beneficiaries of the same class.

2.2.2 Code of Trustee Governance

While legislation is necessary to express specifically the duties that trustee-directors will have to observe, the Panel believes that it should be supported by a Code of Trustee Governance for trustees and trustee-directors. The Panel has in mind a Code much like the one developed by the ASX Corporate Governance Council. The Code of Trustee Governance is discussed in more detail in section 7 of this chapter, along with the Panel's recommendation concerning the content of the Code.

3 STANDARD OF COMPETENCE FOR TRUSTEE-DIRECTORS

The competence of trustee-directors is fundamental to the governance of superannuation funds. The Panel is concerned that the lack of substantive requirements for serving as a trustee-director means that competence is not always assured in the current environment. Because boards act collectively, it is not possible to determine if all trustee-directors are contributing to the board's deliberations and, consequently, trustee-director shortcomings could remain undetected.

Further, under the enhanced trustee-director duties outlined above, trustee-directors would be expected to meet a legal high standard of care, skill and diligence. The industry generally, and members particularly, would benefit from ensuring that the trustee-directors who are in principle held to this high standard are both capable of achieving it and are actually delivering it in practice.

3.1 Fit and proper standard

The only regulatory measure specifically directed at the competence of trustees and trustee-directors is the requirement under sections 29D(1)(d) and 31(2)(ma) of the SIS Act that all trustees be 'fit and proper' in order to receive a licence. These requirements are more fully explained in APRA Superannuation Guidance Note 110.1 but, generally, 'propriety' goes to the person's integrity and character and 'fitness' addresses the knowledge and skills required to perform the role. The requirements are not especially prescriptive. There are, for instance, no particular educational or experience requirements and trustee-directors are not required to demonstrate any particular level of competence prior to appointment.

A number of submissions argued that the imposition of minimum educational requirements for trustee-directors would be undesirable.[13] There was a concern that people capable of contributing meaningfully to the board might be discouraged from seeking appointment.

The Panel is, however, concerned that as the challenges facing trustees become more sophisticated, the standards of competence currently required of trustee-directors under the 'fit and proper' test will be inadequate. The Panel believes that trustee-directors will require director skill-sets more akin to those required of the boards of listed entities of a similar scope and scale. That said, APRA data also show that the majority of trustee-directors do possess tertiary or vocational qualifications relevant to their roles.[14]

The Panel's attention was drawn to APRA's draft Prudential Practice Guide 520 on Fitness and Propriety (dated 14 August 2009) which is more prescriptive than the current standard as to the knowledge that trustee-directors are expected to have in order to be regarded as 'fit' for the role. For example, paragraph 28 of the draft Guide requires a director to understand the SIS Act section 52 covenants, to have a working knowledge of the SIS Act as well as basic knowledge of investments, the elements of an RSE licence and trust law. While this has not yet been formally issued by APRA, the Panel believes that the Guide is a step in the right direction.

3.1.1 A requirement to be 'expert'?

The Panel recognises that the governance and operation of a superannuation fund can involve decisions requiring highly specialised, technical knowledge. Failure on the part of trustee-directors to master that knowledge could result in poor processes and decisions, adversely affecting the

interests of members. (The Panel comments on this further in connection with investment governance in chapter 3.)

One factor mitigating against this risk is the availability of external advisers and service providers to help trustees on more technical matters. In this regard, the Panel does not want to encourage over-dependence by trustees on advisers and service providers. Without some minimum level of knowledge or expertise, trustees will find it difficult to question and monitor service providers to optimum effect. Neither, though, does the Panel want to suggest that only narrow technical skills are relevant to the governance of a large superannuation fund. It is largely for this reason that the reference above to the standard of care required of a trustee is that of a 'prudent person of business' rather than a 'prudent expert'.[15]

The Panel is also of the view that in many cases the internal management teams conducting the day-to-day business of superannuation funds will increase in number and size, so that there is less reliance on external service providers. In those cases, the trustee's ability to direct and monitor such teams (including very able chief executives), as well as form judgments on when, and to whom to outsource functions, will call for skills that are distinct from those that trustees in the past have required.

3.1.2 Individual vs collective competence

The Panel would like to see more emphasis on the board's collective fitness and a demonstration by each board that, collectively, it has the necessary blend of skills.[16] After all, the collective fitness of the board is the reason that each individual trustee-director is not required to have specific skills or knowledge. The Panel is concerned that a comprehensive analysis is not always performed by trustee boards so that gaps in knowledge are not identified and, consequently, neither individual trustee-directors nor the collective board are aware that important skills are not present at the board table.

The Code of Trustee Governance could provide guidance on these matters and the Panel also sees value in having an independent annual review of the board and its performance, which would specifically address the issue of the board's collective fitness.

3.2 Training

The regulatory scheme currently does not impose training requirements on trustee-directors, at least not directly. APRA's Superannuation Guidance Note 110.1 on 'Fit and Proper' also has no specific training requirements, but encourages trustees to develop an on-going training plan for all trustee-directors.[17]

The Panel recognises that many trustee boards already require training for trustee-directors. For example, according to the AIST, 92 per cent of their member trustee boards require their trustee-directors to undertake a minimum of 20 hours of professional development per annum.[18] Much of that training is directed towards understanding the legal dimensions of the trustee-director role, investment issues and aspects of the administration of trust affairs. ASFA likewise conducts trustee training courses on a wide range of practical issues relevant to super fund trusteeship.[19] The Panel believes this commitment to training is a very positive aspect of the superannuation system and commends those boards that have made this commitment.

Mandatory training is a feature of the regulatory schemes in some other countries.

Ireland's Pensions Board has launched an e-learning system that requires trustees to undertake professional training every two years. The e-learning system is free of charge and comprises nine major lessons. The training is designed both for new trustee-directors and for more experienced ones. New trustee-directors are required to complete the training courses within six months of their appointment. Some submissions have called for similar arrangements to the Irish Pension Board e-learning system be adopted for trustee-directors in Australia, although other means of training should also be encouraged.[20]

Similarly, in the UK, section 247 of the Pensions Act 2004 requires a trustee-director to have 'appropriate knowledge' of the relevant law relating to trusts as well as investment principles and, in the case of DB funds, funding principles. To help trustee-directors demonstrate that they have the requisite knowledge, the Pension Regulator has created a code of practice to guide them as to what is the relevant knowledge and understanding. As in Ireland, the regulator provides an e-learning programme free of charge.[21] Newly appointed trustee-directors have six months from the time of their appointment to complete the required learning.

Although a number of submissions recommended the imposition of minimum trustee on-going training requirements,[22] the Panel does not believe that training, per se, ought to be the subject of regulation. As noted above, Australia's regulatory scheme requires that boards and trustee-directors be competent to play the role expected of them,[23] and that they actually discharge that obligation. What is required to achieve and maintain that competence will vary dramatically by person and, potentially, by the type, activities and complexity of the fund. It is, however, an issue that the Panel believes should be addressed in the Code of Trustee Governance (see section 7 of this chapter).

Recommendation 2.2

Trustee-directors should not be required to have specific pre-appointment skills or training. However, APRA should consider further strengthening it's administration of the 'fitness' test under the SIS Act including requiring potential trustee-directors to be fully briefed before accepting the position (or deciding to seek nomination, where applicable) as to their responsibilities and potential liabilities. The Code of Trustee Governance should address the on-going training requirements that trustees and trustee-directors must meet on an annual basis.

Recommendation 2.3

The board of the trustee must demonstrate on an annual basis that it has the collective skill set to govern the APRA regulated fund or funds for which it is responsible and this should be one of the subjects covered in the independent annual review of the board.

4 THE STRUCTURE OF THE BOARD

The SIS Act has some basic rules regarding board structure. The Corporations Act, however, has no special rules for the governance of companies that act as trustees of superannuation funds.

4.1 Board size and director tenure

Information provided to the Panel indicates that board size is a problem for some funds in that the boards seem to increase (or there is pressure on them to increase) whenever a successor fund transfer or merger occurs. In some cases, the transferring trustee makes 'seats on the board' a condition of the transfer occurring, even though the transfer is in the best financial interests of members. In the Panel's view, this is inappropriate and shows that trustee-directors can sometimes forget that members' interests are always to be preferred.

The Panel can, however, understand that, in the context of a fund merger, there might be a need for the board to settle on its optimum size over time (having regard to the Code of Trustee Governance) after an appropriate transition period. In these limited circumstances, the board might for a time need to be increased beyond what is regarded as an optimum size and that increase should be permitted so long as the board has a plan as to how and when the number of trustee-directors will be reduced to the optimum size.

Research in corporate governance generally shows that boards should be of an appropriate size and that boards that are too large can become ineffective and inefficient.[24] Further, the Panel has been made aware that some trustee-directors seem to be appointed for an unlimited term and that turnover on the board rarely happens, or only happens for some trustee-directors and not others. Again, research shows that succession planning and regular turnover on the board is important for good governance and new ideas.

The Panel resisted making a recommendation on board size and tenure and, instead, has recommended that both issues be dealt with as important matters in the Code of Trustee Governance discussed in section 7.

4.2 The equal representation model

Equal representation was an important aspect of the governance structure established by the SIS Act in 1993. As the government noted at that time:

> *"One of the most important ways in which members are able to participate in the management and protection of their retirement savings is through representation on the board of trustees."*[25]

The Review received submissions both endorsing[26] and challenging[27] the effectiveness and appropriateness of the equal representation regime, as implemented. However, the Panel has come to the view that changes in the industry over time and certain implementation practices mean that equal representation no longer seems to achieve its original stated objective.

1. The superannuation system has moved substantially away from single-employer defined benefit funds that were dominant in 1993. In that environment, an employer and its employees might both be regarded as having a legitimate interest in the operation of the fund.

The introduction of fund choice, together with the prevalence of defined contribution funds today, materially changes (and in many cases severs) the close relationship that previously existed between the employer and the super fund.

2. The employer and employee representatives on many trustee boards are not, in fact, elected by employers or members, but rather are nominated by third party organisations, such as employer associations and trade unions. Current employment and industrial relations practices mean that these organisations do not necessarily represent all employers or all employees. Thus, the democracy that the equal representation policy appears to embed in the governance of superannuation funds is not always present in reality. The equal representation model also could result in a perception that individual trustee-directors are required to answer to the organisation that appointed them in respect of trustee decisions or that they are dictated to by that organisation.

3. The large number of employers, employer organisations and employee organisations related to a fund can sometimes result in trustee boards being far larger than makes sense for efficient governance of that fund.

4. 'Policy committees' have been an adjunct to the equal representation model as the SIS Act requires a public offer trustee, which does not have equal representation on its board, to establish 'policy committees' in respect of each employer with a group of 50 or more employees who are members. The SIS Act requires policy committees to meet even though they have no responsibility. Consequently, many public offer fund trustees have been reluctant to move away from equal representation due to the additional work that policy committees require. The Panel is of the view that maintaining equal representation merely because of the administrative burden of policy committees is not in keeping with the spirit of what the SIS Act and equal representation intended to achieve.

5. Equal representation leaves significant groups 'unrepresented.' Key among these are members who are pensioners (and potentially other post-retirement members in the future) and members who have joined the fund because they exercised fund choice. These groups of members, already sizeable in some funds, can be expected to grow in the future.

There was a strong consensus in submissions that for the most part trustee-directors understand and respect the principle that they are required to safeguard the interests of members as a whole, and not simply to represent one class of member, an appointing organisation or some other stakeholder. However, this result does not appear to arise from the equal representation model, but from the overarching SIS Act and general law requirements that all trustees (and their trustee-directors) have regard for the interests of members as a whole. The equal representation model appears to impose rigidity into fund governance practices and reduce accountability, without contributing materially to the representation objective on which it was predicated.

Recommendation 2.4

The SIS Act should be amended so that it is no longer mandatory for trustee boards to maintain equal representation in selecting its trustee-directors. The Panel expects that trustees would review and amend corporate constitutions to ensure consistency with this recommendation.

Recommendation 2.5

The SIS Act should be amended so that policy committees are no longer mandatory where the trustee board does not have equal representation.

4.3 'Non-associated' trustee-directors

Best practice in corporate governance includes the presence of independent directors on the board.[28] The Panel believes that the same broad principle is relevant to superannuation fund boards. However, given the different types of superannuation funds, the reasons why independence is valuable differs. For example, for retail funds, independence from management would be an important objective; on the other hand, for many not-for-profit funds obtaining an 'outside perspective' is vital. The Panel believes that outsiders or 'non-associated' trustee-directors (that is, people who generally have no historic connection with the fund or the appointor) could help to provide an objective assessment of issues that would assist the employer and member representatives. Of course, the boards of many superannuation funds already include independent trustee-directors. The Panel believes that those trustee-directors have brought great value to the boards that they serve, a proposition borne out in several submissions.[29]

The Panel believes that a minimum number of non-associated trustee-directors should be required on all boards. Also, the Panel believes it is important that such trustee-directors have a 'critical mass' so that they can genuinely influence the decisions of those boards.

For this purpose, the term 'non-associated' would have a different meaning from the term 'independent' in the SIS Act. For example, the Panel believes that a member of the fund could be a 'non-associated' trustee-director. Non-associated trustee-directors would still need to be free of connections to, or associations with, employer sponsors, the appointor (other than by reason of the appointment itself), entities related to the trustee, employer groups, unions, service providers and should not be current or former executives of the fund or a related entity. Of course, if a non-associated trustee-director is paid for their duties as a trustee-director, the fee should be paid only from fund assets and not by any third party.

Section 89 of the SIS Act currently requires (where there is equal representation) an independent trustee-director to be appointed 'at the request' of employer representative or member representative trustee-directors. The Panel thinks that a non-associated trustee-director should be able to be appointed in the same way and must be non-associated with the entity that requests the trustee-director's appointment (other than by reason of the appointment itself).

Recommendation 2.6

The SIS Act should be amended so that if a trustee board does not have equal representation, the trustee must have a majority of 'non-associated' trustee-directors (as described in this chapter).

Recommendation 2.7

For those boards that have equal representation because their company constitutions or other binding arrangements so require, the SIS Act should be amended so that no less than one-third of the total number of member representative trustee-directors must be non-associated and no less than one-third of employer representative trustee-directors must be non-associated.

It has been brought to the Panel's attention that not all independent trustee-directors are presently afforded the right to vote on trustee company business under the terms of the company constitution. While the Panel questions the validity of such a provision, it believes that it is important that all trustee-directors be eligible to vote on all company business (subject to any conflicts) and, consequently, any trustee company constitution provision to the contrary should be ineffective.

Recommendation 2.8

The Corporations Act should be amended so that any provision of a trustee company constitution that prohibits any trustee-director from voting on any trustee company business (other than in the event of conflict of duty or interest) is ineffective.

5 ACCOUNTABILITY TO MEMBERS

Given that the interests of members are paramount, the Panel believes that any trustee governance model must guarantee that trustees and trustee-directors are accountable to members. The special public purpose which superannuation plays also requires that trustees and trustee-directors be accountable as a matter of public policy.

The Panel has observed that trustees and trustee-directors often seem removed from members and do not always understand, or seek to understand, members' positions or concerns. 'Accountability' is more than just compliance with the relevant law. The Panel sees accountability as a way for trustees to obtain members' confidence that the trustees and trustee-directors are acting in a way that benefits members. It is important for them to demonstrate that they know what they are doing and that they are willing to be open and transparent in their decision-making and regarding the outcomes they achieve for members.

5.1 Transparency

One of the weaknesses of trust law is that, traditionally, trust beneficiaries often cannot acquire information from trustees about decisions that affect beneficiaries' interests.[30]

This aspect of trust law, when applied to the superannuation context, has attracted adverse comment by the courts on a number of occasions. The courts have been persuaded by the fact that participation in a superannuation fund is mandatory for almost everyone in the workforce, that preservation rules mean members cannot easily withdraw their money until retirement and that superannuation contributions are properly regarded as part of the member's remuneration.[31]

The Panel shares these concerns and believes that the current constraints on members gaining access to the trustee's reasons for decisions should not be thwarted by the trust structure.

Recommendation 2.9

SIS Act section 101 should be amended to require a trustee to provide a member with reasons for its decision in relation to the member's formal complaint.

5.2 Indemnities

Section 197 of the Corporations Act generally makes a director of a trustee company liable if the company has not (and cannot) discharge that liability; and the company is not entitled to be fully indemnified out of the trust assets because of:

- a breach of trust by the company;
- the company acting outside the scope of its powers as a trustee; or
- a term of the trust denies or limits the company's right of indemnification.

Section 56 of the SIS Act, on the other hand, provides a right of indemnification to the trustee from the assets of the superannuation fund (and section 57 has a corresponding right in respect of trustee-directors). The only restrictions on the SIS Act indemnity is if the trustee has failed to act honestly, has intentionally or recklessly failed to observe the requisite standard of care or is subject to a monetary penalty under a civil penalty order.

There is a clear conflict between the two statutes as to what the trustee's right of indemnity encompasses. The Panel believes that it should be made clear what the rights are for a trustee and trustee-director in these circumstances.[32]

The Panel believes that section 197 of the Corporations Act should have no application to a company to the extent that it is acting as trustee of an RSE.

Recommendation 2.10

Section 197 of the Corporations Act should have no application to a director of a company to the extent that the company is acting as a trustee of an RSE and the Corporations Act should be amended accordingly.

5.3 Member democracy

In some large APRA funds, members elect the member representative trustee-directors who are to serve on the trustee board (it is more unusual for them to vote on employer representative trustee-directors). Some would argue that this act of participatory democracy makes trustee-directors more accountable. However, accountability only occurs if there exists in the member a corresponding right to remove a trustee-director should a majority of members be unhappy with the trustee-director's performance.

In its first Issues Paper on Governance, the Panel canvassed the idea of trustees holding an annual general meeting (**AGM**) for members of large APRA funds so that members would have a forum to exercise powers in the same way that shareholders can exercise powers with respect to directors at an AGM. While the Panel was initially somewhat attracted to this concept, it has been convinced by the overwhelming weight of submissions[33] that the structural and logistical issues inherent in the superannuation industry make it impractical and undesirable at this time to require superannuation funds to hold AGMs.

However, the Panel would expect trustee-directors, who are charged with acting in members' interests, to have satisfied themselves that they know what those interests are and to seek to make themselves accountable even if the law does not explicitly require an AGM. Submissions to the Review revealed that several funds already hold consultative meetings with members (for example, in small groups, via webcasts) and the Panel would like to encourage all trustees to consider ways of ensuring that member feedback is obtained and that member views are known.

5.4 Enforcement

Clearly, it is a basic principle that trustees should always endeavour to comply with the relevant law and members would expect nothing less. If trustees do not comply and that leads to damage or loss to members, trustees should be accountable to members who are affected.

In the Panel's view, however, it is dangerous to rely too heavily on the threat of regulatory sanction to deter transgressions because not all transgressions are detected in a timely manner and formal remediation is typically cumbersome and often cannot fully compensate those affected. Such an environment can lead to excessive caution and lack of action and this is not in members' interests either. The Panel believes that its various recommendations for more transparency in superannuation will do more for members than heavier enforcement penalties for wrongdoing.

There is also the problem that trustees are not required as a matter of law to have indemnity insurance so that there is a risk that a successful claim against the trustee might not be able to be paid if the trustee is not capitalised. Even if there is a right of indemnity under the SIS Act, that may mean that other members are indirectly paying the claim. The Panel believes that, as a matter of member accountability and protection, all trustees should be required to have appropriate indemnity insurance and that it should be an RSE licence condition to provide a certificate of currency annually to APRA.

Further, the SIS Act and the Corporations Act currently provide a range of actions that APRA and ASIC can take against a trustee or trustee-director who fails to comply with the law. This ranges from criminal sanctions to enforceable undertakings to civil penalty orders. In chapter 10 the Panel recommends extending the flexibility of the enforcement regime.

As for members enforcing their rights, the Superannuation Complaints Tribunal is available, but has limited jurisdiction (this is addressed more fully in chapter 10). Of course, when damage or loss is incurred, members also have recourse to the courts, but this is expensive and time-consuming and not an attractive option. While class actions provide a vehicle for members to share the costs of bringing an action, that has not occurred to date.

Section 298 of the SIS Act allows the regulator to initiate an action in the name of a person who has suffered damage. The limitation is that the information on which the action is predicated must arise from an investigation conducted under the Act.

Recommendation 2.11

All trustees should be required, as a condition of their RSE licence, to have an appropriate level of indemnity insurance cover and to provide an annual certificate of currency to APRA.

Recommendation 2.12

The enforcement provisions of the SIS Act and the Corporations Act should be reviewed and an appropriate proportionate penalty regime should be designed to take into account the new duties imposed on trustees and trustee-directors.

6 MANAGEMENT OF CONFLICTS

While many trustees and trustee-directors are alert to actual and potential conflicts of interest and conflicts of duty when performing their roles, the Panel is of the view that more needs to be done in this regard and that APRA should provide strong prudential guidance. Disclosure of the conflict and non-involvement in decision-making do not constitute an adequate solution in a great number of cases.

In the Panel's view, the SIS Act does not address conflicts of interest and conflicts of duty clearly enough in the superannuation context. The enhanced trustee-director duties recommended above in section 2.2 go some way to remedying this shortfall. However while trustees are required by the SIS Act and the general law to act in the interests of fund members and no one else, as the industry has become more complex and consolidates, it is often difficult for them to identify conflicts of interest and conflicts of duty and to know what their responsibilities are in each instance. Direct prudential guidance may be required for specific types of issues that arise commonly in the superannuation context.

6.1 Multiple trustee-directorships

As a basic principle to address possible conflicts of duty, the Panel suggests that it should be exceptional for a person to serve as a trustee-director on more than one public offer fund trustee board. There might be related party group situations where it might be acceptable, but not otherwise.

Multiple directorships in corporate life very rarely occur in an identical line of business (for example,, a person serving on the boards of two of the big four banks or on the board of more than one airline) and the Panel believes that the trustee boards of superannuation funds should be concerned about this occurring, especially as the industry consolidates. Nonetheless, the Panel is recommending a flexible approach on this issue.

Recommendation 2.13

In order for a trustee-director to act as a trustee-director on the board of more than one APRA-regulated fund, the person and both boards need to attest to APRA that at the time of appointment there is no reasonably foreseeable conflict between the person's duty to the members of each fund and to the person's duty to each trustee company. There would be a transitional period for existing trustee-directors with multiple board positions. APRA would need the appropriate regulatory tools to administer this requirement.

6.2 Embedded provisions and service provider contracts

Several submissions expressed concern about the presence of provisions in the trust deeds of some superannuation funds that 'embed' specific service providers into the administration of the trust (generally related parties). Other submissions pointed to the benefits that vertical integration can have in delivering tailored, cost-effective services to a trustee. The Panel sees some merit in both these arguments.

However, the Panel believes that from a governance perspective it is important that the benefits of vertical integration (say by appointing a service provider like an administration company or an insurer from within the same group of companies) be tested regularly against external alternatives by the trustee. This could be addressed in the Code of Trustee Governance discussed in section 7 of this chapter.

Generally, when selecting a service provider, the trustee would carry out appropriate due diligence and negotiate terms before making an appointment. However, if the trust deed contains a provision mandating a certain product provider, then the trustee has no discretion to exercise in the matter and is prevented from making another selection.

The Panel's research suggests that this practice is not common in modern deeds, but is still present in some older deeds.

Recommendation 2.14

The SIS Act should be amended so as to override any provision in the governing rules of an APRA-regulated fund that requires the trustee to use a specified service provider in relation to any services in respect of the fund.

The Panel notes that if this recommendation were adopted, a trustee with such a provision in its trust deed would still be able to appoint the named service providers if it thought it were in the best interests of members, but that it would not be bound to do so.

6.3 Gifts and other emoluments provided by third parties

As trustees and trustee-directors have a duty to avoid conflicts of interest, the Panel believes that disclosure of any gifts, emoluments and benefits provided to trustees and trustee-directors is a logical extension of this principle. Members should be able to have confidence that persons are fulfilling the role of trustee-director for the right reasons and that members' interests are

transparently paramount. The Panel does not think that it is necessary to prohibit these gifts and emoluments as it believes that boards can decide what is appropriate in this context and develop and implement a policy addressing this issue.

The Panel is of the view that trustee companies should keep registers of all gifts, emoluments and benefits provided to the trustee, trustee-directors and management and disclose that information on an annual basis to APRA, in the annual report to fund members and on the fund's website.

Recommendation 2.15

A record of all gifts, emoluments and benefits (subject to an appropriate materiality threshold) provided to trustees, trustee-directors and management should be kept in a register maintained by the trustee and disclosed to APRA annually as well as in the annual fund report to members and on the fund's website.

Recommendation 2.16

APRA should develop a prudential standard that sets out particular examples of conflicts of interest and conflicts of duty to illustrate behaviour that would not be allowed in relation to all APRA-regulated funds so as to ensure that trustee-directors and trustees observe their duty of loyalty to members.

6.4 Conflicts matrix

The Panel believes that it is of primary importance for trustees and trustee-directors to understand and manage conflicts of interest and conflicts of duty appropriately. Good governance demands that there be no improper motivation for trustee and trustee-director decisions.

Trustees that have an Australian financial services licence (**AFSL**) are required to have a conflicts policy for the purposes of their Corporations Act obligations. Given the Panel's recommendation that the Corporations Act obligations for trustee-directors now be in the SIS Act, it follows that trustees must formulate, as part of their management plans, a conflicts policy that addresses not only the conflicts issues which would be required under the Corporations Act, but also those conflicts issues that are relevant for their SIS Act duties, including those identified in this section 6. The policy should be available to fund members on the fund website and should be up-to date at all times.

While the contents of the conflicts policy can be developed after industry consultation and while the current AFSL conflicts policy requirements are a good place to start, the Panel is of the view that, in the interests of superior trustee governance, the contents of the policy should significantly exceed what is currently required. For example, the Panel believes that the policy should contain a section which puts in context the trustee's relationship with those who are involved in the operation of the fund, whether or not they are a related party of the trustee's. These persons would include, not only the fund administrator and insurer, but also, for example, related party investment managers, life offices, any financial planning/distribution arrangements or proxy voting consultants. The Panel sees this exercise as providing a useful matrix for the trustee as assembling this type of information would require the trustee to turn its mind very specifically and deliberately to any conflicts that might arise from each of those business relationships. Further, the information will also be helpful in assisting stakeholders, including members, to understand who provides what services to the fund. The Panel

also sees value in the policy setting out other details such as the industry organisations to which the trustee pays dues. Ideally, the matrix would be disclosed via the fund's website.

The policy would, of course, go beyond merely identifying conflicts of interest and conflicts of duty and set out the ways in which the trustee proposed to deal with each of the actual conflicts it has identified and any potential conflicts which could arise. The policy would also have to address conflicts of interest and duty with respect to management of the company as well as those affecting trustee-directors.

The Panel suggests that the policy would only be effective if all those covered by the policy understand what it means and its practical implications with respect to their individual actions and the fund's operations. Consequently, the Panel believes that all trustee-directors and senior management must have specific training to ensure that they understand the policy's principles and are aware of the policy's application to the fund's operations.

The Panel believes that the policy matrix concept has substantial value to add to members in all sectors of the industry.

Recommendation 2.17

Trustees of APRA-regulated funds should, as a condition of their RSE licence, be required to articulate and follow a conflicts policy specifically tailored to their business structure that addresses all relevant issues regarding their role under the SIS Act and as a fiduciary to the members of the fund.

7 A CODE OF TRUSTEE GOVERNANCE

7.1 Introduction

The Panel believes that the combined effect of a compulsory system outsourced by government to the private sector and preservation demand a higher level of governance than that appropriate for members of major listed entities. Members of those entities have chosen to invest and are free to sell their holdings at any time.

The Panel strongly supports the establishment of a Code of Trustee Governance for trustees that would reflect the unique context of a superannuation fund. Several industry associations have already compiled similar guidance for their trustee-director members and the Panel believes these could be used as a starting point for developing such a Code.[34]

The Panel sees the ASX Corporate Governance Principles and Recommendations as a benchmark for what can be accomplished with appropriate 'buy in' from industry. The ASX Principles and Recommendations are the work of the ASX Corporate Governance Council, which is charged with ensuring that the principles-based framework is a practical guide for listed entities and that stakeholder confidence in the corporate governance practices of listed entities is maintained. The Panel is of the view that a similar council would be of value to the superannuation industry and the council would be asked to assemble, to prepare, and to review and monitor a Code of Trustee Governance. APRA could coordinate membership of the council and provide secretariat support. If

the industry cannot work together to establish such a council then, in the alternative, the Panel suggests that APRA creates the Code. The Panel would not regard it as satisfactory if there were more than one code.

The Panel believes that the superannuation industry has reached the point where broad equitable principles are not sufficiently targeted to meet the needs of a multi-trillion dollar statutory system intended to serve a very distinct public policy objective. The rules should be much clearer and should only default to 19th century principles of equity where absolutely necessary. The 'best interests of members' has become a relatively ineffective mantra in such a complex and sophisticated industry.

A Code of Trustee Governance would be more flexible than legislation and could keep pace more easily with changes in the industry.

The Code would not be the law in the formal sense and would be voluntary, but the Panel believes that non-compliance with the Code should be assessed on a stricter basis than the 'if not, why not' basis used by the ASX. This is principally because superannuation funds are not normal commercial enterprises, but specialised vehicles charged with fulfilling a very narrow and specific public policy purpose: optimising the retirement incomes of members.

The Panel is of the view that the trustee's performance should be audited against the Code's requirements annually and that the auditor's assessment and comments in this regard should be made available on the fund's website. The Panel believes that this is information that members and the industry generally would want to have.

While the auditor's report could provide a reason for APRA to open dialogue with the relevant trustee or trustee-director, or both, any failure to comply with the Code would not result in an APRA enforcement action. Further, the Code's existence would be taken into account by courts and other decision-making bodies to the extent that the Code was relevant to what was at issue and, in that way, would serve to make the trustee more accountable to members. It is also possible that compliance with the Code could become relevant for employers in selecting MySuper products in tenders and in the process for nominating them for the purposes of industrial awards.

The April 2010 report by the Corporation and Markets Advisory Committee (**CAMAC**) recommended that there not be a new code developed for the purposes of guiding company directors on how to perform their job. CAMAC found that there were already many sources of guidance for directors, including the ASX Principles and Recommendations. CAMAC was also careful to say that a code should not be introduced or developed by a regulator because there were dangers 'in moving to a more prescriptive approach'.[35] Of course, company directors are not themselves subject to licensing in the same way that trustee companies are. Consequently, it seems to the Panel that trustee-directors of a licensed trustee company may require more guidance on how they perform their director role in that context.

In any event, the Panel considers that the approach to the Code of Trustee Governance which it recommends is in accord with that preferred by CAMAC. The Code of Trustee Governance would not be the work of a regulator and is intended to be broadly similar to the ASX Principles and Recommendations in both its normative and regulatory effect.

7.2 Gender equality

As superannuation fulfils many social policy objectives and as superannuation covers almost all Australian workers, the Panel believes that it is important that the Code of Trustee Governance include a principle so as to ensure that gender equality is pursued on trustee boards with reasonable haste. A number of submissions indicated support for the notion that the gender balance on trustee boards, though further advanced than other areas of corporate life, could be improved.[36] While the Code would not necessarily mandate a specific quota, the Panel notes that a goal of at least 40 per cent of directors being women would be in keeping with emerging international best practice.[37]

Recommendation 2.18

An industry council (coordinated by APRA) should develop, in consultation with all stakeholders, a Code of Trustee Governance for trustees of superannuation funds and their trustee-directors to assist with identifying best practice in the industry. The Code could cover, but not be restricted to:

(a) the imposition of a higher standard of competence and a greater commitment of time from those appointed to chair a super fund board than is required of other trustee-directors;

(b) board size, including whether a maximum is appropriate and any transition period for successor fund transfers and mergers;

(c) length of time in office and retirement by rotation;

(d) development of an enhanced conflicts-handling policy, including maintenance of an affected-decisions register and regular reporting to APRA;

(e) skill set for each director to demonstrate within the first 12 months of appointment;

(f) a skill matrix for the trustee board and analysis of how the current composition of the board provides the skills required under the matrix;

(g) a procedure for a rigorous and independent annual review of the performance of each trustee-director and the overall collective competence and performance of the board;

(h) gender and other diversity requirements;

(i) tendering for and benchmarking service providers; and

(j) minimum ongoing training requirements.

Recommendation 2.19

If industry cannot work together to establish such an industry council, or cannot finalise a Code of Trustee Governance within two years, then APRA should create the Code.

Recommendation 2.20

There should be an annual audit of the trustee's performance against the requirements of the Code of Trustee Governance and the results of that audit should be made available on the fund's website.

ENDNOTES

1. For a brief discussion, see Robert P Austin, Harold AJ Ford and Ian M Ramsay, *Company Directors. Principles of Law and Corporate Governance*, (LexisNexis Butterworths, Sydney 2005), pp 5-14.
2. ASX *Corporate Governance Principles and Recommendations*, 2nd edition, p 3.
3. Hon. John Dawkins, MP, *Strengthening Super Security* (October 1992) at 6.
4. SIS Act sections 29D(1)(d) and 31(2)(ma) and discussed in APRA Superannuation Guidance Note 110.1.
5. For a discussion of some of the technical legal complexities that can arise, see Pamela Hanrahan, 2008, '*Directors' liability in superannuation trustee companies*', Journal of Equity 2(3), pp 204-224.
6. In strict legal terms, 'codification' is a complete restatement of the law and excludes all common law and equitable principles from affecting the 'code'.
7. See for instance *Invensys v Austrac Investments* (2006) 198 FLR 302; *Manglicmot v Commonwealth Bank Officers* Superannuation *Corporation* [2010] NSWSC 363.
8. *Re VBN* [2006] AATA 710.
9. See for instance Michael Vrisakis, '*The best test of (or the 'bestest') interests of members*' (2006) 17 Australian Superannuation Law Bulletin 138 – 141; Justice Margaret Stone, *'The Superannuation Trustee: Are Fiduciary Obligation and Standards Appropriate?*', (2007) 1 Journal of Equity 167; Geraint Thomas, *'The duty of trustees to act in the "best interests" of their beneficiaries*' (2008) 2 Journal of Equity 177; Scott Donald, *'"Best" interests*' (2008) 2 Journal of Equity 245.
10. IFSA, Submission no. 72, pp 30-31.
11. LCA, Submission no. 73, p 7.
12. J D Heydon and M J Lemming, 2006, *Jacobs Law of Trusts in Australia*, at [2921].
13. For example, ISN, Submission no. 41, p 16; QSuper, Submission no. 86, p 10; Watson Wyatt, Submission no. 31, p 10.
14. APRA, 2008, *Superannuation fund governance: Trustee policies and practices,* APRA INSIGHT, 2008(1). Also, Shey Newitt, *'What drives superannuation trustee board performance?*', AIST Fund Governance Conference (Melbourne, May 2009) <www.aist.asn.au/Pages/Events/SubPage_SFGC/Program.aspx>.
15. In this respect the recommendation varies slightly from the OECD's preference; see OECD Insurance and Private Pensions Committee and Working Party on Private Pensions, 2006, *OECD Guidelines on Pension Fund Asset Management*, 2.1; <www.oecd.org/dataoecd/59/53/36316399.pdf>.
16. For example, Ernst & Young, Submission no. 38, page 4; ICAA, Submission no. 43, p 6; Law Council of Australia, Submission no. 73, p 13; PwC, Submission no. 85, p 12.
17. APRA Superannuation Guidance note 110.1 (July 2008), paragraph 31, p 10.
18. AIST, Submission no. 62, p 11.
19. ASFA, Submission no. 32, Confidential part (permission granted to cite).
20. See for example AIST, Submission no. 62, page 12; Mercer, Submission no. 296, p 39.
21. Pensions Regulator (UK), <www.thepensionsregulator.gov.uk>.
22. For example, AIST, Submission no. 62, page 11; AMP, Submission no. 59, page 14; ASFA, Submission no. 32, Confidential part (permission granted to cite); AXA, Submission no. 34, p 10; Ernst & Young, Submission no. 38, p 5; Mercer, Submission no. 75, p 36; Rice Warner, no. 233, p 15; Tower, Submission no. 54, p 4.
23. APRA Superannuation Guidance note 110.1 (July 2008), paragraph 14, p 6.
24. See for instance research cited in Grant Fleming, 2003, '*Corporate Governance in Australia'*, Agenda, Volume 10, Number 3, 2003, p 195-212.
25. Hon. John Dawkins, MP, *Strengthening Super Security* (October 1992) at 12.
26. For example, AIST, Submission no. 150, page 23; ASFA, Submission no. 32, Confidential part (permission granted to cite); Corporate Super Specialist Alliance, Submission no. 394, page 12; ING, Submission no. 412, p 20; Unions NSW, Submission no. 370, p 12.

27 For example, EquipSuper, Submission no. 328, page 11; ICAA, Submission no. 137, p 11; Mercer, Submission no. 75, p 28; Noel Davis, Submission no. 67, p 1.

28 For a brief summary see IOSCO Corporate Governance Task Force, 2006, *Consultation Report: Board Independence of Listed Companies*, p 32. < www.iosco.org/library/pubdocs/pdf/IOSCOPD228.pdf>.

29 For example, Cbus, Submission no. 35, p 1; EquipSuper, Submission no. 328, p 11; UniSuper, Submission no. 56, pp 5-6; PwC, Submission no. 85, p 6.

30 *Crowe v SERF* [2003] VSC 316; *Avanes v Marshall* [2007] NSWSC1068. For a discussion generally see Dimity Kingsford-Smith, "*Who Knows Best? Review of Discretionary Powers in Superannuation Funds*" (2000) 28 Australian Business Law Review 428 – 442; J C Campbell, 2009, '*Access by trust beneficiaries to trustees' documents, information and reasons*.' 3 Journal of Equity 97.

31 See for instance *ASEA Brown Boveri Superannuation Fund v ASEA Brown Boveri* [1999] 1 VR 144; *Ansett Australia Ground Staff Superannuation Plan Pty Ltd v Ansett Australia Ltd* [2002] VSC 576; *Sayseng v Kellogg Superannuation* [2003] NSWSC 945.

32 Cooper, J, "*Piercing the veil of obscurity*" – the decision in *Hanell v O'Neill*, (2004) 22 C&SLJ 313.

33 For example, ABA, Submission no. 102, page 17; AIST, Submission no. 62, p 23; ASFA, Submission no. 32, pp 19-20; CPA, Submission no. 37, p 10; CSA, Submission no. 66, p 8; Ernst & Young, Submission 38, p 5; IFSA Submission no. 72, p 15; LCA Submission no. 73, p 25; Mercer Submission no. 75, p 7; REST Submission no. 99, p 8.

34 For example, ASFA Best Practice Paper No 7, 'Superannuation Fund Governance', June 2008; IFSA Blue Book, Guidance Note no 2 'Corporate Governance: A Guide for Fund Managers and Corporations, June 2009.

35 CAMAC report, p 80.

36 For example, AIST, Submission no. 62, page 36; ASFA, Submission no. 32, Confidential part (permission granted to cite).

37 Public Listed Companies Act (Norway); www.gender.no; http://www.businessweek.com/news/2010-06-09/bearded-women-challenge-french-boys-club-boards-in-paris.html.

SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 3

Investment governance

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KEY THEMES

Issue

Proper investment governance and investment efficiency play a role in better investment performance, but those factors are not always emphasised by trustees. The interests of investment advisers and managers are not necessarily aligned with the interests of members, and this conflict is not always properly identified and addressed by trustees. Remuneration and fee structures for investment managers can result in incentives that do not contribute to better results for members. Complex fee arrangements can make it difficult to know exactly what fees are being paid and this lack of transparency does not help members evaluate trustee performance.

Proposed solution

The Panel proposes measures, including:

- expansion of the factors to which a trustee must have regard when developing an investment strategy, including costs involved, taxation consequences and the availability of valuation information;
- a new 'performance fee standard' developed by APRA to reduce the possibility that trustees would agree to inappropriate performance fees for fund managers;
- a focus on managing investments for after-tax returns; and
- requiring trustees to have a proxy voting policy and disclose their voting behaviour on the fund website.

Benefits for members

Members will benefit from these measures to improve investment governance as:

- better governance can assist in better investment returns;
- retirement income will be boosted if the incentives for investment managers serve members' interests and inappropriate fees and fee structures are avoided; and
- member benefits can be enhanced if there is a greater trustee awareness of the taxation consequences for the fund of its investment strategies.

1 WHAT IS INVESTMENT GOVERNANCE?

The way in which the assets in super funds are invested is a key determinant of the success of the system. In a system that today is predominantly defined contribution in nature, the consequences of failures and/or inefficiencies in the investment of the assets are borne directly by members.

Good investment performance is dependent on a number of factors. Investment governance is one of them. The Panel recognises that good investment governance will not guarantee that a super fund delivers good investment performance. However, the Panel is convinced that poor investment governance puts at risk the achievement of the super fund's goals. Research in a variety of countries and analogous contexts supports this basic conclusion.[1]

This chapter addresses the governance and efficiency issues that arise from the investment of super fund assets. It recognises the increasing diversity of models chosen by super funds and the complexity that underlies some of those models. In so doing, it seeks to identify specific instances in which the interests and incentives of participants in the model (such as fund managers and asset consultants) have the potential to conflict with the interests of the super funds (and their members) on whose behalf they act. It also identifies ways in which the complexity that has crept into the system has resulted in inefficiencies and a diffusion of accountability, and proposes some measures to address these trends.

2 OVERVIEW OF INVESTMENT STRUCTURES

As the industry has evolved, super funds have developed a variety of structures to invest their assets.

As a general rule, trustees delegate investment management tasks to external funds managers, usually on the advice of an asset consultant. In this model, the trustee generally retains control over the long-term strategic asset allocation of the fund, but decisions about which individual securities to buy, sell and hold (and in some cases which market to invest in as well) are taken by fund managers acting under investment management agreements. Physical custody, corporate actions and record-keeping are, in this model, undertaken by an independent custodian acting on behalf of the trustee. This model is implicit in the way the system is regulated by the SIS Act and remains influential in the way many people think about the superannuation system.

The past decade or so has seen the emergence of a variety of different structures and variations on this general model.

In some cases, the trustee invests not in the assets directly, but in pooled funds offered by third parties. This was historically the route chosen by small and medium-sized super funds that did not have the scale to justify the custodial and administrative costs of investing directly. This approach is still reasonably common today, even for relatively large funds, in areas where they struggle to attain sufficiently-diversified exposure on their own (for example, in the hedge funds and private equity 'fund of funds' segments). Usually, the third party responsible for managing the pooled fund is a fund manager. Sometimes, the pool is managed on an after-tax basis (for example a Pooled Superannuation Trust), but in most cases the pool is a simple unit trust, albeit one that is restricted to large-scale investors.

'Implemented consulting' is a variation on this model in which the asset consultant provides the vehicle that administers the investments of different super funds, as well as providing the advice that underpins that investment structure. For some providers, including both industry and retail funds, the asset consultant and even some of the asset management firms employed in the structure, are ultimately owned by the operators of the super funds themselves, albeit legally and operationally separate legal entities.

A second important model is the corporate master trust. In this model, the entire governance of the scheme including trusteeship has been passed on to external service providers operating on a commercial basis.

The third model that has emerged as important over the past decade has been the self-managed super fund (**SMSF**). SMSFs are dealt with separately in chapter 8.

A range of governance and efficiency issues clearly arise in each of these models and need to be addressed to ensure optimal operation of the system. Some of the key issues are:

(a) the ability of super fund trustees to secure the interests of their members in their dealings with the funds management industry, especially those related to fees and mandate specification;

(b) the alignment of interests between trustees and fund managers (or lack thereof), and the impact that has on the way in which fund assets are managed; and

(c) the diffusion of accountability that occurs as a result of the multiple layers of responsibility present in some models.

3 OUTSOURCING TO FUND MANAGERS

Notwithstanding the diversity of investment structures employed by the trustees of Australian super funds, very few ultimately 'manage' the money themselves. In almost all cases, the selection of individual securities and instruments is delegated to specialised funds management firms. Trustees take direct responsibility for the overall design of the investment strategies to be followed, including the strategic asset allocation and rebalancing protocols and for the engagement of multiple managers in individual asset classes.

The Panel is aware of the ongoing debate about whether there are fund managers that can consistently beat the market, after costs and taxes have been taken into account.[2] In the superannuation context, there is the further complication of whether trustees can pick in advance who those managers are going to be.[3] The Panel does not believe it ought to attempt to come to a definitive conclusion on this issue. Ultimately, the trustees of each superannuation fund are best placed to formulate the investment strategy most suitable for the circumstances of their fund, including how to mix active and passive management, the mix of growth, value and other styles and whether risk management overlays and other strategies are appropriate.

Even allowing for the potential impact that active management has on the efficiency of the capital markets, the system, and more particularly the members within it, bear the costs of this intermediation.[4] The Panel therefore believes it is necessary for the industry to confront some of the

more obvious areas of inefficiency and leakage of value. The Panel's comments and recommendations in this section are made on this basis.

3.1 Fund managers are formally outside the superannuation system

The fact that the fund management of Australian superannuation funds is almost always outsourced to fund managers has a number of consequences for the regulation of the system.

3.1.1 APRA licensing of fund managers?

The first consequence is that because fund managers are not licensed under the SIS Act or some similar measure, APRA and ASIC have limited ability to regulate a key component of the superannuation system. This state of affairs is largely taken for granted in the Australian system. It is, however, significant in light of the different approach taken in the United States under the Employee Retirement Income Security Act (**ERISA**) which deems fund managers to be 'fiduciaries.'

On balance, the Panel is not in favour of APRA licensing fund managers. The absence of regulation in this area gives super funds access to a much wider range of fund managers than might otherwise be the case. It does, however, place responsibility on the trustees of super funds to conduct more thorough due diligence than might be required if a licensing regime (or similar) were in place. In particular, trustees in this jurisdiction must recognise that they retain sole accountability for investment decisions that are made on behalf of their members, even when those decisions are delegated to other parties.

3.1.2 A new statutory duty on fund managers?

The second consequence is that the relationship with the fund manager is, in most cases, purely contractual. What this effectively means is that notwithstanding the quite specific and onerous provisions in the SIS Act directed at the trustees of super funds, the majority of the assets in the system are managed by people who are not directly regulated by any of those provisions.

The Panel did consider whether fund managers should expressly be under a higher duty to members than is currently the case.

However, the Panel has decided against recommending such higher duty, believing instead that the cumulative impact of all of its recommendations in other areas will have sufficient positive outcomes for members.

3.2 Fund managers as agents[5]

When trustees delegate investment decision-making power to fund managers and asset consultants they have to deal with what are commonly termed 'agency issues'.[6] These issues arise inevitably from the fact that the interests of the fund manager cannot be perfectly aligned with those of the super fund for whom the fund manager acts.

A number of potential agency problems are especially pertinent to the trustee-fund manager relationship. The Myners Report[7] in the UK, for instance, identified that many fund managers were engaging in 'closet indexing' where they prioritise their business risk over the interests of fund members by constraining the amount of active risk they were prepared to take in investment

portfolios. The result was that funds paid for more expensive active management of their portfolio only to receive benchmark-like returns.

Academic researchers in Australia and elsewhere have also identified evidence of behaviour symptomatic of unresolved agency issues. This behaviour includes:

(a) **Tournament behaviour:**[8] fund managers adjust the level of investment risk in a portfolio according to whether their recent performance has been ahead or behind the relevant benchmark and hence whether they believe their retention as a fund manager (or their level of remuneration, where a performance fee was involved) for the super fund is at risk.

(b) **Window dressing:** the fund manager temporarily adjusts portfolio holdings around disclosure dates to mask what is actually occurring in the portfolio.[9] An analogous practice, sometimes termed 'portfolio pumping,' sees funds managers bid up the prices of illiquid stocks at the end of each month to artificially boost performance.[10]

(c) **Herding:** in a highly competitive market where recent past performance relative to a benchmark is regarded as of paramount importance, fund managers may be reluctant to take investment decisions they believe will result in material divergence from their competitors.[11] This is reinforced by institutional factors, including the influence of asset consultants[12] and the attraction of 'momentum investing.'[13] It is also exacerbated by the pressures on managers to stay 'true to label'. There is an inevitable tension between requiring a fund manager to stay 'true to label' and providing it with the flexibility to pursue the strategies it believes will add most value.

These types of agency issues are by no means unique to funds management. The typical response in other contexts is for the principal to design contracts in which the incentive to pursue self-interested strategies is limited, re-directed or, ideally, reoriented to align more closely with those of the principal. The Panel believes that the design of incentive structures and benchmarks, and most particularly the way in which fees are calculated and paid to fund managers, is a more appropriate mechanism for addressing these 'agency' issues than direct regulatory intervention. This is discussed in more detail below.

4 REMUNERATION AND INCENTIVE STRUCTURES

The fees charged by investment managers are a material component of the costs of running a super fund. These costs are in most cases passed straight through to members. Therefore, the level and cross-sectional variation in fund management costs across the system as a whole is not something that can be ignored. This is the case notwithstanding the Panel's view that trustees are in the best position, and ought to be held accountable, for all key decisions made on behalf of members. Specifically, the Panel believes that the trustees of super funds are best placed to ascertain how best to structure the remuneration arrangements they have with all outsource providers, including investment managers.

The Panel recognises that direct observation of the fees actually charged by fund managers is problematic. Many super funds negotiate fees differently from those recorded in stated fee schedules. It is also relatively common for fees to be 'tiered' in some way so that lower percentage fees apply to the proportion of portfolios that exceed certain dollar sizes. And, as noted in chapter 4, there is a wide range of ways in which the fees and costs are currently classified and disclosed.

Nevertheless, some general comments are warranted here to supplement the more detailed discussion of costs disclosure that appears in chapter 4.

4.1 Asset-based fees

4.1.1 Fee methodology

Fund managers in Australia are remunerated primarily by way of asset-based fees, that is, fees that are expressed as a percentage of the total assets subject to the contract. A number of submissions expressed a concern that remunerating investment managers via asset-based fees might not be the best way for trustees to secure the best interests of their members.[14]

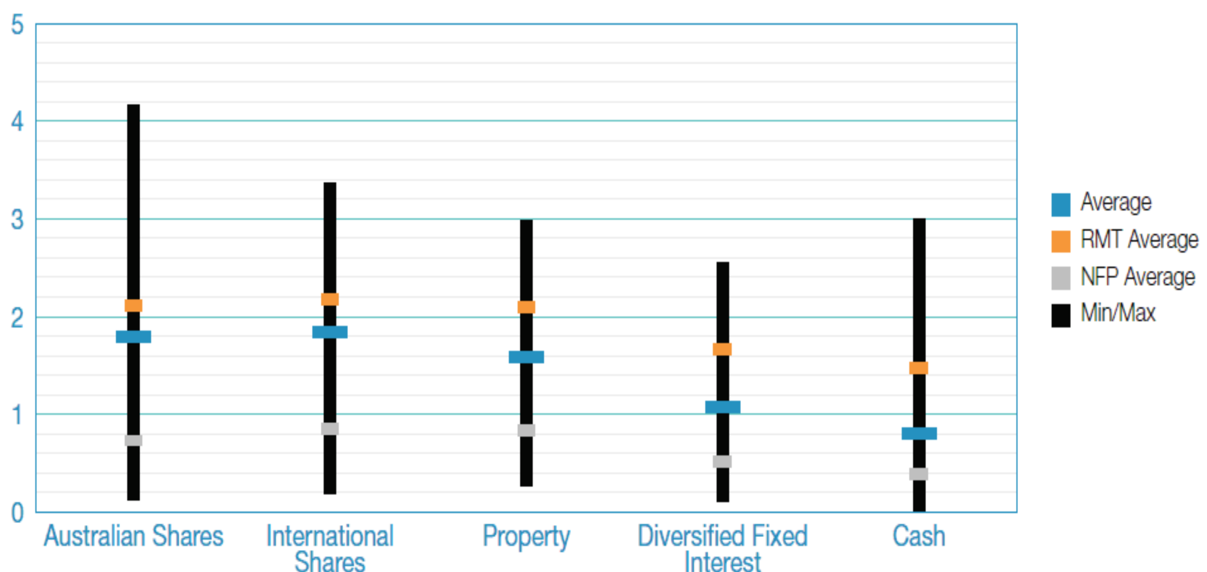
The connection between the fees charged for managing a portfolio and the quantum of assets in that portfolio is taken for granted by many in the superannuation industry.[15] The Panel notes that the practice is broadly consistent with institutional investment practices (including pension funds) around the globe. However, given increasing economies of scale and the consistent flow of SG contributions, attaching the fee to the level of assets alone seems sub-optimal, as it is likely to lead to exponential growth in revenue for agents without a commensurate increase in underlying value to the members.

4.1.2 The relevance of the asset mix

The level of fees charged by investment managers typically varies according to the nature of the assignment. It is, for instance, typically more expensive for the management of growth assets such as shares and property, and relatively cheaper for the management of fixed income and cash assets.

Figures 3.1 and 3.2 below demonstrate that this variation in the investment management fees charged on different asset types is typically passed on to members. Most obviously, the variation is reflected in the fees charged on different types of investment options. Figure 3.1 charts the range of fees charged by super funds for different investment options offered to members.

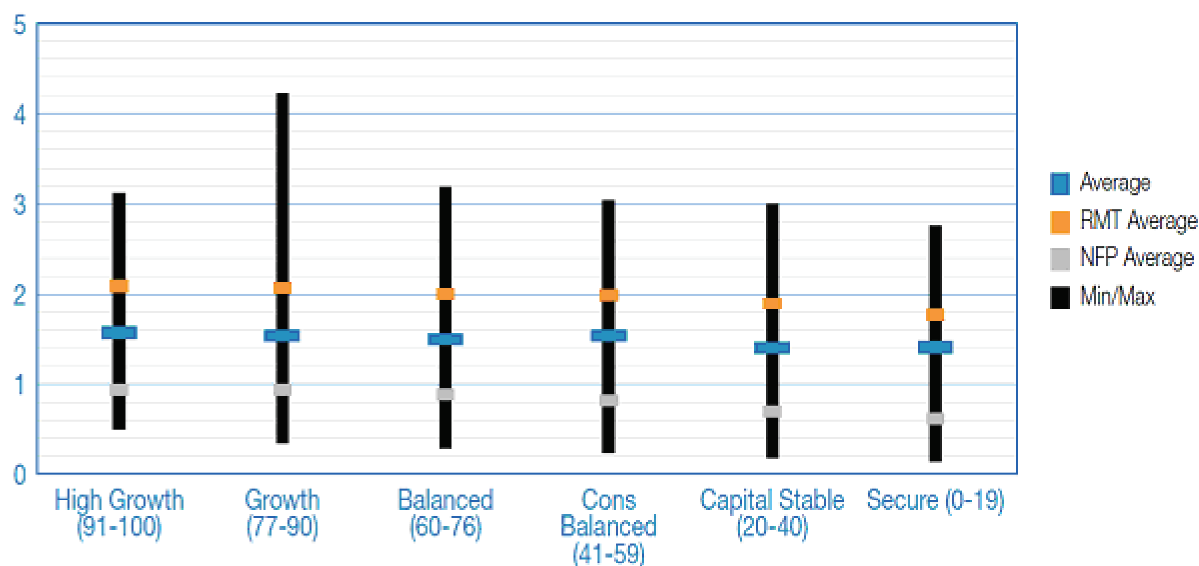
Figure 3.1: Range of fees (% of assets, per annum) charged by asset class option type



Source: SuperRatings 2010 Benchmark Report for the period ending 30 June 2009.
Note: RMT — Retail Master Trust; NFP — Not-for-Profit

The variation is also embedded in the fees charged on funds that are diversified across multiple asset classes. Figure 3.2 shows this relationship is most obvious in the not-for-profit sector, though it is evident across the population of funds as a whole.

Figure 3.2: Range of fees (% of assets, per annum) charged by diversified option type



Source: SuperRatings 2010 Benchmark Report for the period ending 30 June 2009.
Note: RMT — Retail Master Trust; NFP — Not-for-Profit

This variation has two important ramifications. First, it highlights that the investment strategy decisions taken by trustees in diversified funds have an important cost dimension. A number of submissions identified the trend towards super funds investing in alternative assets as one factor causing increasing investment management fees in industry funds, in particular, in recent years. The Panel believes that the trustees of super funds are increasingly likely to have to consider investing in such investments in coming years and is concerned to ensure that such considerations have explicit regard for the cost implications of each transaction and mandate.

Secondly, it emphasises the important role that costs disclosure has to play in the choice segment of the market. Prospective members need to be alerted to the fact that the investment management fees attached to the different options they may be considering might be quite different. This issue is taken up in the recommendations in chapter 4 that relate to the calculation and disclosure of fees more generally. Those recommendations are designed to give members, prospective members and regulators the ability to assess the overall picture of fees and costs, including those related to investment, that pertain to a particular fund, and to facilitate comparison between funds. Only in this way can market forces be expected to exert pressure on trustees to continue to strive for more efficient and cost-effective ways to deliver good investment performance.

Section 52(2)(f) of the SIS Act deems there to be a covenant in the governing rules of a trustee requiring it to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including a range of enumerated matters. The Panel's approach is to make a number of recommendations adding further investment governance matters to which the trustees would be required to have regard.

Recommendation 3.1

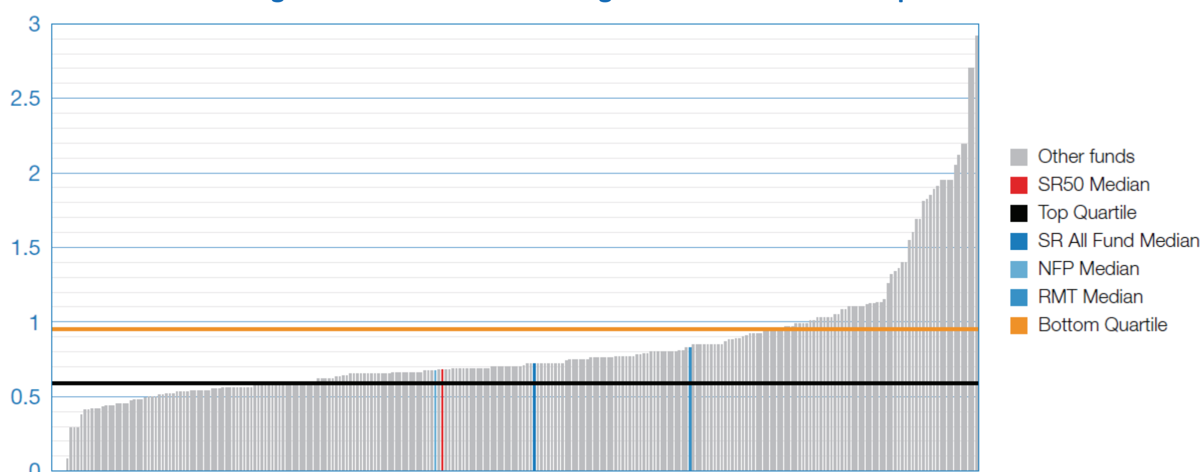
That section 52(2)(f) of the SIS Act be amended to include 'the expected costs of the strategy, including those at different levels of any interposed legal structures and under a variety of market conditions', as one of the factors to which APRA fund trustees must 'have regard'.

4.1.3 Cross-sectional variation in investment management fees

Cross-sectional variation in fees is an inevitable part of a system, such as the Australian superannuation system, that relies on private market providers. A range is to be expected, but market forces might be expected to act as a discipline on the most expensive funds, to the extent that those funds are not delivering additional benefits.

Figures 3.1 and 3.2 both clearly demonstrate that the investment management fees charged by different funds can vary quite materially. Figure 3.3 below highlights that this is also true for super funds' default options. What Figure 3.3 also highlights is that though the overall median is 0.72 per cent per annum, there is a sizeable minority of funds whose investment costs are materially greater than their peers. The Panel believes that the presence of disengaged members in the default options of super funds means this is a bigger problem than in situations where members can be assumed to have made an express choice to invest in specific options or funds.

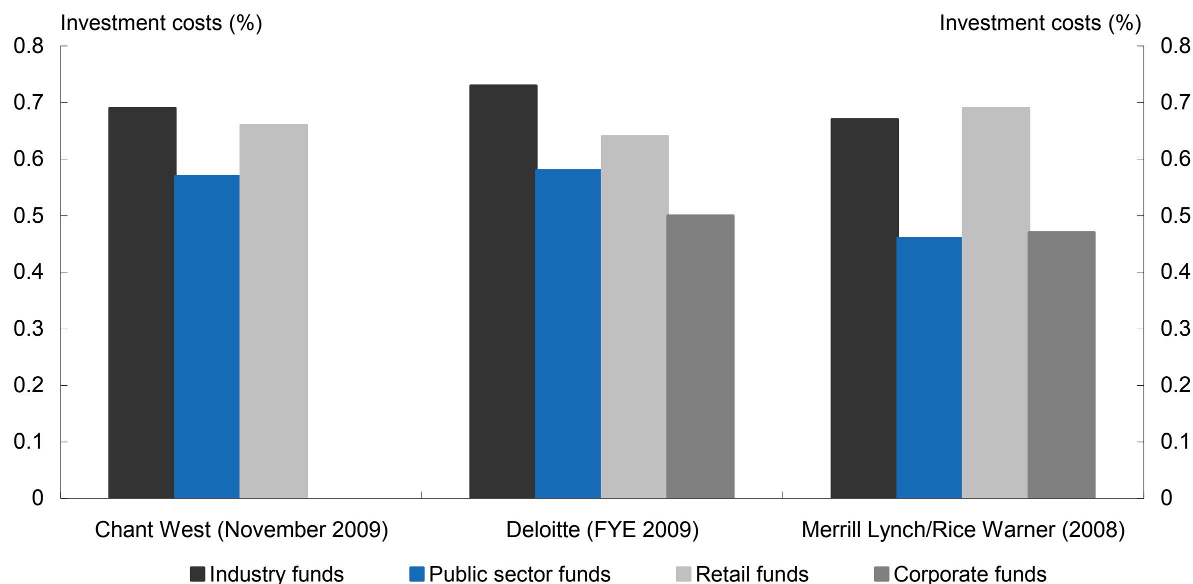
Figure 3.3: Investment management fees of default options



Note: The Not-for-Profit median default investment option fee is 0.67 per cent, the SuperRatings 50 Median is 0.68 per cent, the SuperRatings All Fund Media is 0.72% and the Retail Master Trust Median is 0.83 per cent.
Source: SuperRatings 2010 Benchmark Report for the period ending 30 June 2009.

There is some evidence that investment management fees vary by segment. Figure 3.4 presents the findings of a range of researchers into the investment management fees of different segments. It highlights that though there do appear to be differences in the average investment management fees incurred by members in different sectors, these differences are not as great as is sometimes claimed, being of the order of 0.1-0.2 per cent per annum. The figure does not, however, have regard either for the potential that the investment strategies employed in each sector might, on average, differ, or that there may be significant variation between funds within the sectors.

Figure 3.4: Investment management fees by market sector



Source: Chant West, 'Good cost, bad cost — there is a difference,' December 2009, Volume 7, number 4. Deloitte unpublished survey data, May 2010. Merrill Lynch/Rice Warner: Banc of America Securities - Merrill Lynch estimates based on Rice Warner 2008 fee analysis.

4.2 Performance-based fees

Performance-based fees have been suggested in some quarters as a way to better align the interests of the fund manager with those of the member than either flat or asset-based fees.[16] However, a number of submissions identified both conceptual and practical concerns with this argument, at least in its simplest form. The Panel shares some of these concerns.

Performance-based fees were until recently typically only charged by hedge funds or in the context of mandates relating to alternative assets. Quite quickly, they have become much more widespread with super funds in both the retail and not-for-profit fund sectors paying them in a range of circumstances. The Panel is also aware of some funds which are charging performance fees on investment options based on relatively unchallenging hurdle rates, which are most likely resulting in members paying higher fees for only average performance.

The Panel's view is that performance-based fees should be the exception rather than the rule in superannuation funds. Trustees should have the buying power to demand fully-focused, motivated and incentivised managers by reason of the price they contract to pay for those managers' services, and should not readily share member returns with fund managers in the hope that this will engender higher returns.

4.2.1 Conceptual/theoretical issues with performance fees

There are a number of conceptual issues with performance fees. The first of these is that the causal link between fund manager effort and investment returns achieved can be quite difficult to establish, particularly over short periods. Incentive remuneration based on past performance risks rewarding fund managers as often for luck as it does for skill. It is, therefore, unclear precisely what 'incentive' performance fees actually provide. Indeed, as long ago as 2001, the Myners review in the UK concluded:

> *"Overall, there is little evidence that incentive fees changed performance patterns, either for better or for worse."*[17]

Secondly, there is the potential for managers to maximise the value of the performance fee 'option'[18] by taking higher active risk, or by adjusting the level of risk at key points in the performance measurement cycle.[19] This is something that fund managers can directly manage.

Not surprisingly, this potential, an example of what is commonly termed 'moral hazard,' was widely identified in submissions.[20] As noted above there is empirical evidence of just such 'tournament' behaviour in some markets. One commentator has suggested that:

> *"performance fees will end up doing much more harm than good from the investors' point of view unless the fees' undesirable incentive to increase risk is thoroughly checked."*[21]

The Panel's recommendations outlined below address this issue directly.

Lastly, performance fees are asymmetric in nature. This is the reason why Recommendation 3.1 expressly makes reference to the requirement for trustees to have regard for '*the expected costs of the strategy … under a variety of market conditions.'*

4.2.2 Practical issues related to performance fees

A number of submissions noted that performance fees can introduce complexity into the fee, tax reserving and unit pricing calculation processes. They can also give rise to some difficult disclosure issues as well as comparability issues for current and prospective members. These are quite fundamental issues with which trustees need to become conversant, and solve, before they agree to remunerate fund managers via performance fees.

The Panel is, however, concerned that few trustee boards today have the in-house skills to perform the highly technical analysis required to evaluate the net effect of a dynamic portfolio of performance fees on their fund's overall performance outcomes.

4.2.3 Empirical research on performance fees

The Panel was prepared to accept the possibility that trustees had in fact overcome these conceptual and practical challenges and were employing performance fee structures in ways that were in the interests of members. What little empirical evidence is available suggests that this has not been the case.

A recent study commissioned by Grant Thornton in the United Kingdom found that:[22]

- performance fees do not generally affect performance, have a limited influence on manager behaviour and do not appear to stimulate better performance;
- over the five-year period from 2003 to 2007, on average, funds without performance fees performed slightly better than those with performance fees. Funds with performance fees have historically beaten their benchmarks 53 per cent of the time, while those without performance fees did so 59 per cent of the time;
- only 10 per cent of fund managers in the industry are 'real stars' who consistently beat their benchmarks without using leverage;

- performance fees can encourage fund managers to use more derivatives, change stocks more frequently or be more ready to go into cash or cash equivalents; and
- the principal effect of performance fees has been to increase financial returns to the management companies.

Anecdotal evidence together with a number of submissions received by the Panel suggest that the situation in Australia is much the same. The Panel therefore remains concerned that the practical issues implicit in performance fee arrangements have not been adequately addressed.

4.2.4 Implications for trustees

Having identified these issues and research findings, the Panel accepts that trustees should still have the freedom to negotiate performance-based fees if they believe it is in the best interests of members. This view was shared by a number of submissions.[23] The Panel does, however, query the level of inquiry and due diligence that is undertaken to ascertain that it is, in fact, in members' interests. No submissions contained any empirical data that demonstrated that performance-based fees produce better outcomes for members.

Nonetheless, the Panel's intention is to help trustees arrive at a workable set of principles for the use of performance-based fees in superannuation.

4.2.5 Regulations in other jurisdictions

In the United States, performance-based fees are regulated by the Securities and Exchange Commission (**SEC**)[24] and the Department of Labor.[25] The SEC rule only allows investment advisers to share profits with a 'qualified client'. Under ERISA, in simple terms, the fee has to represent reasonable compensation. The general idea of the regulations is that a fee that involves an adviser or fiduciary sharing the profits of the client is one that calls for special rules. The Panel believes that this sends a useful signal as to how such fees should be approached.

4.2.6 APRA performance fee standard

In light of all these factors, the Panel believes that APRA should develop a standard dealing with performance-based fees. The issues and principles to be addressed in the 'performance fee standard' should include:

(a) **Application and setting of 'high water marks'** — that is the circumstances in which performance fees should be payable if a period of strong performance only occurs after a period of declines that have lowered the base from which the next period's performance fees are calculated.[26]

(b) **Clawbacks** — whether and if so when the manager should be liable to repay some or all of the performance fee from prior periods; particularly where it is based on short-term results.[27]

(c) **Taxation basis —** whether performance measurement should be on an after-tax basis even if fees are credited on the basis of an assumed 'average' tax rate and then subsequently adjusted for variances.[28]

(d) **Base fees** — How it can be shown that performance fee arrangements are predicated on a demonstrable reduction in base fees; that is that there is in fact an appropriate risk-sharing arrangement in place.

(e) **Hurdles** — the need for performance fee eligibility to be assessed against a benchmark that is relevant to the asset class and timeframe being managed, not against simple measures like absolute market growth.

(f) **Resets** — a prohibition on resetting hurdles or high water marks during the period to which the performance fee relates.

(g) **Unit pricing** — The way that performance-based fees are unit priced needs to be very carefully managed and clearly disclosed.

(h) **Longer testing period** — Ideally, though performance fees should be calculated on a rolling basis, for example every month, a much longer period (at least the previous 12 months or even longer) should be used to assess performance.[29]

(i) **Fee caps** — Whether there should be an upper limit on the fees payable by the trustee, and if so what that upper limit should be.

(j) **Portfolio effect** — the effect of any performance fee arrangement on the fees paid in the portfolio as a whole.

(k) **Disclosure** — Trustees must disclose performance fees clearly to members. Trustees should be accountable for agreeing to spend member money on these fees and should disclose what fees have been paid in prior periods so that members have at least some reference point as to what might be charged in future periods.

Recommendation 3.2

An enforceable 'performance fee standard' should be developed by APRA in consultation with industry.

Recommendation 3.3

No performance-based fees may be paid by the trustee of a MySuper product unless the payment conforms with the 'performance fee standard'.

5 MANAGING FOR AFTER-TAX RETURNS

5.1 The problem

Members accumulate their retirement savings and retire on after-tax returns, not pre-tax ones and yet there is a wide variation in the extent to which most trustees and investment managers have regard to the optimisation of tax outcomes for members. This is a concern because, as a submission from KPMG noted:

> *"Tax is the single biggest expense for most superannuation entities. It should be constantly monitored and be part of an appropriate risk framework. Poor tax governance can mean diminished after-tax returns to fund members while compliance breaches can result in losses to present and future members."*[30]

The relatively low tax rate on superannuation[31] generally appears to cause trustees and managers to believe that the potential leakage from lack of careful tax management is minimal, but in a large super fund, even a few basis points can mean millions of dollars.

The benefits of dividend imputation credits and capital gains tax (**CGT**) discounts are only realised where the underlying investments are held at the time of dividend distribution, or for a specified period. Investment 'churn' or portfolio trading that ignores tax consequences can result in the premature turnover of assets where the potential after-tax benefits to members are lost.

Income on assets underpinning a pension under current tax rules attracts a zero tax rate. This gives retired super fund members a very strong interest in the generation of franking credits from Australian share investments (as these are credited to zero-taxpaying investors in the form of additional returns), but much less interest in capital gains tax discounts which have no value to non-taxable investors, unlike accumulation phase members who do benefit from CGT discounts. In other words, the pension phase creates quite distinct and conflicting tax considerations that, on one view, call for separate management altogether.

5.2 Industry practice

The underlying practical problem seems to be a by-product of standard funds management practice.[32] Tax issues are more complex for investors that are not super funds and so fund managers do not necessarily manage non-super mandates in a tax-aware manner. Gordon Mackenzie (ATAX) commented in his submission to the Review;

> *"In 2006 ATAX researched the relationship between tax managers and fund managers in Australia financial institutions. What was observed was that there was very little integration between tax management and funds management in the financial services companies who responded to the survey. That lack of integration suggested that fund managers had limited regard to tax when managing their portfolios."*[33]

Another group of researchers has commented to similar effect, that:

> *"Institutional equity fund management in Australia is principally focused on the pre-fee and pre-tax performance surveys of leading asset consultants."*[34]

The same is true in the back-office. Many investment managers do not separate super from the rest of their operations. Therefore, with the exception of some very high level considerations, the Panel has concluded that super fund tax issues are not being given adequate priority by the industry.

The United States mandated after-tax reporting (as well as pre-tax reporting) for mutual funds nearly a decade ago.[35] IFSA, Morningstar and ASFA, together with FTSE, have all introduced initiatives to promote tax-awareness. But, this mostly focuses on investment manager behaviour, not on behaviour at the trustee level.

5.3 After-tax benchmarking

One of the reasons for the persistence of before-tax reporting in Australia is the near-universal use of market indices as the benchmarks to measure and compare performance. These indices merely record the rising and falling capital value of the securities covered by the index, plus any distributed income, generally weighted to the proportional market capitalisation of each security. These benchmarks typically do not take taxation into account.

As Gordon Mackenzie (ATAX) notes, other reasons include:

> *"the expensive IT systems that would be needed, lack of visibility of investors tax status, lack of post tax benchmarks and that some investors are not tax paying."*[36]

The Panel though notes, as a move in the right direction, the recent development of the 'FTSE ASFA Australia Index Series', which covers the Australian equity market and is designed to better align investment decisions with tax positions.[37]

5.4 Portfolio turnover

Turnover in the underlying holdings is an inevitable consequence of managing an investment portfolio. Contributions and withdrawals have to be effected and various forms of investment income (mostly dividends, interest and rent) have to be re-invested. Active management is another potential source of turnover, though the Panel notes that even passive (or index) investment management typically incurs some level of portfolio turnover.[38] There is also evidence that some forms of active management result in more turnover than others.[39]

Portfolio turnover can be costly in terms both of the transaction costs incurred and its tax implications. Although transaction costs will typically be included in the evaluation of a fund manager's performance, as noted above, the tax consequences typically will not.

5.5 The solutions

The Panel believes that the current failure of the super fund and investment management industry as a whole to focus adequately on investment returns on an after-tax basis is primarily an investment governance problem. That is to say, it is an issue for trustees and not simply for fund managers.

The Panel has four objectives regarding this issue:

(a) trustees should have express regard for taxation issues at all stages of the investment process: strategy, implementation and monitoring;

(b) managers should manage portfolios in a tax-aware manner for the benefit of members;

(c) fund manager remuneration structures should be adapted to create more incentive to do so; and

(d) there should be a system for reporting both pre-tax and after-tax returns and the publication of any investment return information solely on a pre-tax basis should be prohibited.

While the Panel is not suggesting that investment strategies be solely focused on tax considerations, it does believe that more effective tax management practices would ultimately lead to members receiving increased net returns. Estimates of the cost of this lost tax efficiency vary, ranging from around 5 basis points per annum (considering the impact of turnover alone)[40] up to some 200 basis points per annum on a more holistic basis.[41]

Ultimately, it is beyond the reach of this Review to define precisely what processes trustees ought to have in place to have due regard for tax. It is a complex, technical area. However, the Panel fully expects that the industry has the ability to work co-operatively to start to define processes and approaches (including the methodologies and key assumptions required) that will raise overall standards in this area. The Panel notes the valuable initiative taken by IFSA in this regard in the launch of its Guidance Note on the calculation of after-tax returns in July 2008.[42] Several submissions indicated that awareness in this area is increasing,[43] albeit from a low base.

Recommendation 3.4

That section 52(2)(f) of the SIS Act be amended to include 'the taxation consequences of the strategy, in light of the circumstances of the fund', as one of the factors to which APRA fund trustees must 'have regard', and to ensure that trustees consider those taxation consequences when giving instructions in mandates to investment managers.

6 OTHER BARRIERS TO GOOD GOVERNANCE

6.1 Diversity of structures

The Panel recognises the value of allowing trustees to choose from a wide range of different funds management structures as they strive to get the best outcome for members.

6.2 Fees and costs

The technical complexities of measuring and reporting costs, fees and other leakages from superannuation funds are described in chapter 4. The lack of transparency in some fund structures can exacerbate this problem.

In complex funds management and investment transactions, there are many points at which prices are struck for any number of products, including foreign exchange and derivative dealings. These transactions will often involve a mixture of an express (visible) charge for the service, together with a spread (that is the difference between the bid and offer price in the relevant market). The implications of the spread and who is transacting as a counterparty are often more difficult to assess. Similarly, there are a number of implementation and execution issues where leakages can occur. These leakages can occur during portfolio transitions, order allocation and illiquid trading where unintended market exposures, wide bid-offer spreads on account adjustments and internal cash management fees can add to costs beyond expressed charges. Such costs will be invisible except under quite close scrutiny.

The Panel strongly believes that trustees have the same obligations to understand, monitor and manage the fees and costs incurred in the investment of the fund's assets regardless of the structure or number of intermediaries involved. Trustees should not be able to evade accountability for the success or failure of their strategies on the basis that any manager or underlying manager was incapable of providing information that the trustee would have had access to had they not chosen to delegate the task to another, or to invest in a product. In the Panel's view, a trustee that implements a structure in which such information is not available runs the risk of breaching its duty to act with due care and diligence. This is the reason why Recommendation 3.1 in this chapter expressly makes reference to the requirement for trustees to have regard for '*the expected costs of the strategy, including those at different levels of any interposed legal structures.*'

6.3 Valuation

The Panel fully expects that superannuation funds will increasingly be looking to invest their portfolios in strategies, securities and vehicles that are not market-listed. The trend towards investing in real estate, hedge funds and other unlisted types of assets is already well-established and the Panel believes that such exposures, if properly managed, can potentially offer valuable sources of returns and diversification for super funds.

One challenge posed by many such strategies is ensuring that there is a reliable, accurate and independently-verified process for valuing such assets, especially in times of market turbulence.[44] As a submission from MLC noted:

> *"The accuracy and method of fund asset valuation is critical to the governance function of superannuation funds."*[45]

A number of submissions noted the link between valuation (and potentially liquidity) of the underlying assets and the redemption and application terms offered by some funds.[46] Inaccurate valuations, especially where there is an undue lag in re-valuation of the underlying assets, can mean inaccurate unit prices (or crediting rates) and hence cause inequity between members.[47] The GFC also highlighted that they can be a precursor to investment losses.

The problem is compounded because deriving such a valuation, for instance on a complicated over-the-counter derivatives-based strategy, can be highly technical. In other circumstances, valuations may be subject to considerable uncertainty, such as when valuing a partnership or joint venture interest in which there are limits on transferability. The Panel is therefore strongly of the view that trustees cannot simply assume that a custodian, whether acting on its own or on advice from the product, security or structure provider, will be able to value such assets properly. Rather, trustees must satisfy themselves that there is a process (which may well include the custodian) that includes regular, timely input that is both expert and independent of the underlying product or service provider or security issuer. Absent such a process, the Panel is of the view that the investment of super fund assets in such strategies can only be regarded as imprudent.[48]

Recommendation 3.5

That section 52(2)(f) of the SIS Act be amended to include 'the availability of valuation information that is both timely and independent of the fund manager, product provider or security issuer', as one of the factors to which APRA fund trustees must 'have regard'.

6.4 Voting

Another area where the lack of transparency can have implications is in the governance of the fund's underlying investments. There was a strong consensus in submissions that trustees should have procedures to ensure that the voting rights attached to the assets of the fund are being actively managed in the interests of members.[49] The Panel firmly endorses this view.

This does not, of course, mean that the trustee has to vote in each and every case. The decision on whether and how to vote can be delegated (for instance to a proxy consultant or a fund manager) so long as the delegation makes clear:

(a) the obligation on the delegate to consider whether to vote in each case;

(b) the requirement that the decision as to whether and how to vote must be made in pursuit of the best interests of members; and

(c) that information on how votes were cast in respect of fund assets should be available to trustees routinely and on request.

Former UK Financial Services Secretary, Paul Myners, addressed these issues in a recent speech:

> *"Fund managers in most cases act as agents for clients, the ultimate owners of companies. As the agents of owners, the asset management industry is critically placed to ensure that companies in which they invest their clients' money deliver long-term, sustainable returns. Not all fund managers offer 'governance' as part of their bundled package, but it is clearly incumbent on pension fund trustees and others in similar positions to ensure that someone is taking this role seriously on their behalf — and doing it well. The onus here should clearly be on the ultimate owner — the investment trust, insurer or pension fund. If the owner's interests are not represented through effective stewardship, we cannot be surprised if agents substitute their own goals."*[50]

The Productivity Commission, in its report into Executive Remuneration in Australia, made the following recommendation in relation to voting on remuneration reports and other remuneration-related issues:

> *"Recommendation 12*
>
> *Institutional investors — particularly superannuation funds — should disclose, at least on an annual basis, how they have voted on remuneration reports and other remuneration-related issues. Initially this should be progressed on a voluntary basis by institutions in collaboration with their industry organisations. The Australian Securities and Investments Commission should monitor progress in relation to super funds regulated under the Superannuation Industry (Supervision) Act 1993."*[51]

The Panel agrees that trustees should consider ways in which voting decisions can be communicated to members, perhaps on the fund's website. Consistent with the Productivity Commission's thinking, perhaps the Code of Trustee Governance suggested in chapter 2 could include principles dealing with the disclosure of voting decisions.

The Panel recognises that many trustees already have arrangements such as these in place.[52] It also acknowledges the valuable work done by ACSI, ASFA, IFSA and other industry associations in

promoting more efficient, effective proxy voting by institutional investors such as trustees, and in many cases extending the investment governance processes even further into the realm of direct engagement with investee companies on corporate governance, sustainability and other issues.

Recommendation 3.6

All large APRA funds should publish their proxy voting policies and procedures, and disclose their voting behaviour to members on their websites.

ENDNOTES

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4 R. Bird and J. Gray, Submission no. 3, p 3.

5 Agent here is being used in its economic not its legal sense.

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12 Adam Clements and Michael Drew, 2004, 'Institutional Homogeneity and Choice in Superannuation', Accounting Research Journal, 17 pp 102-112; Natalie Gallery and Lynn McDougall, 'Don't Judge a Superannuation Default Investment Option by Its Name' Australian Accounting Review (forthcoming, 2010).

13 Nicole Choi and Richard Sias, 'Institutional industry herding', Journal of Financial Economics, 94, 2009, pp 469-491.

14 For example, Harry Fechner, Submission no. 106, p 17; ICAA, Submission no. 137, p 18; ISN, Submission no. 225, page 7 of the Q & A Report.

15 Several submissions cited the announcement in December 2009 by Frontier Asset Consulting that it would seek an alternative methodology for fees. However, this was the only example cited to the Review of a materially different approach.

16 For example, AIST, Submission no. 150, p 67; CHOICE, Submission no. 211, p 26; Mercer, Submission no. 170, p 81.

17 Myners P, 'Institutional Investment in the United Kingdom – A Review', March 2001, UK Treasury, p 85.

18 It is possible to treat the typical performance-based fee as effectively a call option on portfolio performance written by the trustee on behalf of the fund manager. It is possible to 'price' that option as the average expected revenue from the portfolio mandate. It then becomes possible to study the impact of imposing various fee conditions and to analyse the sensitivities against various assumptions such as the expected information ratio, tracking error, market return and so on.

19 David Blake, 'Pension Economics', Wiley & Sons Inc, 2006, pp 80-81.

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23 For example, IFSA, Submission no. 226, p 85; AIST, Submission no. 150, p 67; CPA Australia, Submission no. 156, p 16; ASFA, Submission no. 147, p 56; AXA, Submission no. 207, p 16.

24 Investment Advisers Act of 1940, Rule 205-3.

25 ERISA section 406(1)(b).

26 For example, ASFA, Submission no. 147, p 56; Morningstar, Submission no. 171, pp 7-8; Statewide, Submission no. 188, p 22.

27 For example, ASFA, Submission no. 147, p 56; Statewide, Submission no. 188, p 22.

28 For example, Warakirri Asset Management, Submission no. 57, p 4; CHOICE, Submission no. 211, p 26; Statewide, Submission no. 188, p 22.

29 For example, CBus, Submission no. 152, p 15; FPA Submission no. 224, p 33, NICRI, Submission no. 179, p 9.

30 KPMG, Submission no.397, p 4.

31 Unlike a normal managed fund where investors can be paying tax at rates anywhere between zero and the top marginal rate, an accumulation phase super fund pays tax at 15 per cent on its income and at 10 per cent on its longer-term capital gains. Moreover, the average tax rate in fact paid by funds can be considerably less than these headline rates. This is because funds can access franking credits on dividends, concessional tax rates on capital gains and potentially can utilise unclaimed prior year tax losses.

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34 Kingsley Fong, David Gallagher, Sarah Lau, Peter Swan, 2009, 'Do active fund managers care about capital gains tax efficiency?,' Pacific-Basin Finance Journal, 17, pp 257–270.

35 The Mutual Fund Tax Awareness Act of 2000.

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39 Mercer-IRRC, 'Investment Horizons. Do managers do what they say?', 2010, <www.mercer.com/ri>.

40 Mercer, Submission no. 170, p 120.

41 Gordon Mackenzie, Submission no. 429, p 15.

42 IFSA, Guidance Note, No. 25.00, 'Product Performance - Calculation of After-tax Returns,' June 2008, <www.ifsa.com.au/documents/25GN_IFSA%20Guidance%20Note%20After-tax%20Returns_0625.pdf>.

43 Chant West, Submission no. 221, p 25; IFSA, Submission no. 72, p 62.

44 For example, AXA, Submission no. 34, p 3; KPMG, Submission no. 397, p 3; Rice Warner, Submission no. 233, p 12.

45 MLC, Submission no. 95, p 11.

46 For example, IFSA, Submission no. 72, p 11; KPMG, Submission no. 397, p 3.

47 For example, ISN, Submission no. 225, p 10 of the Q & A Report; PwC, Submission no. 85, p 5; REST, Submission no. 99, p 3.

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49 For example, AIST, Submission no. 62, p 60; ACSI, Submission no. 61, p 8; CPA Australia, Submission no. 37, p 10; IFSA, Submission no. 72, p 52.; RIAA, Submission no. 29, p 3; S. Gilbert, Submission no. 21, p 2; UniSuper, Submission no. 56, p 17; Watson Wyatt, Submission no. 31, p 14; Unions NSW, Submission no. 370, p 14.

50 Lord Myners, Launch of the Asset Management Working Group Report, 9 November 2009, <www.hm-treasury.gov.uk/>.

51 Productivity Commission Inquiry Report No. 49, 19 December 2009, p 380.

52 For example, see the VicSuper proxy voting register: <www.vicsuper.com.au/resources/documents/Proxy_voting_August_2008.pdf>.

SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 4

Outcomes transparency

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KEY THEMES

Issue

The Australian superannuation system is characterised by a lack of transparency, comparability and, consequently, accountability. There is no standardised methodology for calculating and disclosing relevant fund or investment option information. Members often rely inappropriately on historical investment return data which gives no information about the risk attaching to those returns.

Proposed solution

The Panel proposes measures, including:

- development by APRA (in consultation with ASIC and the industry) of outcomes reporting standards aimed at standardising the way in which performance and costs are reported;
- a new forward-looking risk and return matrix complemented by disclosure for investment options in a user-friendly 'dashboard' style;
- disclosure by trustees of all costs incurred by the fund, to at least the first non-associated entity level, classified into 'cost categories' for the purpose of benchmarking and improving fund efficiency and performance;
- all past investment return information must be accompanied by information about its volatility and be stated net of all costs and after tax; and
- a government website (www.super.gov.au) to be developed, displaying superannuation information and resources to enable Australians to understand and navigate Australia's superannuation system more effectively.

Benefits for members

Members will benefit from these measures to improve transparency of the superannuation system as:

- increased transparency and disclosure will result in improved understanding for members and, consequently, better decision-making; and
- the new 'forward-looking' investment option disclosure template would enable members to examine possible future performance outcomes, rather than basing investment choices solely on past investment performance information.

1 IMPROVING OUTCOMES TRANSPARENCY

On 16 October 2009, the Panel released its Phase Two: Operations and Efficiency Issues Paper which canvassed a range of issues about fees, costs and disclosure in super funds. These issues went directly to the efficiency with which Australian super funds are being run, a theme central to the terms of reference and work of the Review.

While some of the Phase Two issues are addressed in chapter 9, this chapter focuses on fees, costs and investment returns and how to improve transparency through more meaningful reporting to advisers, researchers, analysts, regulators and, ultimately, to members. The aim of this reporting would be to bring about more comparability, promote the efficient operation of the superannuation market and, ultimately, drive more accountability for member outcomes.

1.1 Current issues

Transparency is critical to the efficiency and operation of a market-based savings system. It improves understanding, awareness and engagement at various levels; not always directly at member level.

The Panel has concluded that the superannuation system lacks transparency, comparability and accountability in relation to costs, fees and investment returns.

The Panel believes that this is due to the following factors:

(a) there are not sufficiently strong incentives for trustees to be transparent about the various outcomes: fees, costs, investment returns, and other aspects that are important to members;

(b) the system has evolved over time from various origins, including the life insurance industry, the UK and US style of funds management, corporate defined benefit plans and the not-for-profit sector, each with different business models and approaches, often making comparability difficult;

(c) outsourcing of many functions has led to an inherent complexity, with fees and charges being incurred at multiple layers;

(d) a cultural and attitudinal barrier to effective disclosure of costs and fees; a belief that it is only the net investment return that matters, without clarity around risk exposure;

(e) disclosure requirements (for example, in Product Disclosure Statements (**PDSs**) have tended to mechanistically reflect existing complexities, which in turn has invited a 'data dump' approach to fee disclosure, quite commonly resulting in too many pages of fee disclosure in PDSs;

(f) there has been a lack of effective enforcement against those who fail to comply with their disclosure obligations; and

(g) the language of debate around data and disclosure has been largely captured by those whom it has suited to characterise members as 'investors' and the purpose of data disclosure as limited to enabling investor choice of fund or investment option.

1.2 New approach

The Panel has concluded that the current model of consumer sovereignty in super, with member autonomy underpinned by complex disclosure, is not optimal. The requirement that disclosure be 'clear, concise and effective' has not worked in superannuation.

MySuper (discussed in chapter 1) represents one element of reframing the model, with sound product design and regulation replacing the need for detailed member-level disclosure.

Other critical elements include:

(a) a requirement to prevent fees and costs from being obscured through use of intermediaries, unnecessarily complicated language and netting of fees from investment returns;

(b) recognition that, in an imperfect market, most disclosure needs to be targeted to member proxies such as independent advisers, regulators, researchers and analysts to enhance competition between funds and sectors; and

(c) information that is given to members being simpler, standardised where necessary (to enable comparability) and being forward-looking.

There should also be a more concerted effort by fund trustees to understand the incurred fees and costs. The Panel believes that a core element of governance is that trustees should be able to demonstrate that they understand all elements of incurred expenditure and can manage the impact of that expenditure on member retirement savings on an after-tax and after-cost basis. This would improve the ability of trustees to provide better transparency of fees and costs outcomes to members.

There are two ways to improve the level of transparency in the super industry: a change of attitude on the part of participants, or a tougher regulatory stance. Given the inability of the industry, however well-intentioned, to arrive at a universally-accepted model, the Panel believes that well-focused regulatory pressure is the best way of ensuring that adequate information is disclosed in a form that is comparable, meaningful and helpful to members, regulators and the industry.

It was recently noted in the media that the industry remains split over proposed changes to the way super fund performance is measured.[1] This supports the Panel's belief, and the views expressed in many submissions, that real changes that will benefit members can only be achieved through regulatory intervention.

2 OUTCOMES REPORTING STANDARDS

The Panel believes that the lack of transparency of outcomes in Australian superannuation can be resolved through a new tool: 'outcomes reporting standards' to be developed by APRA in consultation with ASIC, the industry and other relevant stakeholders. The standards would be developed by APRA under a new standards-making power that the Panel has recommended be given to APRA, as discussed in greater detail in chapter 10.

Improving transparency and outcomes reporting within Australia's complex super system requires fine adjustments. The Panel sees these standards as the best way of achieving tailored solutions to

many of the measurement, disclosure and comparability issues affecting the industry. The Panel believes that outcomes reporting standards have the potential to resolve the vast majority of problems identified in this chapter in a way that best suits the needs of stakeholders. They can be the subject of comprehensive consultation and have the flexibility to provide innovative solutions, such as effectively overlaying existing (and unsatisfactory) accounting standards. This is discussed later in section 4.1.

3 INFORMATION PROVIDED BY SUPER FUNDS

3.1 The users of super data

It is not the Panel's position that the average member has a need for a large amount of data about superannuation, but there are a number of stakeholders who need different types of data for a variety of reasons. These stakeholders include:

APRA, which, as part of its prudential supervision of superannuation funds, needs to know that the fund is being operated soundly by the trustee in accordance with its risk management plans, its investment strategies and other trustee policies. APRA uses the data it collects to help risk-rate each fund. Major changes in trend data, or other indicators of increased risk, will lead to earlier and a more intensive on-site review of the trustee's operations, and mitigate (though not eliminate) the risk of member losses due to mismanagement. APRA's use of data in this way is of direct benefit to members. The Panel is now proposing that APRA be given a new mandate; to monitor and regulate the efficiency and outcomes of super funds. This is discussed in more detail in chapter 10.

Employers, who are generally required to choose a default fund for their employees, benefit from the ability to compare how efficiently different funds perform and manage a variety of costs.

Financial advisers, who need to make sound, evidence-based recommendations to their clients, whether individuals, or employers seeking a default fund for their employees.

Government and its policy advisers, who need reliable industry-wide data in order to assess the continuing soundness of policy settings and the need for any adjustments. Reliable data on fund performance after fees and taxes would also provide an essential degree of industry-wide accountability for the $22 billion a year investment the government makes in the super industry by way of tax concessions.

Members, who might wish to compare the performance and cost of their fund (or investment option) with others available to them.

Researchers and commentators, both in Australia and overseas, who use data to analyse the industry, help drive innovation and competition, and improve understanding.

Trustees, that might want to compare and benchmark their fund's performance with the performance of other funds locally and internationally.

3.2 Current sources of information

Trustees are required to provide information directly to members by way of periodic statements. These statements provide useful information on the performance of the member's own account, but form a very limited basis on which to make a comparison with other investment options or make a judgment about the whole of the fund. While members can request a copy of the audited financial statements for the fund, this report is highly aggregated and rarely requested. An annual fund report is also available to members. There are generic requirements for these annual fund reports to include the information that the trustee reasonably believes a member would reasonably need for purposes of understanding the management and financial condition and the investment performance of the fund, and a description of the investment strategy and objectives in respect of the fund.[2] Trustees also provide some financial information about the costs of investment options in PDSs. However, information on costs is often presented in ranges, which diminishes its usefulness. Trustees must also report to APRA and can voluntarily provide data to commercial research houses.

APRA collects data using its powers under the *Financial Sector (Collection of Data) Act 2001* (**FS (CoD) Act**). It uses this data principally for the purpose of its prudential supervision of the industry, but also to fulfil its mission to 'act as the national statistical agency for the Australian financial sector'[3] and to provide data required by the Australian Bureau of Statistics (**ABS**) in preparing the national accounts. To meet the latter purpose, APRA also publishes available data from Exempt Public Sector Superannuation Schemes (**EPSSSs**) and data on SMSFs, which is provided by the ATO. APRA's publication of industry, sectoral and fund level data is therefore not designed, nor intended, to help members select funds, or investment options based on past performance data.

Commercial research houses[4] collect and provide data on investment performance of individual investment options. These data are generally only available to paying subscribers. Additionally, the data suffer from several inherent limitations, such as:

(a) selection bias as the data is submitted voluntarily by trustees. Trustees may avoid submitting data on poorly performing funds, or investment options, to avoid adverse comparisons. The data coverage is therefore incomplete and results are skewed towards better performing funds;

(b) the submitted data on investment performance of individual investment options are calculated by the fund trustees and are unaudited;

(c) data disclosed by trustees are inconsistent, and can require substantial adjustment by the agencies to enable reasonable comparability;[5]

(d) naming of investment options differs across superannuation funds, so obscuring the underlying asset composition and making comparison difficult. Methodologies for performance comparisons also differ across research houses; and

(e) the potential for conflicts of interest as commercial research houses might find it difficult to be objective about a poorly-performing fund that buys other services the research house provides.

4 DEFICIENCIES WITH EXISTING FINANCIAL REPORTING INFORMATION

> *"Financial reporting is a key governance mechanism by which superannuation fund trustees are accountable to fund members and other stakeholders. Apart from highly aggregated information contained in abridged financial reports, information disclosed to members in annual reports is unregulated and generally unaudited. This situation presents scope for trustees to manipulate disclosures, thus potentially misleading fund members and adversely affecting their decisions ... findings reveal a lack of transparency in superannuation fund reporting that limits the usefulness of disclosures as a fund governance mechanism."*[6]

The concern expressed in the quote by two prominent accounting academics is shared by the Panel. The current disclosure position is an inadequate compromise: members get quite complex and often unhelpful information and experts get aggregated and non-specific data.

4.1 Accounting standards

Financial disclosure should play a critical role as a governance mechanism and in improving transparency and comparability. However, despite its importance, the current accounting regime relating to the superannuation system leaves a great deal to be desired.

The accounting standard AAS 25 — Financial Reporting by Superannuation Plans (**AAS 25**) requires only aggregated or 'whole of fund' financial reporting, while the industry and super members are concerned about the performance of the investment option in which they are invested. This is the 'product' that the industry has created and which the members 'consume'. For this reason, financial statements at fund level are rarely used by analysts, researchers or members.

The disconnect between AAS 25 and the financial information that users require is demonstrated by the following examples:

(a) the PDS for the fund must disclose the fees and returns at an investment option level;[7]

(b) member periodic statements must contain information about the investment return applicable to each particular member;[8]

(c) the annual report to members usually contains information relating to the investments, returns and management expense ratios for the various investment options offered by the fund;[9]

(d) the potential for inconsistency of treatment of specific expenses such as the administration expenses — for example, some funds currently follow IFSA Standard 6.00 (which requires administration expenses to be deducted in arriving at net investment returns) while other funds do not;[10]

(e) the potential for trustees to report returns and expense ratios selectively — a long-standing concern as identified in the 2002 Ramsay report to ASIC;[11] and

(f) AAS 25 treats the investment return from a life company that wholly backs a superannuation fund as the proceeds of an insurance policy, and there is no need for the accounts to disclose underlying fees and costs or any other information. This is clearly unsatisfactory and creates a regulatory imbalance between super funds that have access to this structure and those that do not.

While management accounts are typically prepared at the investment option level to enable allocation of earnings and costs to members, it is only the fund financial statements prepared at the whole of fund level that are audited. Other investment vehicles, such as registered managed investment schemes, and even SMSFs, which are significantly smaller than the average investment option in a large APRA fund, require annual audits.

The Australian Accounting Standards Board (**AASB**) has issued an Exposure Draft 179 — Superannuation Plans and Approved Deposit Funds **(ED 179**) to replace AAS 25. While this will modernise an outdated accounting standard and improve whole of fund disclosure, the Panel does not believe that ED 179 will materially improve the information needed by users, in particular members.

4.2 The solution

In this context, the Panel therefore sees the need for outcomes reporting standards (discussed in section 2) that would require trustees to calculate and disclose items such as fees, cost and performance, at MySuper and investment option level, according to a standardised methodology and tailored to the contemporary needs of the industry. These standards would operate as an overlay to AAS 25 and ED 179 for large APRA funds.

The standard methodology would then be applied by trustees of all large APRA funds in the calculation of both investment performance and costs. This would provide interested parties with the ability to make the comparisons they believe are warranted. The regime would have the flexibility to deal with any number of the current transparency and comparability problems affecting the industry.

It its Second Phase One Preliminary Report on MySuper, the Panel said that MySuper would require separate audited financial statements to support transparency and comparability. The Panel's concluded view is that an outcomes reporting standard could produce a better outcome for all stakeholders, but still believes that a level of assurance by way of audit would still be required. The mechanism by which this would occur should be specifically addressed in the relevant outcomes reporting standard.

Recommendation 4.1

With an enhanced rule-making power, APRA, in consultation with ASIC and industry, should develop outcomes reporting standards as an overlay to the existing accounting standards AAS 25 and ED 179 to facilitate consistent and comparable reporting by large APRA funds of investment performance and costs at investment option level, including for MySuper products.

4.2.1 APRA whole of fund reporting

Current APRA performance data reporting is at an aggregated whole of fund level. Many submissions noted problems with this approach; the data have limited comparability and are not necessarily representative of the investment returns of individual investment options. A number of submissions suggested that APRA's publication of whole of fund level data be discontinued. For example, ASFA said that:

> *"The investment performance data published by APRA provides limited assistance in regard to checking the relative performance of superannuation funds. The APRA "whole of fund" return figures, which for each fund show the return for the total of all the different investment options every member has chosen, is of limited relevance to individual consumers."*[12]

As a matter of general principle, the Panel disagrees with this suggestion, even though it sees the limitations in the whole of fund performance data. There is still a community interest in the structure and operation of funds overall. The Panel therefore believes that whole of fund level reporting by APRA should continue with one important change. Whole of fund level reporting by APRA would **not** include APRA-derived fund level performance data (that is, investment return). Instead, the Panel proposes that APRA publish performance data in relation to MySuper products, but not other investment options.

4.3 Investment option level reporting

As at 30 June 2009, the average number of investment options offered by the 121 retail funds was 165, with the median offering being 17.[13] Even though there are many common options and many of these are single-sector options, there are still many distinct investment options to consider. The data collection task would be potentially enormous and organisation and distribution of the data would need to be very efficient.

While the Panel favours the publication of performance data at investment option level, it proposes that investment option performance data, for choice products, be disclosed on fund websites, as opposed to being published by APRA. In addition, this information could be disclosed on the government superannuation website to facilitate comparison across funds. The website is discussed in more detail in section 9 of this chapter. The Panel considers that it would be an unnecessary cost for APRA to publish investment option level data across the industry.

The Panel recognises that enhancing the reporting obligations at investment option level might add a cost to the industry. This is expected to be minimal given that trustees currently have an obligation to calculate returns and costs for each investment option for the member's periodic statement. Additionally, it is necessary to provide effective disclosure to members and stakeholders.

The outcomes reporting standards would detail the reporting requirements at investment option level such that comparable investment option performance reporting could be achieved. As indicated by ASFA:

> *"Fund members need access to investment performance information relevant to their fund and their particular investment option so that they can make educated choices about the fund they are in. If an intended use of the data is so that members and*

> *prospective members can compare investment performance then it is essential that information be collected at the investment option level."*[14]

The Panel agrees with this view, subject to resolving a number of issues of calculation, standardisation and comparability that are dealt with in section 5.

Recommendation 4.2

In addition to whole of fund reporting, APRA should publish investment return performance data for MySuper products.

Recommendation 4.3

All funds should be required to publish on their websites an investment option performance table (as shown in table 4.1 in this chapter) showing investment returns and costs at investment option level, in accordance with an outcomes reporting standard to be developed by APRA in consultation with ASIC and the industry.

4.3.1 Lack of standardisation and consistency

There is a fundamental lack of consistency in the way fund information is calculated and disclosed. The lack of consistency reduces the comparability of information and fund performance.

Chant West recently conducted an exercise where they looked at the information disclosed in PDSs of the 30 largest industry and 30 largest retail funds. They indentified a large number of material differences in how trustees disclosed fees, performance and insurance information, which required Chant West to make 146 adjustments before the information from all funds was comparable. They found that making the adjustments for comparability can make a difference of up to 20 per cent in the disclosed fees.[15]

Some of the reasons why fund information was not comparable were:

(a) costs were reported either before or after tax;

(b) investment returns were reported either before or after tax;

(c) performance fees paid to investment managers were not disclosed;

(d) fees paid to underlying investment managers in fund-of-fund products (for example, hedge funds and private equity) were not disclosed;

(e) member protection costs, particularly in years with low or negative returns, were not disclosed;

(f) investment returns were disclosed where not all costs had been deducted; and

(g) insurance commissions were not disclosed.

While a number of research houses analyse fund performance to improve comparability of information, this leads to extra costs and makes members more dependent on intermediaries. The

Panel believes that standardised reporting, based on a prescribed methodology in an outcomes reporting standard (discussed in section 4.1) would improve the comparability and usability of information that is being directed at members.

4.4 Collecting industry level data

Given the Panel's objective to improve efficiency across the sector, super fund trustees should be required, to the extent possible, to lodge statistical reports with only one public sector agency. The Panel believes that information provided to private sector research houses on a voluntary basis is a matter for trustees' commercial judgment, subject to their fiduciary duties and governing rules.

Additionally, the Panel considers that assessment for taxation purposes is a distinct issue, and does not contemplate that as part of the single reporting process.

APRA currently has a comparative advantage in the collection and publication of superannuation data because:

(a) it must collect data directly from all funds (other than SMSFs and EPSSSs) to fulfil its prudential supervisory role;

(b) both the core financial data and the accuracy of most elements of annual returns are subject to external audit; and

(c) the understanding of the fund by the responsible APRA supervisors gives the opportunity for apparent anomalies to be identified, explained and addressed.

At the same time, the Panel recognises that there are efficiencies for SMSFs and the ATO if the ATO continues to be the primary collector of SMSF data. The ATO should continue to pass SMSF data to APRA for preparation of consolidated industry wide statistics.

In chapter 8, the Panel has recommended that the Government give the ATO a specific mandate to collect and produce SMSF statistics.

Recommendation 4.4

APRA should be the sole public sector agency responsible for collecting data for all public purposes in respect of all APRA funds and EPSSSs. APRA should have the primary responsibility for the publication of all superannuation data in as disaggregated a form as is consistent with privacy principles.

Recommendation 4.5

The ATO should continue to collect data in relation to SMSFs.

5 STANDARDISING INVESTMENT OPTION INFORMATION

5.1 Standardisation of disclosure

The lack of standardisation in preparing and disclosing data reduces comparability and transparency in the superannuation industry. Chant West expressed the view that:

> *"The super disclosure regime is a mishmash of statutory requirements, some of which are open to selective interpretation, and unenforceable 'guidelines' which individual funds either follow or not depending on whether it suits them."*[16]

The Panel agrees with this view and believes that standardisation, by way of flexible outcomes reporting standards that can keep up with industry changes, is of paramount importance in achieving a more efficient super system.

5.2 Investment option labelling

Investment options offered by super funds are often identified by labels such as 'balanced', 'growth', 'capital stable' and the like. Currently, these labels have no standard meaning, resulting in reduced comparability. For example, some 'balanced' investment options have 80 per cent of so-called 'growth' assets, while others have as little as 60 per cent. Apart from anything else, existing investment option descriptions do not allow members to make informed decisions because they provide inadequate information about the expected returns and volatility of various investment options.

The Panel does not believe that it would be feasible to mandate asset types and allocation ranges within the existing nomenclature or that it would be desirable to impose that level of rigidity on products. The Panel instead favours the introduction of a risk and return targeting framework in the formulation, disclosure and measurement of investment options and their performance. This is discussed in section 6.2.

5.3 Disclosure of investment option volatility (risk)

The Panel believes that members overestimate the likelihood that past performance will persist. This leads to inappropriate decision-making and is a cause for concern. A substantial amount of the advertising in the industry is based on explicit and implicit representations about past performance.

United States research house DALBAR has conducted a number of studies showing how individual investors earn much lower net investment returns than the headline returns of the funds they invest in. This is because investors often chase past performance by switching funds or investment options, often at an inappropriate time and overlooking tax and transaction costs. For example, quantitative analysis of investor behaviour performed by Dalbar Research in 2005 showed that over the 20 years from 1986 to 2005, the average investor in a US equity mutual fund earned 3.9 per cent compounded annually before tax. Over the same period, equity mutual funds reported average earnings of 9.3 per cent annually. US inflation over the period averaged 3.0 per cent per annum.[17]

The Panel considers that members should be made more aware of the likelihood of variance from past performance. It should be mandatory for trustees to disclose a standardised measure of the

uncertainty or volatility associated with the return when quoting past investment option or MySuper product performance. This would enable advisers and, in time, a growing number of members to examine the theoretical likelihood of achieving a similar level of performance in subsequent periods.

This view was also supported by ASFA which indicated that the provision of an indication of risk and volatility "*will have potential benefits for fund members …* [but] *there has been a lack of progress made by the industry on this issue to-date*."[18] This supports the Panel's conclusion that tailored regulatory intervention is the most appropriate mechanism to achieve necessary change in the industry.

The Panel believes this risk measure would need to be developed in consultation with industry but, by way of example, it could be based on the number of quarters with negative investment returns for a particular investment option over 10 years, that is, 40 quarters. Trustees would then be required to disclose this measure when quoting past investment returns, as is shown table 4.1 in section 5.6 of this chapter.

The Panel notes that, as part of these proposals, new funds or investment options would not have sufficient data with which to calculate volatility against 10-year returns. The Panel believes that this issue would need to be considered as part of the development of an outcomes reporting standard, specifically addressing how an adequate measure of volatility could be disclosed for newly established funds or investment options. One possibility could be to require that trustees offering options with less than 10 years of investment returns would supplement the actual history of the option with a measure calculated by APRA to publish a fair indication of volatility over a 10-year period.

Recommendation 4.6

It should be mandatory, when referring to past performance of a MySuper product or a choice investment option, to disclose a standardised measure of the uncertainty or volatility associated with the return (an example of which is shown in table 4.1 in chapter 4). This requirement, and the volatility measure to be used, should be in an outcomes reporting standard to developed by APRA in consultation with ASIC and the industry.

5.4 Explaining costs on a pre-tax basis

Explaining costs to members on a notional after-tax basis (that is, so that a $100 cost is shown as $85) is confusing. It reduces comparability, as most superannuation funds use gross or pre-tax costs when communicating with members. Referring to costs on a gross basis should be required by an outcomes reporting standard.

Recommendation 4.7

All forms of cost and fee disclosure by superannuation funds should be on a pre-tax basis, that is, gross of tax, in accordance with an outcomes reporting standard to be developed by APRA in consultation with ASIC and the industry.

5.5 Reporting of net investment returns

Super funds are currently able to report their investment returns either before (gross) or after (net of) tax and certain costs. This leads to reduced transparency and comparability between funds and is unhelpful for members. To mitigate this confusion, a number of submissions suggested the adoption of standardised reporting of performance on a net basis, that is, net of all costs and taxes. For example, ASFA recommended that after-tax returns "*should … form part of a reporting standard*."[19] Morningstar also believes that there should be a regulatory standard for after-tax reporting.[20]

There were other submissions that argued that disclosure of after-tax returns was unnecessary. For example, AIST suggested that "*trustees appropriately balance tax and investment aspects in their overall investment strategy and operations. As such we do not believe there should be any major reforms in this area.*"[21]

Different approaches to investment return disclosure are found across the industry. In some cases, fund and member administration costs are not taken into account as part of the investment return calculations or in the subsequent disclosure of investment returns. Other funds treat such expenses as part of generating the net investment return. This lack of consistency is obviously highly unsatisfactory.

The Panel notes the commencement of IFSA's standard 6B, intended to apply to its membership on a phased basis starting from 1 July 2010, with full implementation from 1 July 2012.[22] However, in contrast to the approach currently required of IFSA members (and already generally adopted by industry), the new IFSA standard proposes that returns be reported net of tax and investment fees, but gross of administration, contribution, withdrawal and advice fees.

Given that member benefits can only be received on an after-tax basis and after all costs are paid, it is illogical and misleading for investment returns to be reported to members on anything other than an after-tax basis and after all costs have been deducted. Before-tax reporting allows investment managers and trustees to take less care in managing the consequences of their investing style (discussed further in chapter 3). At the same time, revealing gross returns with tax and costs to give the net return allows members and other stakeholders to analyse how costs and tax are managed. Standardised reporting showing both gross and net investment returns on an after-tax and after-cost basis would ensure greater transparency and accountability. A submission from CPA Australia also suggested that:

> *"mandating the reporting of after-tax investment returns would also assist members to better understand the performance of their superannuation funds and be able to properly compare the investments of different superannuation funds."*[23]

Since 2001, the U.S. Securities and Exchange Commission has required mutual funds to disclose in their prospectuses, advertisements and other sales materials after-tax returns based on standardised formulae.[24] The Panel supports a similar approach being adopted and believes that APRA needs to develop an outcomes reporting standard for after-tax and after-cost reporting of investment returns.

Recommendation 4.8

An outcomes reporting standard should be developed by APRA, after consultation with ASIC and the industry, which would deal with how investment returns have to be calculated both gross and net of all costs (administration and investment) and taxes and then disclosed only in a format governed by the standard.

5.6 Disclosure of investment option performance

The Panel believes that trustees should disclose performance data for each MySuper product and choice investment option in the format shown below in table 4.1. An outcomes reporting standard to be developed by APRA, in consultation with ASIC and industry, would detail how this table would have to be presented, including the requirement to report:

(a) gross investment returns for the investment option for 1, 5 and 10-year periods;

(b) costs (investment and other) on a pre-tax basis for 1, 5 and 10-year periods;

(c) investment returns net of all costs (administration and investment) and taxes for 1, 5 and 10-year periods; and

(d) the number of negative quarters of investment returns the investment option has incurred in the past 10 years (as discussed in section 5.3).

The Panel believes that to improve comparability, all figures should be quoted as a percentage of average assets held in the option over the reporting period, and not in dollar figures.

The Panel believes that the information in this table should be available to members for as long as the fund remains in existence (that is, beyond 10 years). The historical information should be easily accessible to members and non-members on the fund's website. This would enable members and industry to monitor the performance of a particular investment option over time.

The investment option performance table should be produced on an annual basis in line with the fund's balance date. The Panel believes that the timing of disclosure of investment option performance should be stipulated in an outcomes reporting standard.

As indicated by a submission by the Association of Independent Retirees (AIR):

> *" … additional contributions from employment, either at the superannuation guarantee level or as voluntary contributions, attract contributions tax at the rate of 15%. This tax is separate from the tax liability of the earnings on assets, which also attracts tax at the rate of 15% when the assets are held in the accumulation phase. In the drawdown phase, provided the requirements of the regulations are met, there is no tax liability on earnings on assets in the fund or on the pension paid. Furthermore, earnings from employment above the age of 75 do not attract employer contributions tax except under certain special circumstances."*[25]

Consequently, the Panel believes that taxation information relating to contributions tax and investment earnings should be separated, as shown below in table 4.1.

The proposed method (because it covers single, 5 and 10-year return reporting) has the potential to replace some existing disclosure requirements.

Table 4.1: A sample MySuper or choice investment option performance table

Investment Option: Blue Investment Option			
	Investment return information		
	10 Years	**5 Years**	**1 Year**
Gross investment return			A%
Less investment costs			B%
Net investment return (before all other costs and taxes)			C%
Less administration/operating costs			D%
Less net investment-related taxes			E%
Less net contributions tax			F%
Net return (after all costs and taxes)			**G%**
Number of quarters of negative investment returns in past 10 years			**Number of negative quarters/40**

Recommendation 4.9

In consultation with industry, government should finalise the details of an investment option performance table for MySuper products and choice investment options, building on the model proposed by the Panel. APRA should then specify this in an outcomes reporting standard. Specifically, the consultation would progress the development of a standardised disclosure format containing:

(a) gross investment returns, costs and investment returns net of all costs (administration and investment) and taxes for investment options for 1, 5, and 10-year periods; and

(b) the number of quarters of negative investment returns the investment option has incurred in the past 10 years, or a proxy figure developed using data published by APRA for those options with a history of less than 10 years.

Recommendation 4.10

Investment option performance table data would have to be maintained by trustees and be easily accessible on the fund's website for as long as the fund remains in existence.

6 A NEW APPROACH — A PRODUCT DASHBOARD

The broad effect of the SIS Act and SIS Regulations is to require a trustee to explain the investment objectives of the strategies offered and to provide information for the purposes of the member understanding the risk involved in each strategy.[26] However, in practice, the quality and usefulness of the disclosure is limited, resulting in a lack of trustee accountability on the performance of investment options. There is need for improvement.

The Panel believes that information about the investment strategies of MySuper products and choice investment options should be displayed in a simple, plain-English 'product dashboard'. The product 'dashboard' would not substitute for a fuller description of the investment strategy or option by the trustee as may be required, that is, the 'dashboard' would not replace the PDS (including the new short-form PDS)[27] or the equivalent on-line disclosure material developed for MySuper products.

This standardised methodology would be mandatory wherever a trustee discloses investment option information, whether in a PDS, advertising material or online.

6.1 Squam Lake Working Group standardised disclosure model

The Panel's proposed model is similar to one proposed separately in the United States by the Squam Lake Working Group on Financial Regulation (**SLWG**) in its 2009 paper titled '*Regulation of Retirement Saving*'.[28] The ideas proposed by the SLWG resonated with the Panel because they aligned with its thinking. The SLWG consists of 15 prominent academics, from various academic institutions,[29] who offer guidance on the reform of financial regulation in the United States.

The SLWG propose a standardised disclosure 'label' to encourage comparison-shopping on important attributes and to provide meaningful information about the cost and risk of the investment that would help decision-making.

The SLWG model addresses fees, a range of 'payout' scenarios over an appropriate investment horizon, the annual risk of negative return and the portfolio turnover or 'churn' ratio within the option. The model is reproduced in appendix 1 of this chapter. The Panel is attracted to the SLWG model, particularly given that it does not include any element of past performance as a relevant consideration. The Panel believes that a model like this could provide fund members with suitable information to assess the fees, risks and returns of an investment strategy or option without relying on past performance.

6.2 Risk and return targeting

The Panel suggests that trustees, in devising diversified investment strategies, focus on the investment return objective and level of risk, rather than on the asset class exposure for the particular investment strategy or option. This could be called 'risk and return targeting'. Some of the benefits of this approach would include:

(a) trustees would be responsible for managing the total investment risk of the diversified investment option, rather than focusing on the management of asset allocation benchmarks. This would emphasise the significant responsibilities of trustees in identifying and managing investment risk on behalf of members, particularly in MySuper products;

(b) trustees would have greater flexibility to adjust their asset allocations in changing market conditions in order to maintain their targeted risk/return balance, avoiding their portfolios being anchored to portfolio weightings that have been overtaken by market circumstances;

(c) it would leave the detail of the asset allocation in the hands of the trustees, who are best placed to understand the needs and attitudes of members, with the member simply identifying their risk and return preference (if any); and

(d) a risk-targeting framework is forward-looking while the current performance information is backward-looking and does not provide members with a proper indication of expected future returns. Disclosing forward-looking information would help manage member expectations by highlighting the potential volatility of a particular strategy.

A submission from David Bell of St Davids Rd Advisory also argued for a risk-targeting approach to replace products defined by generic asset allocation rules. He argued that enforcing a risk-targeting approach would make funds more accountable for the risk they take and the return they deliver for that risk. Specifically, the submission recommended:

> *"Shift to a risk targeting framework. This would replace the concept of asset mix defined products. The onus for risk and return would be placed firmly in the hands of the investment managers of the super fund (where it belongs). This would force the industry to implement substantial improvements to risk management practices (and I believe substantial improvements are required). Investors would also have a better understanding of how much risk they are taking."*[30]

The Panel agrees with these views.

Risk and return are fundamentally correlated (which is the essence of the risk and return targeting idea). Without being able to assess their risk exposure, fund members cannot properly know whether the published investment return is reasonable in the circumstances. Rice Warner Actuaries submitted that trustees should state their investment risks in a standard form and the Panel also agrees with this view.[31]

The investment returns that markets provide over any period are unpredictable, but the volatilities of investment returns are much more manageable if the trustee has a greater flexibility in asset allocations. Accordingly, the Panel considers that diversified investment options should be classified according to risk and return categories. These could be expressed in many different ways; for example, a return of 'CPI + 4 per cent' over a particular period, with risk indicated by a return volatility or the probability of a negative return in any year or period of years.

For the purposes of the proposed product 'dashboard' (see section 6.2.2), the Panel believes that the level of investment return targeted by each investment strategy or option should be expressed as an annual percentage rate above inflation, over a rolling 10-year period. This could be displayed as a set of standard ranges of return above CPI as stipulated in the outcomes reporting standard. This would be developed by APRA in consultation with industry. The Panel considers that this projection of real return, accompanied by the requirement to deal with investment returns on a wholly net basis, would be most relevant to super fund members. Of course, some funds already communicate to their members the expected long-term real returns of their investment options.[32]

For the purposes of the proposed 'dashboard' disclosure, the Panel is attracted to the general concept of the 'possible 10-year payoffs' in the SLWG model (see appendix 1). The Panel envisages trustees would detail the potential performance of the investment for a set amount, and in a range of scenarios. This representation of the risk associated with the investment option could be expressed in a visual, 'box plot,' format. This would enable the member to see the potential range of outcomes for an investment option given the aim and cost of that option (cost is discussed further in section 6.2.1).

In designing their investment options, trustees should have a number of bases (for example, historical data, assumptions, expert opinions and other evidence) to support the objectives they propose to present to members.

Under the risk and return targeting approach, each trustee would be more accountable to members and also, ultimately to the regulator, for the reasonableness of its assessment of the return and risk assumptions of its various investment options. Non-trivial or prolonged deviation from the trustee's disclosed objectives would be cause for investigation and, if appropriate, proportionate action by the regulator. This would likely lead to more intensive supervision and public disclosure of the deviation and the reasons for it. In severe cases, it might lead to the forced withdrawal of the investment option due to the trustee's incapacity to manage it appropriately.

Risk targeting could only be achieved within diversified investment options as opposed to undiversified options. Undiversified option labels typically refer to the underlying assets in the option. Consequently, any 'risk and return targeting' in such an option would result in changing those assets, making the option no longer true to label. For example, if an investment option only contained unhedged overseas equities, an attempt to target risk and return within this option would likely result in the need to replace some of the unhedged overseas equities with other assets. With respect to an undiversified investment option, the Panel proposes that the trustee should clearly indicate that the option is not diversified by expressly disclosing the underlying asset(s) of that option.

6.2.1 Product 'dashboard' — fees and costs

The investment fees and costs component of the product 'dashboard' is an aspect distinct from the presentation of the objective and risk of the investment strategy or option.

The SLWG concluded that:

> *"fees above a threshold should trigger a warning about the long-term consequences of high fees, analogous to the surgeon general's warning on a package of cigarettes."*[33]

This proposition is very similar to the 'traffic light' question the Panel posed in its Phase Two Issues Paper.

Many submissions argued that high investment fees can be justified where the fund achieves higher performance. However, no data has been provided to the Panel that supported the assertion that higher fees either across the industry (or for an equivalent asset allocation and risk exposure) correlated in any meaningful way with higher long term investment returns. In fact, most research contradicts this view.[34] The impact of investment costs can be damaging to the members' net return and subsequently the members' retirement benefit. This is why the SLWG proposed including the above warning.

The Panel favours a peer-ranking approach where the 'dashboard' would show, via a simple dollar sign graphic, which fee quartile the option fell into when compared to all others with the same objective. APRA would collect and publish the fee quartile data. Four dollar signs would signify the most expensive quartile and one dollar sign the least expensive quartile.

Additionally, the Panel believes that a useful comparison tool for members is comparing the projected Total Annual Expense Ratio (**TAER**) to the investment objective and projected 10-year outcome. The TAER is a new expense ratio, recommended by the Panel, that captures **all** the

investment and administration expenses of a MySuper product or choice investment option to at least the first non-associated entity level, as calculated according to an outcomes reporting standard.

While the TAER would typically be historical, for the purposes of the 'dashboard', this ratio would be forward-looking (that is, trustees would forecast a TAER based on historical data and predicted results). The Panel believes that using TAER, instead of only those fees charged directly to members, could be equally useful for members to compare the ability of trustees to manage costs against projections. Consequently, the Panel believes that trustees should publish the historical TAER on the fund website and the forecast TAER on the investment option 'dashboard' (see section 6.2.2). The historical TAER is discussed further in section 8.3.2.

6.2.2 Sample product 'dashboard'

Despite developing an example standardised disclosure label, the SLWG recommended that the form and specifications should be developed by a "*committee of academics, regulators and industry experts*."[35] The Panel proposes a similar approach, but again starting from a fairly concrete conception of what the 'dashboard' is intended to achieve and what it should contain.

Building on what has been discussed in previous sections, the Panel believes that the following issues would need to be covered in a simple visual format:

(a) the investment return target in putting forward a particular investment strategy or option;

(b) the risk target or range of possible outcomes of the strategy or option; and

(c) the projected TAER in relation to that strategy or option and its projected liquidity.

The information identified by the Panel above could be displayed as set out below in the following figure diagram.

Figure 4.1: A sample product 'dashboard'

XYZ Blue MySuper	
Type of option	**MySuper**
Investment return target	**CPI + 4-5% over rolling 10-years**
Risk target — range of possible 10-year outcomes (per $100)	$250 $200 $150 $100 $50 $0 Returns above aim, but below 90th percentile Aim of option (CPI + 4-5%) Returns below aim, but above 10th percentile
Projected liquidity	**High**
Projected TAER	**1.21%**
Relative fees ranking	**$$ out of $$$$**

Note: The figures used in the above product 'dashboard' are purely illustrative and do not reflect the characteristics of an actual investment option.

The 'dashboard' would be supported by the following explanations:

(a) **Type of option** describes whether it is a MySuper product or choice investment option;

(b) **Investment return target** describes the real return the trustee will try to achieve for this investment option. This would be expressed on a real basis and net of fees, costs and taxes;

(c) **Risk target — range of possible 10-year outcomes** describes the range of possible outcomes if you invest $100 in this option over 10 years. This would be expressed on a net basis (that is, after fees, costs and taxes). The Panel believes that the range of possible 10-year outcomes in the 'dashboard' should be presented in today's dollars that is, discounted by CPI. Present-day values provide more meaningful information to members as opposed to future dollar values, which can give an unrealistic representation of increased purchasing power. The value of the final (inflation-adjusted) outcome for the investment:

i. has a 10 per cent chance of being below the red box;

ii. has an 80 per cent chance of being within the green, white or red boxes;

iii. is represented by the white box if the option performs according to its aim;

iv. has a 10 per cent chance of being above green box; or

v. can be even more extreme than the range of outcomes depicted.

(d) **Projected liquidity** would indicate whether or not the option was outside the normal 30-day portability rules by classifying the option according to the degree of liquidity, that is, high, medium or low. The Panel believes this is a key disclosure for members in understanding the implications of investing in the option. This measure would be developed through industry consultation and the development of an outcomes reporting standard;

(e) **Projected TAER** is the projected TAER for the investment option of the MySuper or choice fund. The projected TAER captures all the forecast expenses (that is, investment and administration costs) of the option. This projected figure would enable members to compare the forecast expense ratio with the historical TAER achieved by the investment option; and

(f) **Relative fees ranking** ranks the fees charged for investing in this option compared to all other options with the same aim. The number of dollar signs shows that the option is in the lowest, second, third or highest fee group for options that have the same aim. This would be expressed on a gross basis (that is, before tax). The Panel believes that the issues associated with ranking of fees should be determined in consultation with industry.

The 'dashboard' would also need more general explanatory notes about what it aimed to do, the relative significance of each piece of information and its overall limitations.

Recommendation 4.11

Trustees of large APRA funds should disclose each diversified investment option's investment return target and risk target, as shown in Figure 4.1 of chapter 4 in a product 'dashboard'. A similar approach should be required for undiversified options, with the underlying asset class or classes being disclosed in place of the 'investment return target'.

Recommendation 4.12

In consultation with industry, APRA should develop an outcomes reporting standard dealing with all of the requirements for the product 'dashboard'. Specifically, the consultation should progress the development of a product 'dashboard' containing the:

(a) net investment return target (after-tax), which should be expressed as a percentage above CPI, over a rolling 10-year period;

(b) range of possible outcomes for a MySuper product or choice investment option (that is, risk target) over a 10-year period in a visual, diagrammatic format;

(c) the projected liquidity of the MySuper product or investment option;

(d) projected Total Annual Expense Ratio (TAER) which would capture all the projected costs to at least the first non-associated entity level; and

(e) relative ranking of overall fees (as collected and published by APRA).

7 REPORTING TO APRA

The Panel recognises that information to a fairly detailed level is already disclosed to APRA under the FS (COD) Act through the APRA annual and quarterly returns.[36] These returns capture details on a variety of fund operations such as financial performance, financial position, derivative financial instruments, transactions with associated parties, and membership and superannuation entity profile. Quarterly returns are not audited, while some of the annual returns are audited.

These APRA returns contain more detail than the audited financial statements. Even so, many costs are not disclosed or are disclosed only in highly aggregated form. This problem can arise because some of the costs are incurred in 'downstream' entities, rather than in the fund itself. This typically occurs when the trustee owns a subsidiary administrator that provides all services for the trustee as well as the fund; where the trustee is itself owned by an administrator; or where all investment services for the fund are provided by a third party, whether or not that third party is related to the trustee. Another shortcoming is that some of the data is not publicly reported by APRA for confidentiality reasons.

7.1 Standardising the way in which costs are reported to APRA

The Panel proposes that specific superannuation 'cost categories' be developed and reported to APRA. Reporting costs in a limited number of defined 'cost categories' will enhance transparency and comparability between funds, assisting APRA in fulfilling its new mandate to monitor and regulate the efficiency of superannuation funds (discussed in chapter 10).

Superannuation costs would be separated into seven categories, based on the major functions of a typical super fund. These categories, set out below in table 4.2, would capture both explicit and identifiable implicit costs in relation to functions that the superannuation fund must report on. This data would typically be sourced from the management accounts of the fund and must include costs to at least the first non-associated entity level.

Table 4.2: Proposed cost categories

Proposed Cost Categories
Administration
Advice and distribution
Corporate overhead
Investment management
Legal and compliance
Member insurance
Taxation

Set out in appendix 2 in this chapter is a non-definitive list of example costs that would be reportable within the various cost categories.

Under the outcomes reporting standard, funds would not be able to aggregate or net fund costs off against investment returns. Each cost incurred by the fund would have to be properly allocated to

the defined 'cost category' on a look-through basis. This would ensure, for example, that fund costs such as advertising could not be shown as 'membership subscription' costs.

A particular advantage of this approach is that it would provide neutrality of reporting of costs and returns, irrespective of whether an asset were held directly by the trustee, through an investment manager, or in a collective investment vehicle. It would also enable trustees to benchmark their performance with other super funds, and analysts to more readily compare funds and sectors.

Recommendation 4.13

As part of the development of an outcomes reporting standard, APRA, in consultation with the industry, would ensure trustees report costs to APRA on a consistent basis. The standard would prescribe:

(a) cost categories and their composition;

(b) requirement for cost categories to be subject to an annual audit;

(c) 'cost categories' to be reported in the APRA annual return at the whole of fund and MySuper levels; and

(d) costs to be disclosed to at least the first non-associated entity level.

7.2 Benchmarking

To drive the advantages of MySuper, the Panel believes that products should be regularly benchmarked against each other according to a transparent methodology, applied on a consistent and objective basis. The Panel believes that benchmarking for MySuper products would specifically enable trustees to:

- measure their costs and fees incurred against peers;
- determine which funds have 'best practice' in specific functions; and
- identify areas for improvement by gaining a better understanding of the fund's strengths and weaknesses.

Ultimately, this would lead to improved decision-making by trustees, regulators, government and members.

The benefits of benchmarking in superannuation were alluded to in a submission from ASFA, which said that:

> *"It is important for trustees to be able to benchmark themselves against other funds in terms of the underlying cost (and therefore the efficiency) of their operations and services. This will allow them to target areas for improvement and over time continually refine their operations to reduce their costs. This information will be used by trustees for operational improvement purposes rather than being released to members (who are more interested in fees and net investment returns)."*[37]

The Panel considers that this benchmarking is best achieved by APRA putting the work out to tender for industry experts to conduct. This approach creates a separation between the regulator mandated to administer the regime and the expert tasked with measuring how efficiently the participants are operating. Naturally, confidentiality and the potential for conflicts with other roles carried out by the experts would have to be addressed.

APRA could then examine the results of this survey to assist in carrying out its new mandate to improve the efficiency of the superannuation system.

Benchmarking could also address MySuper trustees' duty regarding scale. The Panel has proposed that MySuper trustees would have to demonstrate, on an annual basis, that they have sufficient scale in order to deliver optimal benefits to members. By benchmarking the MySuper product trustees could have an objective measure to assist in determining whether it had sufficient scale.

Recommendation 4.14

Trustees offering MySuper products should be required to participate in APRA-approved benchmarking surveys that would measure their relative efficiency against peers in a number of key areas (for example, administration costs per member, service standards) in accordance with an outcomes reporting standard to be developed by APRA in consultation with ASIC and the industry. APRA should be required to publish the results of such benchmarking surveys.

7.3 Asset allocation

Asset allocation is a significant determinant of returns, volatility and exposure to risk. However, where trustees have invested through collective vehicles such as life policies or pooled superannuation trusts, there is difficulty in determining the actual underlying asset allocations. APRA has proposed collecting asset allocation data on a 'look-through' basis whereby a trustee would report the assets underlying its collective investments to at least the 'first non-associated entity level'.[38] This would help analysts in calculating rates of return that have been adjusted for the risk of the underlying asset allocation. Asset allocation data are required in any event so that the trustee can be satisfied that the fund remains within its investment strategy risk-band. Information at the whole of fund level would still be needed in order to satisfy ABS requirements.

Recommendation 4.15

APRA should have explicit powers to collect superannuation fund data on a 'look-through' basis so that it can achieve an understanding of the fund's asset allocation, risk, returns and costs.

7.4 Disclosure of portfolio holdings

Trustees are currently required by the Corporations Act to provide fund members, in the annual report to members, with details of each investment, or each combination of investments in a group of associated enterprises, that has a value in excess of 5 per cent of total assets.[39]

A trustee is also already required to make available, on request and free of charge to a member, information reasonably required for the purposes of making an informed judgment about investment

performance and to understand the particular investments of the fund.[40] Trustees are not required to make any other public disclosure about the underlying portfolio investments of the fund.

A Morningstar study of global fund investor experiences found that Australia and New Zealand were the only countries among the 16 assessed which do not require regular, full portfolio holdings disclosure.[41] Australia clearly lags global best practice in this area and the current regime is unduly opaque.

In the United States, investment companies provide quarterly disclosure of their portfolio holdings within 60 days after the close of each quarter.[42] As Morningstar submitted to the Review,[43] this practice has a number of advantages:

(a) It would create an information platform that would promotes better analysis of super funds;

(b) Implementation would create an alignment with global practice;

(c) It would allow interested members to minimise overlap with their non-super investments;

(d) It would provide much greater transparency without significant cost or externalities;

(e) The level of illiquid assets in a portfolio would be more observable;

(f) It would not facilitate front-running (a common argument against this sort of transparency) because (as in the US) there would be up to a 60-day time lag before the information needs to be provided to APRA;

(g) It would discourage undesirable manager behaviour like excess turnover; and

(h) It would enable better monitoring of 'true-to-label' issues.

The practice would have to be principles-based so that it was not hindered by complex ownership structures, life office holdings, intermediate entities and so that it gave a true picture of the overall composition and risk of the portfolio (including overlays, hedging, derivatives and so on). The obligation on the trustee would be to disclose details of the underlying portfolio that would be reasonably required by a professional adviser in understanding the nature and extent of the investments and the exposures involved.

Recommendation 4.16

Trustees of large APRA funds should be required to disclose their complete portfolio holdings on a six-monthly basis in accordance with an outcomes reporting standard to be developed by APRA in consultation with ASIC and the industry. This would require disclosure to APRA within 60 days after the end of each six month period, corresponding with normal financial years and half-years, and then public disclosure of the same information, on the fund's website, three months later.

8 SYSTEMIC TRANSPARENCY

8.1 A new direction in transparency

Many submissions asserted that information about super funds did not need to be disclosed because it would be of no benefit to members: either because it would be confusing for them; or because members generally do not ask for, or read, such information. The Panel strongly disagrees with these views.

The Panel does not expect ordinary Australians to be investment experts or to read complex information about their super. However, in financial markets, there is a great deal of benefit in what could be termed 'systemic transparency': that is, disclosure and information available to the system at large, including to regulators, academics, analysts, advisers and informed investors.

'Systemic transparency' is what is largely missing in the Australian super system. There is too little high quality information available to experts who would be able to use such information for the ultimate benefit of members as a whole. Systemic transparency of information about large APRA funds would sit alongside specific member-focused and event-driven disclosure obligations.

It is not to the point that a trustee might think that the average member is not interested in reading the material. While this is likely to be the case, the Panel considers there are other benefits flowing from the low-cost transparency afforded by the availability of information on a fund's website.

Trustees are already generally required to make available — free of charge and on request by fund members — many documents, including the fund's governing rules and the most recent fund audited financial report; and fund actuarial report (if applicable).[44] However, the Panel considers it is unduly restrictive for members to have to request this information and sub-optimal for the industry as a whole that the information is only available to members. There appears to be no reason why documents and information must first be requested before they can be accessed (given that trustees have to then provide that information), and why this material should not be routinely published by trustees on the fund's website as an aid to systemic transparency. These restrictive and un-transparent settings have reached their 'use-by date'.

The Panel believes that information about a fund made available on the fund's website should be freely available to members and non-members alike. 'Members only' sections of a fund website should be kept to an absolute minimum where privacy and confidentiality considerations, including in relation to members' personal information, would legally require the trustee to restrict access.

The Panel considers that there needs to be a low-cost, but dramatic change in this area. This is where large APRA funds must see themselves as different from other businesses. Given that superannuation is a heavily tax-subsidised 'public good', trustees of superannuation funds must get used to being more transparent about their funds.[45] The Panel therefore believes that there should be new standards for web-based systemic transparency for all large APRA funds.

8.2 Publication on fund websites

The Panel considers that the appropriate vehicle for systemic transparency by a large APRA fund is the fund's own website. The Panel believes that the trustees of large APRA funds should be required

to maintain a website to publish systemic information about the fund of at least the kinds discussed below. The Panel's view was supported by the ICAA which submitted that:

> *"The vast majority of fund information including those that satisfy disclosure obligations can and should be made available on fund websites. Documents should only be made available in printed format at the request of members. This would hold significant savings in time and costs for superannuation funds as well as meet increasing environmental expectations of the larger community. When superannuation funds send member statements, they can refer members to the website and advise them that printed copies of documentation are available on request. We don't believe the provision of information in this manner requires the approval of members and seeking approval will simply add another layer of cost. Internet access and the use of the internet are accepted as common usage and should not be viewed as being any different from regular post for the dissemination of information. This could be further enhanced by the use of email to deliver member statements. The ability to contact members via email may also assist in tracking members and reducing lost member accounts.*
>
> *The provision of information in this manner is another way in which administrative cost savings can be achieved for superannuation funds which presumably will be passed on to members."*[46]

Many funds already have in place well-developed websites that make available a range of fund information. The Panel considers that the marginal cost of each additional website disclosures is negligible.

The Panel believes that trustees of MySuper and choice products should retain and make available to members systemic information about the fund over at least the preceding 10-year period, or since inception if the fund is less than 10-years old. This should be easily accessible by members and non-members alike on the fund's website.

The Panel also believes that failure to comply with systemic transparency requirements, outlined below, should be backed up by strong sanctions.

8.2.1 Fund documents

Basic fund structural information should be made transparent on the website, including at least the following fund documents:

- the governing rules of the fund, such as the trust deed and all supplemental and amending deeds and consolidations or extracts/subsets of a fund's governing rules relevant to particular classes of members;
- the most recent audited accounts for the fund as an entity, and for any MySuper product, together with the auditor's report in relation to those accounts;
- the most recent actuarial report on the fund (if applicable) and any subsequent, written advice by an actuary to a trustee to the extent that those documents are relevant to the overall financial position of the fund; and
- the fund's most recent six-monthly statement of portfolio holdings disclosed to APRA to be published three months after disclosure to APRA.

8.2.2 Disclosure documents

All disclosure documents would have to be available on the website including, but not limited to:

- the most recent PDS issued by the trustee with respect to the fund, and an archive of PDSs over the previous 10 years, including supplementary PDSs;
- the most recent annual fund report to members;
- the most recent trustees financial services guide (if applicable); and
- each significant event or material change notification as made by the trustee to fund members or any group of fund members.

8.2.3 Other participants in the fund's operation

The website would have to contain details of the parties who perform the functions listed below in table 4.3 in relation to the fund.

Table 4.3: Proposed fund disclosure functions

Proposed fund disclosure functions
Fund administration
External audit
Internal audit (if applicable)
Fund actuarial services (if applicable)
Investment management
Investment related consulting
Asset custody
Insurance
Legal and tax advice (if engaged on a retainer)

8.2.4 Trustee information

In relation to the trustee, the website would have to contain at least the following:

- the name of the corporate trustee and each person involved in the trusteeship of the fund including, as relevant, each director of a single corporate trustee or individual trustee in a group of individual trustees and any alternates;
- relevant experience and background of each director or individual trustee and any alternates;
- a description of the role of each person above, including, as relevant, the status of each person above as an employer or employee representative director or additional independent director and service on any trustee subcommittee; and
- the fund's procedures for the appointment and removal of the trustee and each director of a corporate trustee, or individual as a member of a group of trustees.

8.2.5 Board and executive remuneration

In relation to the trustee and executive, the fund website would have to contain at least:

- the trustee's remuneration policy in relation to both the trustee-directors and executives of the trustee; and
- remuneration details similar to that required for major listed entities.

In coming to this view, the Panel recognises that the requirements for board and executive remuneration would need to deal with structural issues in the superannuation sector, including that responsible executives may or may not be employees of the trustee and that remuneration may be paid from fund assets or from other sources. However, the Panel considers that the key management personnel requirements for disclosing entities in AASB 124 *Related Party Disclosures* (**AASB 124**) provide a basis for the development of these disclosures.

8.2.6 Related party information

In relation to the trustee, the website would have to contain at least:

- details of parties related to the trustee similar to that required for major listed entities; and
- the trustee's policy in relation to transacting with or investing in related parties.

Large APRA funds are already significant institutions in the Australian financial landscape. The Panel fully expects that the size and significance of large APRA funds — for the economy and community as a whole — will only increase in the future. The Panel observes that if superannuation fund trustees, as investors, expect this kind of information in relation to the listed entities in which they invest, fund members should also expect information of at least the same quality (and arguably higher) from the trustee itself, given that large APRA funds are not normal commercial enterprises.

The requirements for disclosing entities in AASB 124, and also the former key features statement regime,[47] provide a basis for the development of these related party disclosures.

8.2.7 Other information on fund websites

The Panel has also made a number of recommendations in other chapters that require trustees to disclose specific fund information on fund websites. These recommendations cover:

- governance information, including conflicts policy (chapter 2);
- voting information, specifically voting policies and procedures (chapter 3); and
- insurance information, covering terms and conditions and premium tables (chapter 5).

Recommendation 4.17

Trustees of large APRA funds should maintain a website that provides, free of charge, systemic transparency about the fund and the fund's management.

Recommendation 4.18

Trustees should retain the last 10 years' worth of such information and make it available on the fund's website.

8.3 Ratios

8.3.1 Management expense ratio (MER) and indirect cost ratio (ICR)

Traditionally, the funds management industry has used the 'management expense ratio' (**MER**) as a relative measure of the cost of managing funds. In 2005, the Corporations Regulations introduced the 'indirect cost ratio' (**ICR**) as part of a regime for fee and costs disclosure by super funds and managed investment schemes. The difficulty with both ratios is that they are not standardised or consistent in application.

MER is expressed as the management expenses such as investment management and administration divided by the funds under management. However, with MER, managers have the ability to treat certain fees as not being a 'management expense' and hence exclude them from measurement (simple examples include entry and exit fees). This is obviously unsatisfactory. MER is not a useful measure from a member perspective. It was traditionally used by trustees to assess the 'wholesale' cost of one investment manager as against another, assuming a lot of inherent knowledge about other relevant costs. Also, taxes and portfolio transaction expenses fall outside both the MER and ICR calculations.

Many submissions suggested that there was considerable ambiguity in application of these rules, and that the comparative value of the disclosure was reduced as a result.[48] ASFA also said that:

> *"Under the current rules investments could be arranged in such a way that the Indirect Cost Ratio (ICR) for many superannuation funds could be legitimately disclosed as zero. There is little scrutiny and, as such, grey areas in relation to the calculation of ICRs and MERs — need to encourage greater transparency in this regard. Clear standards in relation to the calculation of ICRs and MERs would help."*[49]

8.3.2 Total annual expense ratio

To resolve this, the Panel proposes that trustees publish on the fund website a new ratio for each MySuper product or choice investment option. The TAER would be an expense measure, assessing the ability of trustees in managing expenses within MySuper products or investment options of the fund derived from an outcomes reporting standard. The TAER would capture the total operating costs of the MySuper product or choice investment option to at least the first non-associated entity level. The total operating expense would form the numerator for a new expense comparability measure. The denominator would be the average net assets of the MySuper product or the investment option. Therefore, the TAER would be as follows:

$$= \frac{\textbf{Total operating expense}}{\textbf{Average net assets}}$$

The TAER would replace the MER and ICR. The methodology for calculating and disclosing the total operating expense would be developed as part of the outcomes reporting standard mechanism referred to earlier in sections 2 and 4.2 There would be no subjective assessment or other discretions as to whether or not a cost was a management expense. The outcomes reporting standard would overlay AAS 25 and would dictate that all operating expenses (of whatever nature) are to be included in the calculation. This would include portfolio transaction costs and other costs previously excluded from MER calculations.

The TAER would give members and other stakeholders a fairly reliable tool for making comparisons between MySuper products and investment options in the area of expense management, including via the 'dashboard' referred to in section 6.2.2.

Recommendation 4.19

Trustees should be required to publish on the fund website the historical Total Annual Expense Ratio (TAER), which would capture the historical costs to at least the first non-associated entity level, for each MySuper product or choice investment option within the fund.

The Panel has proposed in section 6.2.2 that trustees would need to disclose the projected TAER for all MySuper products and choice investment options in a product 'dashboard'. This recommendation would specifically require trustees to project the TAER, while the Panel's recommendation in this section requires trustees to disclose the historical TAER of the MySuper product or choice investment option. The Panel believes that this would benefit members and industry participants who could monitor trustee performance in the delivery of actual TAER against the projected TAER published on the 'dashboard'. This would also make trustees more accountable for the projections they make.

9 GOVERNMENT SUPER WEBSITE

9.1 A central source of information

The Panel believes that the basic features of super (for example, how it works; how it is taxed and a whole range of generic information) should be made available through a single widely publicised government website dealing exclusively with superannuation (www.super.gov.au). Almost all submissions to the Review that addressed this topic supported this idea. For example, Cbus submitted that it:

> *"Supports the development of a dedicated government website to educate members and contain generic material such as when members can access super, definitions of things such as preservation age and links to other helpful sites (eg FIDO on the ASIC website for comparison calculators). It underlines that the material is independent and does not promote products. As legislation changes quite frequently this would reduce fund costs in updating disclosure material and withdrawing communication material from circulation. More electronic communication will also assist in relation to the reduction of fund costs and therefore keep member fees as low as possible. However, those members with no access to this form of communication must still be catered for."*[50]

The website would be a one-stop-shop of all the information, products and tools currently provided by a wide range of government websites. This should provide Australians with the resources (such as general advice, statistics and educational material) to enable them to understand and navigate Australia's superannuation system, regardless of their own personal circumstances.

The creation of a government superannuation website could also provide a mechanism to allow comparison of MySuper products. While the Panel is recommending that this information be disclosed on fund websites (recommendation 4.3), the Panel sees no reason why the disclosure of the performance table (recommendation 4.10) for MySuper products could not be incorporated onto the government website. This was supported by IFSA who indicated that:

> *"Superannuation funds are currently assessed by a range of research and ratings providers (for example Super Ratings and Chant West Financial Services). Each has slightly different methods for assessing fund quality and features. We support the concept of industry-wide, standardised and comprehensive league tables to facilitate comparability."*[51]

Display of performance tables for choice investment options on the government website would be more difficult because it is not proposed that APRA collect the necessary data.

The information and resources provided on the government website should be complete; so that a full understanding of all the potential models (MySuper, SMSFs etc) is available. The extent to which this website may cut across what is provided by individual funds is something that would need to be considered in its design.

The Panel believes its objectives and that of the AFTS Review (recommendation 23 and in particular 23 (d)) are similar:

> *"(d) A superannuation portal where people can interact with government agencies and get information on retirement incomes should be developed. Over time this portal should evolve, subject to suitable safeguards, so that people can manage all their superannuation through one channel".*[52]

9.2 Better and cheaper disclosure

Submissions also generally agreed that a central government website would assist in making disclosure cheaper and easier for trustees by allowing them to link to such a site. This would significantly reduce the size of PDSs and would encourage each PDS to be more specific to the features of the fund itself. In other words, all funds disclosure documents could be linked to the government site and incorporate its contents by reference. That way, not only do members and potential members get access to all the generic information about super they need, but other disclosures do not need to repeat this material, but only refer to it.

This would save money, lead to simpler disclosure and ensure that the core information about super is presented uniformly and to a high standard. There is no point in requiring the private sector to interpret and regurgitate this information countless times across the system. This would also reduce fund compliance costs, as the material is being supplied by government.

Recommendation 4.20

Government should task ASIC, in consultation with industry, other regulators and consumer groups, to establish a central website about superannuation to draw together features, including standard disclosure of legislative, tax and other super-related features, and to be a portal to other superannuation-related information. All large APRA funds would be required to link their websites to this site.

APPENDIX 1

Squam Lake Working Group model[53]

Standardized Disclosure Label

Fund Name	Classic Market Index			
Fund Type	U.S Equity			
Fees and Expenses	**Annual**	**Buy**	**Sell**	**10-Year**
	0.30%	0.00%	0.00%	4.67%
Possible 10-year Payoffs (per $100)	**5%**	**50%**	**Average**	**95%**
	$49.54	$132.27	$158.07	$353.16
Turnover	4.00%			
Annual Volatility	20.00%			

Fees and Expenses and Possible Payoffs assume that, after making an initial investment, you reinvest all distributions and then sell the fund in 10 years.

Fees and Expenses

Annual	The percentage of your fund holdings that you pay for fees and expenses each year
Buy	The percentage of your investment that the manager takes when you buy this fund.
Sell	The percentage of your fund holdings that the manager takes when you sell this fund.
10-Year	The percentage of your investment that you will pay for fees and expenses (including buy and sell charges), on average, if you invest for ten years.

Possible 10-Year Payoffs

If you invest $100 for ten years, the final (inflation adjusted) value of your savings will be below the **5 per cent** payoff roughly 5 per cent of the time, below the **50 per cent** payoff roughly half the time and below the **95 per cent** payoff roughly 95 per cent of the time. Payoffs that are even more extreme than the 5 per cent and 95 per cent payoffs are possible. **Average** is the average of all possible payoffs.

Turnover	The percentage of the investment portfolio bought and sold each year.
Annual Volatility	A measure of risk. In a typical year, the return will fluctuate up or down by this much.

APPENDIX 2

Example costs within cost categories

Investment Management	Administration	*Legal and compliance*
▪ Investment manager fees ▪ Fees of underlying managers in fund-of-funds products ▪ Performance fees ▪ Investment costs represented by the difference between gross earnings by a manager and actual returns remitted to the fund ▪ Brokerage fees ▪ Custodian fees ▪ Asset consultant fee ▪ Implemented consultant fee ▪ Investment research costs ▪ Risk management	▪ (reporting, contribution management) ▪ External administrator fee ▪ Administrator performance fee ▪ Annual report/statement production ▪ Member engagement costs ▪ Call centre ▪ Website ▪ Postage and printing	▪ Legal fees ▪ Regulatory levies ▪ Accounting and audit ▪ Tax return/advice ▪ PDS preparation ▪ Unit pricing costs ▪ Actuarial costs
Taxation	***Member Insurance***	**Advice and distribution**
▪ Income tax ▪ CGT ▪ GST (including RITC) ▪ Withholding tax ▪ Stamp duty ▪ FBT	▪ Cost of premiums and managing/monitoring member claims	▪ Various payment models employed
Corporate overheads		
▪ Trustee/director fees ▪ Travel/accommodation ▪ Staff salaries ▪ Member benefit protection ▪ Rent and outgoings ▪ Advertising ▪ Sponsorship ▪ Events ▪ Catering ▪ Trustee indemnity insurance ▪ Equipment ▪ IT and telecommunications to support trustee operations, but excluding fund administration ▪ Subscriptions and conferences		

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SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 5
Insurance in superannuation

www.SuperSystemReview.gov.au

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KEY THEMES

Issue

Insurance cover comes at the cost of foregone retirement savings and earnings. It is a trade-off that has a significant impact on the financial well-being of members. Most members do not specifically consider their insurance needs. The information trustees disclose to members about insurance is not always useful, making it difficult for members to compare insurance options and costs across funds.

Proposed solution

The Panel proposes measures, including:

- each trustee to develop an insurance management strategy specifying the types of insurance to be offered and the default minimum and permissible maximum levels of cover to be offered;
- trustees to be responsible for selecting and administering insurance cover for the benefit of members;
- death and TPD insurance to be offered on an opt-out basis in MySuper products;
- jurisdiction of the SCT to be expanded in respect of the period in which TPD claims can be brought;
- TPD definition in trust deeds to be aligned through statute to the definition in relevant insurance policy;
- commissions cannot be paid on insurance in superannuation; and
- only death, TPD and income protection insurance can be offered through superannuation funds.

Benefits for members

Members will benefit from these measures to improve insurance in superannuation as:

- trustees will be required to develop an appropriate insurance strategy for members and to be aware of all costs and features of the fund's insurance offering;
- better targeting of fund's default insurance level to the requirements of fund members; and
- members would be better able to compare insurance as more information would be available to members on the fund's website.

1 INSURANCE

Insurance cover plays a key part in the superannuation system. Superannuation funds are generally structured towards financing a period of retirement after a long engagement in the workforce. Fortunately, that is the experience of most members. However, for a significant number of members each year, total and permanent disability (**TPD**) or premature death mean that they or their dependants need to call on their superannuation savings much earlier and for a longer period than they would have expected. Insurance plays a crucial role in allowing those needs to be met. An IFSA survey of its life insurance members (covering 90 per cent of the market) found over $2.3B in claims were paid in the 2008 calendar year on nearly 35,000 policies.[1] Most Australians do not have life or TPD insurance cover outside superannuation.[2]

Table 5.1: AIST & IFF — survey of superannuation member insurance cover (June 2008)

	Death Cover	TPD Cover	Income Protection Cover
Have through super fund only	76%	59%	22%
Have other than through super fund only	1%	4%	10%
Have both	20%	8%	2%
Have neither	3%	29%	69%
Total through super fund	**96%**	**67%**	**24%**
Total elsewhere	**21%**	**12%**	**12%**

Source: IFF & AIST Member Insurance Research

The risks of death and permanent disability are not remote. In 2008, there were 12,430 deaths of married men or women of working age (20 to 64 years). This equates to more than 34 families per day losing a member and over half of these (52 per cent) involve children losing a parent. In addition, only four per cent of Australian families with dependent children have adequate levels of insurance cover according to research commissioned by IFSA in 2005.[3]

The 2008 HILDA Survey[4] found that over 235,000 working age people, living as a member of a couple with dependent children, suffered a serious injury or illness in the previous 12 months. The same survey found that over 17,000 employed people who were living as member of a couple with children had been unable to continue working due to illness, disability or injury over the previous year.[5]

Trustees have an important role in setting the insurance offerings for their members. The opportunity cost to members of premiums paid for insurance is the compounding retirement benefit they would have received had those premiums not been subtracted from their superannuation savings.

Currently, trustees must seek to strike the right balance in offering insurance to protect against the risks of being unable to contribute to an adequate standard of living and the impact of premiums paid on ultimate retirement benefits.

Life and TPD insurance are also complex products, and each fund has a different demographic of members with varying risks. Accordingly, a standard, externally-imposed approach to insurance, (such as is applied for compulsory third party motor vehicle accident insurance) would be sub-optimal in the superannuation context.

The Panel believes that trustees have, for the most part, been conscious of these considerations when setting default insurance for members. For example, some funds have adopted new approaches that provide younger members with reduced levels of cover which increases as the member progresses through life stages (gets married, buys a house, starts a family, etc) and reduces again as the member ages and the expected insurance needs decline. The Panel considers that all trustees should consider an age-based tapering policy as part of their insurance strategy.

2 UNIQUE EXPENSE

There are three important issues relating to the expenditure by trustees on insurance each of which calls on trustees to take care that they have the interests of members first and foremost in their decision-making:

- expenditure on insurance does not affect reported investment returns because it is regarded as 'below the line' expenditure;
- expenditure on insurance is tax-deductible to the fund but, unlike other expenditure, it does not detract from reported investment returns; and
- members do not always get an appropriate allocation of the tax deduction for their share of the premium paid by the fund.

3 DEFAULT LEVELS

Currently, in order to qualify as an eligible choice fund that can accept superannuation guarantee contributions, a fund must offer a minimum level of life insurance cover either at a premium of at least $0.50 per week (for a person who has not attained the age of 56 years) or that has a minimum benefit as set out in the table below.[6] These minimum levels do not take into account a member's family relationships and financial circumstances. Some trustees allow members to opt-out of default insurance cover and others do not.

Table 5.2: Minimum life insurance cover that must be offered by eligible choice fund

Age range	Level of insurance in respect of death
from 20 to 34	$50 000
from 35 to 39	$35 000
from 40 to 44	$20 000
from 45 to 49	$14 000
from 50 to 55	$7 000

These minimum levels have eroded in real terms since they were introduced in 2005. In practice, they have not acted as a proper threshold for default insurance as trustees have generally set default insurance cover levels in excess of these minimum levels, making the requirement largely redundant.

3.1 Trustees to set default levels in MySuper

While submissions generally agreed that there should be a minimum level of insurance cover within default funds, they also believed that trustees were best placed to determine this level. For example, ASFA's submission suggests that:

> *"The level of default cover should instead be determined by trustees based on adequacy levels and their knowledge of the needs of their members."*[7]

The Panel agrees with this view.

Insurance cover is taken out by a trustee through group policies that have 'automatic acceptance' provisions. This means that members are automatically eligible for the cover, assuming that they meet some basic requirements (generally to do with being at work at the relevant date). This approach provides wide cover with minimal exclusions.

The Panel considers that life and TPD insurance strongly supports the principles of the superannuation system. The Panel believes that in the MySuper sector, where members are least likely to give consideration to their insurance needs, the trustee should be required to offer life and TPD insurance on an opt-out basis.

Requiring MySuper products to offer life and TPD insurance on an opt-out basis provides a safety net to members who might otherwise not consider their insurance needs; a view supported by many submissions. This will lower the cost of insurance for most members in MySuper, because there is pooling of risk between members who face different risks and financial circumstances.

However, those MySuper members who do give consideration to their insurance situation would be able to opt-out or to purchase additional units of cover (if offered by the trustee).

Recommendation 5.1

Life insurance cover and TPD cover (where available, depending on occupational and demographic factors) must be offered on an opt-out basis in MySuper products.

The Panel believes, however, that where members decide to accept the financial risks of death or disability, perhaps because they have no dependants, or would prefer to take out insurance outside their superannuation, then this should be allowed. The retirement benefits of members should not be reduced by unwanted, but compulsory, insurance.

Recommendation 5.2

The requirement for a minimum level of life insurance that must be offered by eligible choice funds as set out in Regulation 9A and Schedule 1 to the Superannuation Guarantee (Administration) Regulations 1993 should be repealed.

3.2 Insurance strategy

The role of a trustee in selecting an insurer is analogous to the trustee's role in investing member funds. Poor management of insurance on behalf of members can substantially reduce retirement

savings. For this reason, the Panel believes that all trustees should have a new statutory duty to manage insurance and it has made this recommendation in chapter 2 (recommendation 2.1). This section fleshes out in more detail what that duty would entail.

This new duty would extend to two aspects of insurance:

(a) in the trustee's selection of an appropriate insurer and in negotiating policy terms and premium rates having regard to the financial interests of members; and

(b) in the way in which trustees will be obliged to pursue member claims with insurers when an insurer declines cover.

With respect to the second aspect, trustees would have to ensure that benefits are paid to their members in accordance with the terms and conditions of the group policy. An individual claim should be pursued by the trustee if it is reasonable to do so, having regard to the expectation of success.

Recommendation 5.3

Trustees of MySuper products, and trustees of large APRA funds that offer insurance, should have a statutory duty to manage insurance with the sole aim of benefiting members, including:

(a) selecting insurance cover with regard to the cost and value for money for members;

(b) negotiating the terms of the insurance contract, including adequacy of the level of default cover; and

(c) pursuing claims that the insurer has denied in part or in total where there is a reasonable expectation of success.

As insurance is a significant cost for members, the Panel considers that trustees should be required to devise and implement an insurance strategy, similar to the requirement for an investment strategy. This requirement should apply to all trustees of MySuper products and large APRA funds that offer insurance.

To help trustees in formulating an insurance strategy, detailed guidance should be developed by APRA.

Recommendation 5.4

The SIS Act should be amended to require trustees of MySuper products, and large APRA funds that offer insurance, to devise and implement an insurance strategy specifying the types of insurance to be offered and the default and permissible maximum levels of cover to be offered.

Recommendation 5.5

APRA should issue guidance material to trustees to help them in developing an insurance strategy.

3.3 Choice sector

In the choice sector, the Panel believes that trustees should not be required to offer any default insurance. However, if they do offer insurance, choice sector trustees must take into consideration the needs of their members in setting an insurance strategy as outlined in section 3.2. This might lead the trustee to a decision that it is not appropriate to offer insurance in relation to certain products or demographics, even though it is appropriate to offer it in relation to others.

A relevant consideration in the choice sector might be that the cost of administration of insurance (for example claims handling) may be borne across all members. Therefore, if the trustee concludes that insurance will be taken up by only a small number of members, it would be incumbent on the trustee to justify in its insurance strategy any cross-subsidisation in favour of that small number of members.

Similarly, the Panel does not believe there should be an insurance default for SMSFs; insurance in the SMSF context is discussed further in chapter 8.

Recommendation 5.6

In the choice sector, trustees should be allowed to offer life and TPD insurance on an opt-out or opt-in basis, or not at all.

4 TOTAL AND PERMANENT DISABILITY INSURANCE

TPD insurance cover is intended to provide a benefit when a person is permanently unable to work again. Usually, the policy provides a lump sum benefit to the member, but in some cases, it provides an ongoing annuity. While some funds self-insure TPD benefits, for purposes of this section, we are assuming that there is an external insurer.

In processing TPD claims, the insurer and the trustee must undertake a stringent assessment of the member's situation and condition. In certain cases, ongoing monitoring of a claimant's condition is required to ensure that they are permanently disabled. Establishing that a person satisfies the definition of total and permanent disability contained in the trust deed or insurance policy can be difficult and costly.

As the definition of TPD usually requires that the member will never be able to return to work, the member may choose to delay making a claim, to assess their condition and to determine whether there remains any possibility of returning to work. Arguably, it is in the member's and the community's interest for the period in which a member can make a TPD claim to be extended as far as practicable in order to maximise the chances of rehabilitation.

Offsets in many TPD policies reduce the benefit paid to a claimant depending on other payments that they are eligible for — such as workers' or accident compensation, sick leave or Centrelink benefits. This can result in substantial delays in benefits being paid to members and makes TPD insurance less attractive as default cover.

Also, because members might be eligible for other compensation benefits, they might not lodge a TPD claim until those other compensation benefits are exhausted. This could be a significant period of time after the member ceases work.

Trust deeds usually do not contain time limits for bringing a TPD claim, but some insurance policies do and members are not always made aware of that fact by the trustee.

However, section 14 of the Superannuation (Resolution of Complaints) Act 1993 (**Complaints Act**) does impose time limits for making a complaint to the Superannuation Complaints Tribunal (**SCT**) about a trustee decision on a TPD claim. A complaint must be made to the SCT:

- within a period of two years after the trustee makes the decision to which the complaint relates; and
- the claim must have been lodged with the trustee within two years after the person permanently ceases employment.

A member who cannot make a complaint to the SCT can challenge the decision in court. However, this often has high costs for both parties and a court is more limited in the aspects of a trustee's decision it can review. By contrast, the SCT has scope — under section 14 of the Complaints Act — to assess whether a trustee's decision is not unfair or unreasonable.[8]

The Panel recognises that a time limit helps in excluding complaints that relate to a claim that is not genuine, or where the linkage between events which led the member to cease work and the onset of total and permanent disablement can become blurred. However, the Panel believes that the current time limits for lodgement of a claim within two years of ceasing employment can unfairly exclude claimants who had reasonably delayed a claim, and therefore, recommends that it should be extended to six years.

Recommendation 5.7

The *Superannuation (Resolution of Complaints) Act 1993* should be amended to allow the SCT to consider complaints in respect of TPD claims when the claim has been lodged with the trustee within six years of the member ceasing employment and the complaint has been made to the SCT within two years of the trustee's decision.

Further, a TPD definition in a trust deed can be a barrier to successor fund transfers, as trustees are hesitant to transfer members into another fund that has insurance terms that do not match the trust deed. The Panel, therefore, considers there will be benefits for both trustees and members by deeming the definition of TPD used in a trust deed to correspond with the definition contained in any insurance contract that the trustee from time to time negotiates with an external insurer.

Recommendation 5.8

The SIS Act should be amended so that the trust deed of a large APRA fund is deemed to define total and permanent disablement in the same way as the insurance policy held by the trustee at the relevant time.

5 INCOME PROTECTION INSURANCE

Many trustees have decided to offer income protection insurance as evidence shows that most members' disability is more likely to be temporary, rather than permanent. Income protection insurance usually provides monthly benefits for up to two years or, if earlier, the date that the member recovers or becomes TPD (in which case an application for TPD is then lodged). It is particularly relevant for members who are engaged in low paid and casual employment, or who are self-employed, as these groups are unlikely to have access to paid personal sick leave.

The Panel believes that, while income protection insurance provides for current day benefits, it still supports the principles of the superannuation system. As explained in the ISN submission:

> *"Income protection provides a capacity to rehabilitate and retain members who are disabled for their own occupation with a view to returning members to the workforce that will permit them to continue fund their own retirement benefits. Furthermore, income protection can insure the member's superannuation contributions during their period of disability thereby maintain the funding the accumulation of their retirement benefits."*[9]

Trustees have increasingly turned to income protection insurance as it can help meet the immediate financial needs of members across the long period it takes to assess if the member is permanently disabled and eligible for TPD benefits.

However, the Panel acknowledges that there remain different approaches to income protection insurance. ASFA said in its submission that income protection insurance should not be required to form part of a fund's default arrangements as the cost of income protection insurance premiums (that is compared to death and TPD cover) would significantly erode members' superannuation balances, particularly smaller balances.[10]

AIST's submission noted that certain funds might have administrative difficulties in providing income protection insurance because of the need to gather, record and update salary information. There is the added complexity that employers are not currently required to pass salary information on to a super fund.[11]

The Panel notes that these administrative and cost hurdles may prevent certain funds from offering income protection insurance as a default. Therefore, trustees of either MySuper or choice funds should have the option of offering income protection insurance on an opt-out or opt-in basis, or not at all.

Recommendation 5.9

Income protection may be offered on an opt-out or opt-in basis, or not at all by trustees of MySuper or choice funds.

Other types of insurance are not structured to support the goal of superannuation to provide benefits to members in retirement, or when they are no longer able to work. Therefore, the Panel considers that it is not appropriate for them to be offered through superannuation. Trustees currently offering these other types of insurance should have a suitable transition period to phase-out existing policies.

Recommendation 5.10

Apart from life, TPD and income protection insurance, no other type of insurance (for example trauma insurance) should be permitted to be paid for by members through their superannuation and any existing policies outside those categories should be phased out.

6 COMPETITION IN THE GROUP RISK INSURANCE MARKET

APRA data indicate that the annual cost of life and TPD insurance exceeds $3B for large APRA funds.[12]

As trustees act on behalf of members, there appears to be a precondition for effective competition between insurers for group policies. Tendering of insurance arrangements has fostered competition between insurers for superannuation business. Although experience differs between funds, it would appear that trustees can buy insurance at a competitive price for members.

However, over the six years to June 2009, the ratio of proceeds (that is, proceeds of claims paid to super funds) to net premiums for all funds averaged around 43 per cent (proceeds ratio). This means that about 43 cents was paid to super funds in satisfaction of claims for every $1.00 of premium paid.

In table 5.3 below, a sector with a higher proceeds ratio means that an average fund in that sector received more insurance proceeds per dollar of premium than an average fund in a sector with a lower ratio. Of course, proceeds on insurance policies may not be attributable to the premiums paid in that financial year or, when payments are made in the form of an income stream rather than a lump sum, reflect the full extent of payments attributable to claims arising in that year. In addition, premiums are used to cover administration, overheads, commissions and claims-handling costs, as well as funding reinsurance cover. Therefore, the proceeds ratio is not a measure of profitability, but it is an indicator of the policy's value to the policyholder.

IFSA's submission noted that a review of 13 insurance companies, found a ratio of 75.8 per cent on net premiums to policy payments on group life policies.[13] IFSA calculated net premiums after all fees, commissions, expenses and an allowance for profit were deducted from the gross premium. Also, claims were adjusted to take account of claims that had been incurred, but not yet reported, as some claims can take several years to finalise.

Even allowing for these adjustments, there is still a significant gap between net premiums and policy payments.

The Panel notes that some trustees have an arrangement with their insurer for a rebate of premiums so that the proceeds ratio on the group policy does not fall below 80 per cent. This approach, if more widely adopted, would appear superior to the outcomes currently experienced by most superannuation funds according to the IFSA data.

Table 5.3: Ratio of proceeds to net premiums by fund type[14]

	June 04	June 05	June 06	June 07	June 08	June 09
	$m	$m	$m	$m	$m	$m
ALL FUNDS						
Total proceeds on insurance policies ($m)	619.0	632.0	730.0	912.0	1069.0	1333.0
Net premiums ($m)	1322.0	1507.0	1755.0	2117.0	2458.0	3098.0
Ratio of proceeds to net premiums (%)	46.8	41.9	41.6	43.1	43.5	43.0
BY FUNCTIONAL CLASSIFICATION						
Corporate						
Total proceeds on insurance policies ($m)	77.0	70.0	55.0	68.0	66.0	65.0
Net premiums ($m)	127.0	111.0	96.0	115.0	128.0	111.0
Ratio of proceeds to net premiums (%)	60.6	63.1	57.3	59.1	51.6	58.6
Industry						
Total proceeds on insurance policies ($m)	222.0	231.0	266.0	354.0	464.0	591.0
Net premiums ($m)	380.0	472.0	536.0	720.0	886.0	1145.0
Ratio of proceeds to net premiums (%)	58.4	48.9	49.6	49.2	52.4	51.6
Public sector						
Total proceeds on insurance policies ($m)	8.0	9.0	20.0	17.0	22.0	63.0
Net premiums ($m)	12.0	12.0	64.0	72.0	133.0	228.0
Ratio of proceeds to net premiums (%)	66.7	75.0	31.3	23.6	16.5	27.6
Retail						
Total proceeds on insurance policies ($m)	312.0	322.0	389.0	474.0	517.0	615.0
Net premiums ($m)	803.0	911.0	1060.0	1211.0	1312.0	1614.0
Ratio of proceeds to net premiums (%)	38.9	35.3	36.7	39.1	39.4	38.1

Source: APRA.

The ratio of insurance income received to premiums paid is very different between industry sectors. There is also marked disparity within sectors in the level of premium charged to secure a particular level of life cover (see table 5.4).

Table 5.4: Annual death & TPD premiums ($) for $300,000 cover[15]

White Collar	Male 30	Male 40	Male 50	Female 30	Female 40	Female 50
Industry funds	193	266	672	178	251	631
Public sector funds	184	293	800	175	263	678
Retail funds	251	378	1,081	195	329	935
Overall Median	218	322	840	178	295	758
Blue Collar	Male 30	Male 40	Male 50	Female 30	Female 40	Female 50
Industry funds	266	358	895	234	356	895
Public sector funds	215	355	1,040	198	355	966
Retail funds	362	518	1,583	271	476	1,362
Overall Median	**311**	**456**	**1,162**	**240**	**414**	**1,068**

7 DISCLOSURE OF INSURANCE OFFERINGS

When a member changes super funds (either by choice or change of employment), they are no longer covered by the previous fund's policy and might start cover in the new fund on quite different terms. The quality and extent of insurance cover is often at the bottom of the list of reasons surrounding a fund change (even with advice) and is often not thought about at all. This would be acceptable if it did not potentially have negative consequences for members who can find themselves without the same level of insurance (because they don't meet requirements imposed by their new fund) or paying significantly higher premiums.

The different ways trustees disclose insurance premiums makes it almost impossible for members to compare insurance offerings and costing between funds and to find the fund that offers the best insurance for them. Chant West, recently identified that:

> *"Insurance is the worst disclosed area in superannuation. It is almost impossible for the layman — and difficult even for the expert — to compare one fund's insurance offering with another's. And some funds do not even publish their insurance premiums."*[16]

For this reason, the Panel sees advantages in having consistent and comparable insurance information between superannuation products. A standardised approach to disclosure of insurance features and premiums is required.

Transparency and comparability could be improved by requiring trustees to publish on their website the terms and conditions of insurance policies they offer, together with a plain-English explanation. In effect, the policy terms and conditions are the 'product' that members receive. By requiring this disclosure, members could compare the product they currently receive with that of any prospective fund.

Where there are substantial differences in premiums according to age; gender; whether blue or white collar employment; whether or not the member is a smoker; frequency of premium payment; and type of fund,[17] this information is crucial to the effective disclosure of the insurance 'product'. However, most group policies have automatic acceptance limits and so this information is not relevant.

Trustees should also be required to disclose the proportion of the fund's TPD claims that are successful on a basis to be determined after consultation with industry. The rate of success is one measure of the quality of the insurance cover that the member receives.

Recommendation 5.11

Trustees of large APRA funds should be required to publish on their websites the terms and conditions applicable to each type of insurance offered by the fund, along with other information relevant to members, including:

(a) a plain English explanation of the policy terms;

(b) premium tables showing the gross premium charged for each category of member (if relevant) at each $1,000 of cover at current age with a standard frequency of payment. Any additional cost associated with the insurance should be noted as part of this disclosure; and

(c) TPD claim success rate on a basis to be determined after consultation with the industry.

Disclosure could be further enhanced by requiring trustees to publish the fund's ratio of proceeds to net premiums for each type of insurance offered. This could significantly add to competition in the market for group risk insurance as trustees would seek to lift this ratio either through lower premiums, refund arrangements or improved policy terms and conditions. Ultimately, it may provide added incentive for trustees to seek to merge to secure scale, partly in order to achieve better insurance outcomes for members. However, the Panel sees this extended disclosure as a matter for trustees to determine.

8 INSURANCE AND FINANCIAL ADVICE

8.1 Commissions

There is widespread agreement that Australians generally are under-insured.[18] It has been commented that insurance is generally sold, rather than bought, and that widespread under-insurance means that measures to restrict incentives for the sale of life insurance should therefore be considered with caution.[19] In the *Future of Financial Advice* reforms, the Government indicated that it would consult further about whether to extend the ban on commissions to risk insurance (including group risk insurance). This was because insurance has different features from investment products, including the fact that, unlike superannuation, there are no investment funds which might be used to pay for advice. Therefore, concerns about affordability and the potential for under-insurance needed to be explored in this context.[20]

Group risk insurance is bought by the trustee on behalf of members, and offered by that trustee to its members. In other words, superannuation provides an ideal distribution mechanism for insurance. In this context, an adviser can help members in the composition and level of cover that they should have, but if the member receives no advice, they are still likely to be insured through default opt-out coverage. In fact, advice on insurance offered by the trustee could be provided through intra-fund advice, which all MySuper trustees will be required to have available.

The Panel considers that questions of affordability in the context of group life and TPD insurance are of less relevance than may be the case with individually acquired insurance, in that the trustee arranges the insurance, and the member's superannuation balance is available to pay premiums. At the same time, the Panel notes that in the 12 months to December 2009, commissions paid by life insurers for the acquisition and maintenance of policies amounted to $2.09B, compared with $3.8B in meeting death and disability claims.[21] While these figures relate to products both within and outside the superannuation system, it is clear that commissions represent a major expense for life insurers, and by implication for superannuation fund members.

A number of submissions supported banning commissions.[22] The Panel agrees with these views. Additionally, it believes that insurance commissions should be prohibited in respect of all superannuation products regardless of whether the insurance cover is a default cover or not. The Panel is also concerned that allowing commission-based payments for insurance would mean that financial planners could still be conflicted in giving their superannuation advice.

Recommendation 5.12

Up-front and trailing commissions and similar payments should be prohibited in respect of any insurance offered to any superannuation entity, including to SMSFs, regardless of rules on commissions that might apply outside superannuation.

8.2 Intra-fund advice

Advice on insurance will be important for members who have significant family and financial commitments. This arises typically in early middle age and evolves with the number of dependants and paying down financial commitments such as the mortgage on the family home. These matters turn on individual circumstances and, even where addressed, people might need to revisit these issues and their choices as they age and their circumstances change.

Superannuation funds can help meet this need through intra-fund advice and the Panel believes that intra-fund advice should be tailored to meet this need, among the other advice needs of members. As part of the Panel's recommendations, MySuper products would be required to have an intra-fund advice facility. Further, as MySuper members are least likely to give consideration to their insurance needs, the Panel considers MySuper funds should proactively engage with members about their level of insurance coverage within the fund. This should be at appropriate times; for instance, trustees could contact members at age 35 and then at such intervals as it thought necessary.

Recommendation 5.13

MySuper trustees should pro-actively offer intra-fund advice to members in relation to their insurance in MySuper.

9 DEATH BENEFIT NOMINATIONS

Trustees generally have the responsibility, in accordance with their trust deed, to determine who receives the benefits of life insurance policies in the case of death of a covered member. The scope

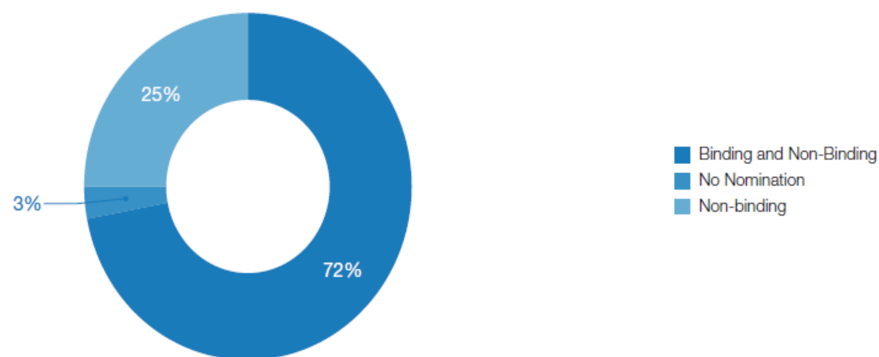
for trustee discretion to determine the beneficiary may be limited by the trust deed for the fund. For example, a trust deed might require benefits to be paid to the estate of the member.

Binding and non-binding death benefit nominations in effect allow a member to nominate their life insurance beneficiaries as the policy proceeds are part of the death benefit from the fund.

SuperRatings research (as set out in figure 5.1) shows that as at 30 June 2009, 72 per cent of funds offered both binding and non-binding death benefit nominations, 25 per cent offered non-binding nominations only and a small minority of 3 per cent did not offer death nominations to their members.[23]

Figure 5.1: Proportion of funds that accept death benefit nominations

Does the fund provide Death benefit nominations?



72% of funds provide binding Death benefit nominations to members which is a substantial increase from 2008. Only 3% do not allow any nomination.

Source: SuperRatings

A trustee has no discretion when the member has lodged a valid, binding death nomination and must pay benefits to the nominated beneficiaries, subject to them meeting the legislated eligibility criteria.

In practice, this means that binding death benefit nominations can lead to a result that is inequitable because the circumstances of the member and the beneficiaries change after the binding death benefit nomination is lodged with the trustee. Nominations can be changed or revoked by the member. Currently, binding nominations must be reconfirmed every three years in order to ameliorate the risk of inequitable outcomes due to a change in circumstances.

Binding death nominations are a useful tool to align the payment of death benefits with the preferences of the member. However, the current rules can lead to unintended outcomes where trustees are bound by death nominations that have not been changed to reflect changes in the member's circumstances, such as those resulting from divorce. The Panel believes that binding death nominations should be invalidated when there are intervening circumstances. The current system used by States and Territories could be looked to for guidance and then an appropriate amendment made to the SIS Act.

Recommendation 5.14

The SIS Act should be amended so that binding death nominations would be invalidated when certain 'life events' occur in respect of the member. The current systems used by States and Territories under which testamentary dispositions are invalidated could be used as guidance for creating a single national model.

If the change in recommendation 5.14 is made to the existing rules, the Panel considers that the requirement for reconfirmation of binding death nominations could be extended to five years.

Recommendation 5.15

Subject to recommendation 5.14 being implemented, the SIS Act should be amended so that binding death benefit nominations only have to be reconfirmed every five years.

10 SELF-INSURANCE

Some funds are currently allowed to self-insure death and TPD benefits. Most of the funds that do so are non-public offer defined benefit funds or defined benefit sub-plans within public offer funds.

The main argument for allowing funds to self-insure is that the profit margin that would otherwise flow to external insurers could be 'internalised' by the fund, thereby reducing the cost of insurance for members. Another rationale is to support particular benefits offered by some funds that are not generally available from the commercial insurance providers — for example, payment of TPD benefits as inflation-protected income streams, rather than as one-off lump sums.

However, the risks associated with self-insurance are high, especially as non-public offer fund trustees are not necessarily capitalised. For example, in a worst case scenario, if the insurance reserves of a fund were insufficient to meet claims, any shortfall would generally have to be met from the fund. This means that the burden would fall on employers in the case of defined benefit funds or in accumulation funds, on the remaining members (depending on the terms of the trust deed).

Prudential requirements imposed on authorised life insurers are an important safeguard that ensure that reserved capital is sufficient and of appropriate quality to meet expected claims, having regard also to reinsurance and other risk management strategies.

Self-insurance arrangements that are not prudentially supervised could also create arbitrage opportunities to be exploited by members. The 30-day portability rules would provide scope for members to leave a self-insured fund if a large number of claims were anticipated (for example, in a catastrophic event such as a pandemic), which could result in a large-scale run of withdrawals.

In conclusion, the Panel is not convinced that the potential gains to members in reduced premiums would outweigh the risks of self-insurance.

Accordingly, in the case of non-public offer funds that are currently permitted by law to self-insure death and TPD benefits, the Panel is of the view that, after a suitable transition period, self-insurance

should no longer be allowed except in the case of defined benefit funds. The Panel's views on defined benefit funds are explained in chapter 6. With respect to a fund that has a particular definition of TPD in its trust deed for which external cover cannot currently be obtained, the Panel's recommendation regarding the harmonisation of the trust deed TPD definition with the insurance policy requirements (recommendation 5.8), should eliminate this problem.

Where self-insurance is permitted to continue, it must be subject to regular APRA monitoring.

Recommendation 5.16

After a suitable transition period, self-insurance of any fund benefits, including death and TPD benefits, should not be permitted in any large APRA fund except defined benefit funds (or sub-plans) that are currently allowed to self-insure.

ENDNOTES

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SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 6

Integrity of the system

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KEY THEMES

Issue

The integrity of the superannuation system is important in maintaining certainty that retirement benefits will be delivered to Australians. Confidence that the industry is stable and that savings are secure must be upheld. While no fundamental flaws have been identified, the Panel believes that improvements can be made in several areas so as to ensure that risks are appropriately monitored and confidence is maintained.

Proposed solution

The Panel proposes measures, including:

- requiring all trustees to have a risk-weighted amount of capital or an operational risk reserve;
- administrators and commercial clearing houses to be licensed by APRA;
- liquidity risks to be specifically addressed in the trustee's RMP; and
- funding of defined benefit funds to focus on coverage of vested benefits, not coverage of minimum requisite benefits.

Benefits for members

Members will benefit from these measures to improve the integrity of the system as:

- capital and reserve requirements will help ensure the viability of trustees as will APRA licensing of administrators and commercial clearing houses;
- liquidity risk will be managed better so that members have access to benefits when they need them;
- more security for defined benefit fund members as vested benefits become the focus in funding; and
- improved confidence in the integrity and stability of the system.

1 INTEGRITY OF THE SUPER SYSTEM

In order for the superannuation industry to make an optimal contribution to retirement savings, fund members must have confidence in the industry's stability and the security of their savings. Capital adequacy and liquidity are key structural elements supporting those aims in respect of APRA-regulated funds.

1.1 Capital adequacy

A feature of the superannuation system is that there has not been a high threshold for entry. This means that non-public offer funds can be established with zero capital backing, and even many public offer trustees hold minimal capital in their own right.

Trustees of public offer super funds are required to meet a minimum capital requirement. Currently, trustees must have net tangible assets of $5 million or that amount available under an approved guarantee (or a combination of the two), comply with conditions regarding the custody of the assets of the fund or hold all the fund's assets in a prudentially regulated entity. Trustees may also be required to be licensed by ASIC, but need only comply with APRA capital requirements.

An approved guarantee can only be called on in the event of a default by the trustee to whom it is provided, so it is far less flexible in responding to any stress situation than having tangible assets available.

The custody alternative referred to above requires that the assets of the fund are held by a custodian with at least $5M in net tangible assets. Custodians hold assets and execute market transactions on behalf of trustees. Trustees who outsource this service do so to minimise the risks of transactional errors, as custodians have large back office operations to support a high volume of market transactions. This provides some additional security for trustees (and members) against the risks of transaction errors, valuation errors and fraud. However, custodians provide no protection to fund members in the event of operational failure on the part of the trustee or another service provider, or any security in relation to fund assets held in downstream investments.

Custodians can hold assets for many funds, but the minimum capital requirement is not correspondingly increased if a custodian holds assets for more than one fund. Capital available from custodians only provides protection for fund members against operational risks arising from custody-related problems, but does not protect against other risks.

In practice, custodians act as a conduit for the trustee's decisions and it is not their role to conduct due diligence to protect against a range of investment-related risks.

At present, even for public offer funds, there is no link between the risks faced by the fund and the amount of capital required. For example, the capital requirements for a public offer trustee would be the same whether the trustee acts for one Small APRA Fund (**SAF**) or for many large defined benefit funds. When there are losses as a result of an operational error (which are not recoverable from third parties, including insurers), those losses must be met from the fund. In other words, the members suffer the losses.

The original thinking behind the $5M capital backing required for public offer superannuation trustees was '*so that only companies of substance can be trustees of public offer superannuation funds*'.[1] The capital requirement was intended to ensure that some financial resources are available to act as a buffer against risk, demonstrate a commitment on the part of the trustee to its superannuation business, and act as an incentive to the trustee to manage the fund well. However, it has not been increased since the inception of the SIS Act in 1993, despite the average size of large APRA funds having increased from $46M to $2B from June 1996 to December 2009.[2]

A high proportion of public offer trustees meet their capital requirements through using a custodian, rather than holding capital in their own right, as shown in the following table.

Table 6.1: How funds meet capital requirements

RSE Licensees at 15 April 2010			
Method of meeting Capital Requirements	**Extended Public Offer**	**Public Offer**	**Aggregate Total**
$5M net tangible assets in own right	6	31	37
$5M approved guarantee	3	6	9
Custodian	8	55	63
Invested in prudentially supervised institution	-	2	2
Total	**17**	**94**	**111**

Source: APRA unpublished data

There are not many professional custodial services in the market so there is a high concentration in a few providers.

The interests of members can be adversely affected by risks arising out of the fund's operations, which may relate to the governance of the fund, the fund's business processes or its employees. These can include conflicts of interest or duty (or both) among the trustee-directors; poor selection and monitoring of external service providers; inadequate insurance; failure to meet compliance obligations; damage to member records; computer failure; failure of software to perform to expectations; fraud, negligence and misconduct; miscalculation of member benefits such as unit pricing errors; and loss of key staff.

While it might be argued that a consistent cash flow from contributions provides a resource from which trustees can respond to a crisis, it is no substitute for capital or a dedicated reserve. In a choice environment, contributions might cease and requests for rollovers multiply in precisely those circumstances when the trustee has greatest need for cash flow.

The Panel is aware of instances of operational error in superannuation funds that have cost many tens of millions of dollars to rectify, principally relating to unit pricing errors. Rectification has been achieved at no cost to members because of the financial strength of the financial services groups of which the trustee formed part, where the groups made a commercial (rather than externally imposed) decision to compensate fund members, notwithstanding the lack of capital directly available to the trustee.

For funds with non-capitalised trustees, if anything goes wrong, the members bear the loss if the matter is not covered by indemnity insurance and if a third party is not liable for the event, giving rise to significant equity and inter-generational issues.

In its response to the 2002 report of the Working Group on Improving the Safety of Superannuation, the then Government said:

> *"The Government supports in-principle a risk sensitive framework for the holding of capital to address operational risk, but considers that the combination of requirements that each trustee be licensed by APRA, and prepare a risk management plan, will substantially address concerns relating to operational risk. Arguably the need for capital in the future may be substantially reduced as other factors come into play to address operational risk. On this basis, the Government supports the retention of the status quo for capital requirements at this time, to be revisited once the impact of the licensing and [risk management] reforms can be assessed."*[3]

The Panel believes that the current arrangements concerning capital requirements are inadequate.

There has been significant industry consolidation since the introduction of licensing, and the risk management processes have become more robust, albeit off a low base. The increased size of funds, while delivering economies of scale, tends to concentrate risk. There is an argument that MySuper and SuperStream should mitigate some of these risks, but not sufficiently, in the Panel's view, to eliminate the need to revisit the question of capital requirements.

1.2 Operational risk reserves

Factors that have led to increased operational risk include the provision of more complex superannuation product offerings; greater flows of funds due to the introduction of choice of fund and the growth in member investment choice; more widespread adoption of daily unit pricing; and a general increase in the number of external service providers that many trustees must monitor.

Many trustees already maintain operational risk reserves in their funds even though they are not legally required to do so. These reserves form part of the assets of the fund, but are set aside for the specific purpose of addressing operational risks such as fraud, pricing errors or system failure. Earnings on the reserve may be directed either to building the size of the reserve or distributed to members. If a reserve is maintained, the SIS Act requires trustees to formulate and give effect to a strategy for its prudential management. Trustees must also consider a range of issues, including the:

- intergenerational equity of the reserve, which will typically act to spread costs across different 'generations' of fund members;
- appropriate levels or range of the reserve;
- controls and procedures for managing the reserve; and
- the manner of distribution if the reserve is no longer required, typically in the event of fund wind-up or merger.

In the event of the catastrophic failure of a fund, internal reserves provide less assurance than would capital held outside the fund by the trustee. However, the Panel's view is that losses of such magnitude as to wipe out fund assets, including its risk reserves, are of sufficiently low probability that the possibility should not distort its recommendations concerning capital.

Mercer did a study in April 2009 on trustees' attitudes to operational risk reserves aimed at compensating members in the event of an operational risk event such as fraud, pricing errors or system failure. The study surveyed 34 super fund trustees, representing 40 per cent of fund assets in the not-for-profit sector. Mercer found that smaller funds, that should arguably have a relatively larger reserve, were less likely to have one. Just over half of the trustees surveyed had either a specific operational risk reserve or a general unallocated reserve. Typically, the level of the reserve was between 0.2 per cent and 0.6 per cent of assets or liabilities.

Mercer recommends that an operational risk reserve should be at least 1.25 times the cost of a fund's annual operations, plus extra for provision of services from an external source in the event of a major problem.[4]

APRA has released for industry consultation a discussion paper and draft Prudential Practice Guide 235 'Use of reserves in superannuation funds'. APRA has withheld finalising the Guide pending the release of the Review's final report. 'Reserves' are not defined in the SIS Act, but the draft Guide distinguishes between amounts set aside for contingent events, which are regarded as reserves, and provisions for accrued expenses, such as administration or taxation, which, in APRA's view, are not reserves.

1.2.1 Levels of capital or reserves

In the absence of adequate trustee capital or reserves, losses incurred as a result of operational error, and not recovered from insurance or third parties, must be met out of current fund earnings or assets, essentially out of the entitlements of current members unless it is a defined benefit fund. Even if losses are recovered from a third party, there is inevitably both uncertainty and a time lag in that process, which can cause detriment to members leaving the fund during that process. The Panel considers that it would be more equitable and prudent if the impact of such losses could be spread over time with the immediate costs being met out of either trustee capital or an operational risk reserve maintained in the fund.

Some submissions supported an enhanced obligation for all registrable superannuation entity (**RSE**) licensees to hold capital,[5] while others suggested that current arrangements provided adequate protection for members so long as they were supported by appropriate risk management strategies and reserves maintained in the fund.[6]

The Panel believes that trustee capital or reserving requirements should be calculated having regard to the risks faced by each fund trustee. This would be consistent with the approach to holding capital against operational risks currently adopted for authorised deposit-taking institutions and proposed for life and general insurance companies.[7]

Trustees of SAFs are currently required to hold $5M in net tangible assets in recognition of the complexity of acting for a large number of separate funds. The Panel considers it would be inappropriate to reduce the protection currently afforded to SAF members through this capital holding, but also that it would be inefficient for an operational risk reserve to be held in each SAF. For that reason, the Panel proposes that SAF trustees should hold capital in their own right equivalent to the operational risk reserve that would be required if the combined SAFs were treated as a single fund.

APRA is also currently conducting public consultation on proposals to extend its prudential supervision framework to conglomerate groups, some of which include superannuation trustees. In

its discussion paper entitled: *Supervision of conglomerate groups*, released on 18 March 2010, APRA outlined its proposed approach to setting capital adequacy requirements at the group level.[8] The Panel also considers that the capital adequacy requirements for conglomerate groups should have regard to the operational risk reserves of relevant superannuation funds and that super fund trustees in a conglomerate group can have regard to the assets of the rest of the conglomerate group.

One purpose of a capital requirement is to ensure that if a fund failure occurs, there are resources available to facilitate an orderly resolution of issues, including taking legal proceedings if necessary. Apart from the level of fund assets, risk factors in determining the appropriate trustee capital requirements might include the extent to which the fund is self-administered, whether the fund's investments are managed in-house, the level of professional indemnity insurance held by the trustee, any other business activities of the trustee (such as operating one or more managed investment schemes) and the extent to which the fund's service providers have provided indemnities and have adequate capital reserves and insurance cover.[9]

The Panel notes that capital held by a trustee in its own right must be serviced, often at a cost to the members, whereas earnings on an operational risk reserve could contribute to the building of the reserve or be distributed to members' as an increment to fund earnings.

At the same time, the Panel is concerned that its proposals should be neutral as between existing industry sectors and should be phased-in over time so as not to impose an undue burden on current members.

APRA establishes the processes for calculating capital requirements in its other prudentially regulated industries by way of prudential standards. The Panel recommends in chapter 10 that APRA be given a standards-making power in superannuation. The greater flexibility provided by prudential standards in providing nuanced instruction to regulated entities, as compared with regulations, makes the use of a prudential standard a preferred option in setting capital or reserve requirements for superannuation trustees.

Recommendation 6.1

New capital requirements for trustees on a risk-weighted basis should be phased-in over time:

(a) the SIS Act should be amended so that the governing rules for all large APRA funds are deemed to include a provision enabling the trustee to maintain a dedicated and identifiable operational risk reserve separate from member account balances;

(b) all large APRA funds must hold a minimum level of operational risk reserve, which reserve cannot be fully offset by trustee capital;

(c) legislation should define a minimum dollar figure for operational risk reserves and a maximum amount, expressed as a percentage of assets in the fund. APRA should have the power to increase the minimum level of capital on a risk-assessed basis. Details of defining a risk-weighted requirement between the minimum and maximum should be developed by APRA in consultation with industry;

(d) should APRA's assessment of risk in the fund lead it to the view that it would be appropriate for the fund to hold a higher level of reserve than the maximum amount set out in legislation, APRA should use other tools available to it to cause the trustee to reduce the risk exposure of the fund;

(e) any capital requirement that would otherwise be imposed under the trustee's Australian financial services licence in respect of non-superannuation business should be in addition to the capital requirement imposed under the SIS Act;

(f) trustees of SAFs should be required to hold an amount of net tangible assets in their own right, calculated by APRA having regard to the operational risk reserve that would be required if the aggregate of SAFs under trusteeship were a single fund; and

(g) the capital adequacy requirements for prudentially-supervised conglomerate groups should have regard to the operational risk reserves in any superannuation fund or funds that are in the group and adequacy requirements for group trustees should have regard to the risk-weighted assets of the rest of the conglomerate group.

In making this recommendation, the Panel has sought to balance the costs to the current generation of members of transition to the new arrangements against the need to provide them and future members with enhanced protection against operational risk.

The Panel emphasises that the mandated operational risk reserve would be distinct from any investment fluctuation or other reserve held by the fund. It would be subject to the existing SIS Act requirement that the trustee devise and implement an investment strategy for the reserve, which includes a requirement, among other things, to ensure adequate liquidity within the reserve.

2 LICENSING OF ADMINISTRATORS

A few very large administrators have emerged over the past 20 years. Their role in the superannuation system is critical to its success. The corporate failure of any one of them could

create a very difficult position for the industry, while the operational collapse of any of them could create a real crisis.

The current lack of ready access to capital by administrators to support ongoing investment in improved technology and to address liability in the face of operational risk represents a real concern which needs to be addressed in the near term, even though this may result in a transitional increase in administration costs for funds.

APRA currently has some regulatory reach into outsourced providers, such as administrators, by way of the outsourcing operating standard under the SIS Regulations.[10] Trustees' contracts with their administrators must, among other things, require administrators to give information to APRA or the trustee on request, to allow APRA access to premises and to meet with the administrator, and to require an audit to be conducted. An arguable limitation of this approach is that the only remedy available in the event of failure of an administrator to meet those requirements is for APRA or the trustee to take a civil court action for breach of contract. APRA currently has no legislative power to supervise the activities of administrators.

Administrators are not required to be licensed, but need an Australian financial services licence (**AFSL**) if they provide financial advice to members on behalf of the trustee. Currently, some administrators hold an AFSL and others do not. However, in any case, ASIC has limited powers over the ambit of work administrators do as delegates of superannuation trustees.

Most of the breach notifications ASIC gets from trustees relate to breaches caused by defects in the administrative process. ASIC requires trustees to rectify breaches and put in place procedures aimed at preventing recurrence, but ultimately both ASIC and trustees rely on fund administrators to get things right. If they do not, then trustees have a limited ability to do anything about it. Trustees are often captive to the administrator, because it is difficult and costly to change administrators. In some cases, they are even more closely connected with administrators because they are either part owners or are themselves owned by the administrator.

Three of the largest superannuation administrators made a submission supporting the notion that they be licensed directly by APRA, rather than the prudential risks being addressed through the current indirect method of reviewing outsourcing arrangements.[11] The administrators suggested licence criteria around capital requirements, adequacy of resources, fit and proper standards and risk management standards. Many other industry players saw advantages[12] in administrators being licensed, though a few opposed the concept on the basis of likely increased costs to the industry and the imposition of a further layer of regulation.[13] For those trustees that conduct in-house administration, the administrative process is already subject to prudential oversight.

There was a view that imposing prudential regulation directly on administrators could result in a blurring of accountability, rather than having full responsibility for the fund's operation borne by the trustee, as is currently the situation.[14] The Panel believes, however, that the trustee should remain the entity that is ultimately accountable and liable to members and that, even though the trustee might have contractual recourse to the administrator in the case of error, the member should not have to look to the administrator in the first instance to correct any error or to pay any damages for loss. To further address this issue, the Panel proposes that the SIS Act explicitly exclude, as a defence available to the trustee in any court action brought by a member against the trustee, reliance on the fact that the administrator was licensed by APRA.

The Panel has no doubt about the prudential significance of the administration function in superannuation. It notes that no other service provider in super — or any other prudentially supervised industry — is subject to prudential supervision, and is conscious that introduction of licensing and prudential supervision for administrators risks having trustees rely on the licensing process rather than their own due diligence in determining the soundness of the administrators' processes.

Notwithstanding these concerns, the Panel has determined that administrators are of sufficient significance to the overall operation and efficiency of the Australian superannuation system, as to warrant licensing and supervision by APRA.

Increasingly, administrators are also acting as clearing houses by being responsible for acceptance of contributions linked with member data and transmission of those contributions and data to the correct super fund, rather than just maintenance of all member records. To ensure that there is a level playing field, the Panel is of the view that all commercial clearing houses, even if they do not perform a general administrative function for superannuation funds, should also be licensed by APRA.

Recommendation 6.2

The SIS Act should be amended to:

(a) define 'superannuation administrator' and empower APRA to license superannuation administrators, to impose conditions modelled as appropriate on the conditions applicable to RSE licensees, and to enable APRA to impose, modify or revoke additional conditions. Licence conditions should include a risk-weighted capital requirement;

(b) require that trustees may only use a superannuation administrator licensed by APRA for administration functions which are covered by the outsourcing operating standard. This process should be funded by a levy on those administrators;

(c) require commercial clearing houses to be licensed as administrators; and

(d) make clear that the trustee remains liable to the member in the first instance even if the trustee has outsourced administration to a licensed administrator.

Recommendation 6.3

Obligations imposed by way of licence conditions on external administrators should be replicated where appropriate by variations to the licence conditions of RSE licensees that operate an in-house administration system.

While administrators and clearing houses acknowledge that theirs is a low margin/low profit business, they were firm in the belief that the market and competition should set both fee levels and fee structures. The Panel endorses that approach, while cautioning trustees against an excessive focus on negotiating down the administration fees, which tend to be highly visible, while paying less attention to other costs, including investment costs and costs associated with the promotion and marketing of the fund.

3 RISK MANAGEMENT STRATEGIES AND PLANS

3.1 Focus on risk

As a core element of maintaining the integrity of the super system, from 1 July 2004 the revised APRA licensing regime required licensed trustees to develop and implement a risk management strategy (**RMS**) at the trustee level,[15] and a risk management plan (**RMP**) at the RSE level.[16] The separate instruments are required because some RSE licensees might act as trustee for more than one RSE and might also conduct other activities such as owning an administrator or managing non-superannuation investment schemes. Where the sole business of the RSE licensee is to act as trustee for a single fund, the RMS and RMP can be combined into a single document.[17] The trustee must also secure an annual audit in the approved form that must include statements as to whether, in the opinion of the auditor, the fund has complied with the RMS and RMP throughout the year.[18] However, the auditor is not required to express an opinion as to the comprehensiveness or suitability of the RMS or RMP.

The Panel considers that the requirement to make an RMP available to members on request has resulted in a less effective risk management regime than could otherwise be the case.[19] Anecdotal evidence suggests that members rarely, if ever, request a copy of the RMP from the RSE licensee. Providing members with the RMP is unlikely to improve member decision-making because members are unlikely to choose one fund over another on the basis of their risk management framework. Further, APRA has noted that dissemination of the risk management measures in the RMP such as fraud prevention and detection arrangements could expose the fund to increased attempts to circumvent those controls.[20]

The Panel believes that the comprehensive requirements of an RMS and RMP have resulted in an increased focus on risk by trustees. However, the requirement to make the RMP available to members detracts from its utility as a genuine risk management tool for trustees. The absence of any requirement on the part of an auditor to assess whether the RMS or RMP is fit for purpose in the context of the trustee's operations reduces its value and tends to have the focus on getting through the audit and making sure that the RMP is not easy to breach, and that leads to 'dumbing it down'.[21]

Recommendation 6.4

Section 29PD of the SIS Act should be repealed, so that the trustee is not required to make a copy of the trustee's RMP available to a member or to the employer sponsor in the case of a defined benefit scheme.

Recommendation 6.5

The SIS Act should be amended to provide that, if a trustee makes a formal decision that the RMS fully addresses all risks relevant to one or more of the RSEs under its trusteeship and documents that fact within its RMS, it is not obliged to prepare a separate RMP in relation to the nominated RSE(s).

3.2 Liquidity

A specific area of risk to be addressed by trustees as part of their consideration of investment strategies and risk management is liquidity. This refers to the capacity of a trustee to transform fund assets quickly into cash to make timely payments as required, such as pension payments or requests from members to exit the fund. Assets like government bonds are highly liquid, while physical assets like property and unlisted investments in infrastructure are far less liquid because they can take much longer to sell and turn into cash. Liquidity needs of funds can vary depending on the age of their membership, growth and rate of entry, exit or switching between investment options and market conditions. Liquidity is different from a fund's net asset position or solvency. An entity can have positive net assets (ie its assets are worth more than its liabilities), but have a liquidity problem if it cannot turn a sufficient amount of those assets into cash quickly enough at an acceptable price.

A fund with a liquidity problem could not only adversely affect its members (particularly those in the pension phase) but also lead to a loss of confidence in the system as a whole. A fund that needed to engage in a forced sale of assets in a depressed market in order to meet short term liquidity requirements would cause long term detriment to all members. There was anecdotal evidence of this occurring in a number of cases during the GFC. For example, during the GFC, previously liquid assets held by some superannuation funds became illiquid due to capital freezes in mortgage, cash management and property trusts. In order to meet portability, switching and capital drawdown requests, some trustees were forced to sell equities into a depressed market, while trustees who were unable to meet these requests applied to APRA for a variation or suspension of portability requirements.

Policy therefore needs to balance having an adequate degree of confidence that a fund will have sufficient liquidity, without unduly impacting a fund's ability to hold illiquid assets that may have attractive characteristics as an investment.

Managing the liquidity risks inherent in 'maturity transformation'[22] (or 'borrowing short and lending long') is a core function for any financial sector entity. Banks, for example, routinely accept liabilities in the form of at call deposits of cash and use these to invest in residential mortgages with a 25 to 30-year repayment horizon. Super funds undertake a not-too-dissimilar function.

There are legal and commercial considerations for trustees in managing liquidity. By law, a member is entitled to ask to leave a fund on '30-days' notice (known as the portability rule).[23] APRA can suspend or vary members' rollover entitlements on request from a trustee if it believes that meeting the rollover request would impact negatively on the fund's financial position, or on the interests of other members of the fund.[24] Even without a legal requirement, there is a commercial imperative for trustees to allow people to exit the fund within a reasonable period.

Most trustees allow members to switch between investment options, and this also requires liquidity within investment options. There are no legislative requirements as to how often trustees must offer switching between investment options nor for the timeframes within which trustees must action a member request for a switch. Trustees can choose to limit the frequency and timeframes for switching. Therefore, investment choice is subject to trustees complying with their disclosure obligations so that members understand the fund's particular rules.

There are exceptions to the 30-day portability rule for investments in illiquid assets. A trustee does not need to comply with the 30-day portability rule subject to certain conditions. First, its disclosure material must say that the investment option is illiquid and specify the maximum notice period for

redemption. An investment is illiquid if it cannot be converted to cash in less than 30-days or converting it to cash within the 30-days would be likely to have a significant adverse impact on the realisable value of the investment. When a member chooses an illiquid investment strategy, the trustee must also get written acknowledgement that the member understands and accepts that a redemption period longer than the 30-days applies (in respect of the whole or part of the requested transfer amount) because of the illiquid nature of the investment. The SIS Act currently addresses the situation where the investment option is illiquid from the outset; however, it does not address what happens when the option becomes illiquid after the investment is made.

The Panel notes that trustees should have a strategy for managing liquidity in each investment option that they offer, not simply at fund level. The availability of switching between investment options means that each investment option needs sufficient liquidity.

Recommendation 6.6

The Risk Management Plan should explicitly include a liquidity management component to ensure that trustees identify and manage liquidity risk at both the fund level and the investment option level.

3.2.1 Liquidity issues during the GFC

The GFC saw some funds facing liquidity strains as members attempted to switch into other investment options (typically cash). Some retirees experienced distress because their superannuation savings were concentrated in options such as mortgage trusts that had been previously thought to offer adequate liquidity, but which were frozen by the underlying fund manager. Such instances were mostly identified in retail funds and members experienced the same liquidity problems as direct investors in these products.

Despite these issues, it is noteworthy that though short-term liquidity of some significant funds was challenged, most funds did not have liquidity problems and there was not a large scale flight toward what was perceived as the most liquid, or safe, fund or investment option. However, many thousands of members of retail funds found their particular investment options frozen.

Some submissions noted that funds with diversified assets were more appropriately suited to deal with adverse short-term liquidity challenges, as were those with large positive net cash flows and stable membership bases. Therefore, funds with substantial exposure to a membership base close to retirement, or with a membership that has shown a high propensity to switch investment options, might have greater liquidity needs.

There seems a good case for ensuring that liquidity requirements match the legitimate expectations of members of a particular fund, including their expectations about being able to switch investment options.

In its submission, IFSA advocated that illiquid funds or investment options should be defined in accordance with the Corporations Act (that is, those with 20 per cent or more invested in illiquid assets).[25] The Panel is wary of instituting such a rule when liquidity needs differ greatly across the superannuation industry. Constant flows of contributions allow some funds to manage liquidity with this cash flow, whereas other funds (or investment options within funds) have to manage liquidity with only the assets they hold. Therefore, instituting a one-size-fits-all approach could create a

disincentive to hold a certain amount of illiquid assets that could offer improved returns over liquid assets.

3.2.2 Liquidity and MySuper

Given that MySuper products are likely to be large in scale with diversified investment portfolios and substantial contribution inflows, liquidity should be more readily managed in those products. It seems appropriate that MySuper members, many of whom will not have actively chosen to be in the product, are able to exit in a timely manner. The Panel considers the current 30-day rule appropriate in these circumstances and that this would not unduly constrain a MySuper product from investing in illiquid assets such as infrastructure.

3.2.3 Liquidity and choice

The Panel believes a less prescriptive approach is appropriate for choice products that invest in illiquid assets. Choice members actively choose their investment strategies and there is merit in allowing different portability rules for investment options with illiquid assets. For instance, a fund might want to offer an infrastructure investment option that allows investors to switch only 20 per cent of their holding of that investment for the first five years. In this regard, the Panel considers that the current exception to the 30-day portability rule for investment options in illiquid assets is appropriate for choice products.[26] There is anecdotal evidence that this exception is not used because of the requirement to get written member consent. Therefore, the requirement to have separate written member consent should be removed provided that there is prominent disclosure to the member that the option is illiquid, together with an indication of the timeframe within which it can be redeemed, such as through PDSs and product 'dashboards' which the Panel, in chapter 4, has recommended be developed.

Recommendation 6.7

The exception to the portability rules for illiquid assets should be retained for choice products only, but the member's written consent should no longer be required provided that there is adequate disclosure to the member before they select an illiquid investment option.

Recommendation 6.8

Subject to recommendation 6.7, the current portability rules should be retained for both MySuper and choice products.

3.2.4 Liquidity and retirement phase

Liquidity risk differs for members in the retirement phase compared to those in the accumulation phase. Members in the retirement phase are likely to be highly reliant on a regular cash flow from their superannuation, as they generally have little capacity to supplement their income from other sources.

It follows that trustees need to assess even more rigorously the liquidity characteristics of investment options offered to members in the retirement phase.

Recommendation 6.9

The trustee's RMP should have particular regard to liquidity characteristics of investment options offered to members in the retirement phase.

4 DEFINED BENEFIT FUNDS

A 'defined benefit fund' is defined in the SIS Regulations. Essentially, under those Regulations, a defined benefit fund is one in which contributions are pooled and are not allocated to any particular members. Further, a defined benefit member is someone whose retirement benefit is calculated pursuant to a formula based wholly or partly on the member's salary. Under the SIS Act, if a fund has even one defined benefit member, it is a defined benefit fund for all SIS Act purposes.

Defined benefit funds have served many members well over a long period because they provide greater certainty about the amount of the retirement benefit and because members do not bear the investment risk.[27]

In 1982/83, 82 per cent of members were in defined benefit funds. By June 2009, only 2 per cent of members of large APRA funds were in 'pure' defined benefit funds, (that is, funds where all members receive only a defined benefit on retirement) 39 per cent were in 'hybrid' funds (funds that offer both defined benefit and accumulation benefits to an individual member, or more commonly have some defined benefit members and a much larger number of pure accumulation benefit members) and 59 per cent were in accumulation funds.[28] This decline in membership is the result of employers being unwilling to bear the investment risk inherent in defined benefit schemes, employees wanting to be members of accumulation funds in order to benefit from upswings in the share market and employees requiring greater flexibility as they changed jobs more frequently.

Defined benefit fund membership will continue to decline in coming years because the vast majority of defined benefit funds are closed to new members. However, in June 2009 there were 188 large APRA funds offering defined benefits (including both pure defined benefit funds and hybrid funds). These funds remain significant to the industry as they contain $382.5 B of assets.[29] Only $53.4 B is in 'pure' defined benefit funds, with $329 B in hybrid funds.

Since defined benefit funds are not subject to the same portability demands as accumulation funds and because members do not have investment choice over the defined benefit assets, the defined benefit assets can be invested for the long term. Defined benefits also have the advantage that investment risk is borne by the employer so that volatility is reduced for any particular member.

4.1 Funding standards and protection of members

4.1.1 The SIS Act

The SIS Act has, relative to many other regulatory regimes in the world, taken a soft approach to defined benefit funding requirements and has given APRA a rather 'light touch' enforcement role.

The SIS Act is primarily concerned with ensuring that 'minimum requisite benefits' are funded, rather than being concerned that 'vested benefits' are covered. Minimum requisite benefits are the

benefits provided in a defined benefit fund to meet the requirements of the SG Act. They are actuarially determined and are not measured in the same way as accumulation benefits.

The failure to fund 'minimum requisite benefits' results in the fund becoming 'technically insolvent' under the SIS Act. The trustee has 5 years in which to restore the fund to a position of technical solvency.[30]

The failure to fund vested benefits (so that the vested benefits index is less than 100 per cent) means that the fund is in an 'unsatisfactory financial position' under the SIS Act. There is nothing prescribed under the SIS Act as to when the fund must be returned to a 'satisfactory position'.[31]

As there is often a significant difference between a member's minimum requisite benefit and vested benefit and as a member's periodic benefit statement does not report the minimum requisite benefit, but does report the vested benefit, it is reasonable to believe that the member would expect funding to be set so as to secure the higher of the two (that is, vested benefits).

In its submission, the Institute of Actuaries of Australia says that the focus of the SIS Act and Regulations ought to change so that vested benefits are specifically protected and so that rectification of an 'unsatisfactory financial position' is emphasised. The Institute also makes the point that the current focus in the SIS Act on solvency and minimum requisite benefits does not help trustees who undertake the process of negotiating higher employer contributions to restore the fund to a satisfactory financial position so that vested benefits are covered.[32]

The Panel recognises that as each defined benefit fund and the financial strength of each participating employer is different, strict prescription about funding is undesirable. Accordingly, the trustee and APRA need to have flexibility so that employers are not put under so much financial pressure that the employer fails, leaving the member without a job. Similarly, it is desirable that large surpluses not be created.

It is important that the issue of coverage of vested benefits is better addressed, preferably by way of APRA issuing a prudential standard under the powers recommended in chapter 10.

Recommendation 6.10

APRA should issue a prudential standard that focuses on funding to protect vested benefits and specifies the time period within which a defined benefit fund that is in an unsatisfactory financial position must be restored to a satisfactory financial position, in much the same way that the SIS Act presently addresses insolvency of funds and minimum requisite benefits.

Recommendation 6.11

The SIS Act should be amended so that a defined benefit fund which is technically insolvent should not be allowed to accept SG Act contributions unless the fund actuary and the trustee form the view that it is reasonable to believe that the fund will be restored to solvency within the period prescribed under the SIS Act.

4.1.2 Corporations Act and employer insolvency

As defined benefits are reliant on the employer being able to continue to contribute the amount which the actuary periodically determines is required, the financial strength of the employer is critical. When an employer becomes insolvent, it is important that member benefits are not compromised because contributions have not been made. Under the SIS Act, APRA has no direct power over the employer in this regard. (In chapter 10 the Panel makes specific recommendations about superannuation contributions in relation to the Government Employee Entitlement and Redundancy Scheme (GEERS)).

In the event of the employer's insolvency, 'superannuation contributions' are regarded as a 'priority payment' (along with wages and any superannuation guarantee charge that is due) under section 556(1)(e) of the Corporations Act which means that they must be paid in priority to unsecured debts and claims. However, there are a number of other items set out in section 556(1) which rank higher in priority than superannuation contributions.

'Superannuation contribution' is defined in section 556(2) of the Corporations Act as follows:

> *"in relation to a company, means a contribution by the company to a fund for the purpose of making provision for, or obtaining, superannuation benefits for an employee of the company, or for dependants of such an employee."*

How this definition applies to a defined benefit fund is not absolutely clear, but there is judicial support for the view that it includes contributions made to a defined benefit fund pursuant to a funding and solvency certificate.[33]

Recommendation 6.12

The definition of 'superannuation contributions' in the Corporations Act should be clarified so that there is no doubt that defined benefit contributions are afforded the same protection as accumulation contributions.

4.2 Defined benefit funds in the choice architecture model

The Panel's design of the MySuper product is premised on MySuper being an accumulation product. MySuper criteria are intended to protect members from excessive fees and to have those members in a properly designed investment strategy in which the trustee has established an appropriate asset allocation and balanced risk and return.

There are very few funds which offer 'pure' defined benefits. In most defined benefit funds, the governing rules have been amended in recent years to add new categories of accumulation members. Further, most defined benefit members can have an accumulation-style component to their benefit, for example, as a vehicle to accept salary-sacrifice contributions or additional voluntary contributions.

Defined benefit members are not exposed to risks in respect of costs and investment performance in the same way that accumulation members are. However, defined benefit members might have this exposure in any accumulation-style account that is part of their overall benefit.

Recommendation 6.13

Defined benefit funds should automatically qualify as 'default' funds for SG Act purposes in respect of the defined benefit provided to members so long as the fund meets the requirements of the SG Act to receive contributions.

Recommendation 6.14

If the defined benefit fund is a hybrid fund, then the MySuper criteria must be met for accumulation members in order for the fund to be accepted as a default fund under the SG Act in respect of those members.

Recommendation 6.15

If a member has both defined benefits and accumulation benefits as part of the defined benefit fund's benefit design, and the accumulation benefit is not necessary to meet the employer's SG Act obligations, then the MySuper criteria do not have to be met in respect of those members.

4.3 Self-insurance for defined benefit funds

A number of defined benefit funds (and sub-plans) presently self-insure death and total and permanent disability (**TPD**) benefits. The most common reason is because the governing rules of the fund include a definition of TPD for which external insurance cover cannot be obtained.

One idea supported in several submissions is to require all funds to have external insurance cover. Other submissions thought that the present system should continue so that APRA would consider self-insurance by public offer defined benefit funds on a case-by-case basis and non-public offer defined benefit funds could continue to self insure.

The risks associated with self-insurance in relation to defined contribution funds are diminished in defined benefit funds, because the employer is liable for funding the promised benefit. At the same time, the inability or unwillingness of an employer to meet those liabilities represents a severe risk for a self-insuring trustee, especially in times of crisis such as a pandemic.

While external insurance is to be preferred and encouraged, the Panel considers that, as most defined benefit funds are closed to new members and declining in number, those defined benefit fund trustees that are presently allowed to self-insure death and TPD benefits should be permitted to continue to self-insure those benefits.

Where self-insurance is permitted to continue, it must be subject to regular APRA monitoring. APRA licensing conditions for the defined benefit fund trustee who is self-insuring would also allow APRA to take into account the actuarial controls and reserves that the trustee has in place.

The Panel discusses the issues relating to self-insurance in defined contribution funds in more detail in chapter 5.

Recommendation 6.16

Trustees of defined benefit funds (or sub-plans) that are presently allowed to self-insure death and TPD benefits should continue to be allowed to do so.

4.4 Legislation and defined benefit funds

There have been several occasions where the circumstances of defined benefit funds have not been appropriately taken into account when new legislation has been considered. This has led to increased complexity in a sector of the industry which was not simple to begin with and has resulted in increased costs as systems had to be manipulated to cope with the legislation.

Submissions provided numerous examples such as:

- the contribution caps relating to notional taxed contributions and grandfathering provisions;
- the crystallisation of tax-free component of benefits as at 1 July 2007, particularly in respect of defined benefit pensions; and
- the portability of benefits, especially for deferred defined benefits.

The Panel urges policy makers to be alert to the complexities that are created in defined benefit funds through regulatory changes designed primarily for defined contribution funds, as defined benefit funds still represent a very significant segment of the overall superannuation market and will remain so for the foreseeable future. It is important that the costs in respect of these declining funds not be unnecessarily increased.

5 CONTROL OVER INVESTMENTS

It is frequently suggested by commentators that superannuation represents a major pool of Australian assets available for investment in various projects which are deemed to be of particular national significance. Some argue that the 'social good' aspect of super, supported by its concessional taxation, justifies it being conscripted for investment in favoured projects. Often, such proposals invoke job creation, industry support or consideration of socially useful areas such as low cost housing or infrastructure as justifications.

The Panel has established as one if its guiding super policy principles (see Part One of this report) that governments should not seek to direct super funds to invest in particular assets or asset classes, regardless of how much it might seem in the national interest to do so.

The basic policy proposition for super is to generate savings for members' retirement. Externalities, whether a national interest in developing infrastructure, or promoting sound environmental, social and governance outcomes, need to be reflected in the risk and return valuation of a potential investment in order to fit within that proposition.

5.1 Managing elements of investment risk — ESG issues

A specific investment risk to be addressed, either in a trustee's investment strategy or its RMP, relates to environmental, social and governance (**ESG**) issues. Australian investment managers and asset owners have generally lagged their counterparts in some other advanced economies in their consideration of ESG issues in making investment decisions. It has been suggested[34] that factors behind this are:

- definitional issues and confusion over what constitutes ESG issues;
- confusion over whether a focus on ESG issues is consistent with a trustee's responsibility to act in the best interest of members;
- a perception that investments selected on ESG criteria underperform when compared with the broader market; and
- a lack of investor demand.

There has been a growing realisation that ESG issues pose investment risks with the potential to impact long-term viability of investments and consequently, the return on those investments. Recent surveys by SuperRatings[35] and jointly by the Climate Institute and the Australian Institute of Superannuation Trustees[36] have found between 71 and 83 per cent of superannuation fund trustees surveyed consider that integrating ESG issues into their investment decisions was part of their responsibilities and consistent with their fiduciary duties.

Further, in May 2010, Australia had 102 signatories to the Principles for Responsible Investment (formerly known as the United Nation's Principles for Responsible Investment). This is more than any other nation with the exception of the United States which had 109. Australia's signatories consist of 53 investment managers, 32 asset owners (including superannuation fund trustees) and 17 professional service partners.[37]

In Australia, section 1013D of the Corporations Act and Corporations Regulation 7.9.14C require trustees to advise members on the extent to which ESG factors are taken into account (if at all) when setting its investment strategy and selecting investments.

To clarify superannuation trustees' concern over whether ESG issues are consistent with their fiduciary responsibilities, the Government asked APRA, in April 2009, to review its guidance to superannuation fund trustees to take greater account of ESG issues in their investment practices. APRA is reviewing the relevant prudential practice guides and will release updated guidelines in the near future.

The OECD's Guidelines for pension fund governance[38] include a statement to the effect that prudent risk management practices should consider intangible risk factors such as environmental, political and regulatory changes, as well as the pension fund's potential market impact through its investment decisions. The guidelines also say that the risk management strategy should seek to identify and explicitly balance short and long-term considerations. The Panel considers that competent trustees and investment managers would have regard to such factors when considering viability and return on investment.

5.1.1 Performance of ESG investments

A growing number of studies have found that there is no significant difference between the financial performance of mutual funds that consider ESG issues and those that do not.[39] These findings were supported in Australia by Donald and Taylor.[40] Several other studies suggest that there might be more risk associated with funds that consider ESG issues. However, these studies also found that there was no significant difference in performance on a risk-adjusted basis.[41]

The 2010 SuperRatings' Fund Sustainability Review[42] found that Australian share options which consider ESG issues have outperformed the traditional Australian share index over the past five years by over 1.5 per cent per annum. However, this outperformance did not continue when comparing balanced options which do and do not consider ESG issues.

SuperRatings' research also showed that less than 1 per cent of total assets of funds surveyed were invested in investment options which consider ESG issues.

5.1.2 Trustees and ESG risks

The Panel considers that superannuation investment is long term and that trustees of superannuation funds, perhaps more than any other type of investors, are well placed to take advantage of long-term opportunities. Accordingly, they should consider ESG risks appropriately.

However, the Panel does not believe that the Principles for Responsible Investment, or similar, should be prescribed.

Recommendation 6.17

In developing investment strategies, trustees should explicitly consider both short and long term risks, consistent with their stated investment horizon. Trustees would not be required to make decisions based on ESG issues but as ESG issues represent one type of long term risk, trustees should consider ESG issues as they think appropriate.

5.2 Investment in infrastructure

5.2.1 Issues

Infrastructure investment is critical to Australia's long-term economic performance. This has been generally recognised most recently in the government's decision, as part of its response to the Australia's Future Tax System Review, to establish a new infrastructure fund for the States and Territories. The Government has also announced its intention to establish a Regional Infrastructure Fund to invest in projects with potential partner funding from States, private investors and/or local governments, with a particular focus on developments in mining regions and those which contribute to resource and export capacity.[43]

Infrastructure investments can also enhance superannuation funds' performance. Investing in unlisted infrastructure can be beneficial (although illiquid) because listed infrastructure (which is liquid) tends to move in line with broader market trends — eliminating much of the benefit of infrastructure as an asset class that is not closely correlated with other asset classes.

However, infrastructure has different characteristics from other asset classes, such as a high up-front cost, long life and potential lack of liquidity. There are significant scale benefits in infrastructure investment and potential investors need to devote substantial resources to understanding infrastructure projects.

There are limited data on superannuation investment in infrastructure. APRA does not currently collect separate data on this, and the different modes available to trustees to gain exposure to infrastructure investments mean that information is buried under different headings. Trustees' investment in listed infrastructure vehicles is reported to APRA as Australian or foreign equities and lending to infrastructure vehicles is reported as fixed interest, while direct investment or participation in private equity vehicles is reported within the category 'other'. At June 2009, 14 per cent of assets in the default investment options of large APRA funds were classified as being in the 'other' category.[44]

SuperRatings examined the average asset allocations of the balanced options in the largest 50 superannuation funds (includes industry funds, corporate funds, public sector funds and retail funds) from June 2005 to June 2009 and found that, on average, 8.1 per cent of assets were invested in direct or unlisted infrastructure.[45]

Super fund investment in other asset classes may also, indirectly, finance domestic infrastructure. For example, super fund participation in privatisations of existing government-owned infrastructure such as the telephone network, railways and airports has freed up government funds to facilitate debt reduction or other capital (or recurrent) expenditure. Direct investment in major companies, including those holding infrastructure assets formerly owned by government, can help finance their infrastructure developments.

The infrastructure fund for the States and Territories recently announced by the government will add another dimension to government financing of infrastructure and opportunities for investors.

It is important to distinguish between factors that might inhibit investment in infrastructure more broadly, and factors specific to superannuation. If there are broader factors inhibiting infrastructure investment, these should be addressed through a generic solution, so as to benefit superannuation and non-superannuation investors alike.

While a few submissions suggested that there are no barriers to superannuation fund trustees investing in infrastructure, most identified a number of barriers including:

- lack of suitable projects;
- lack of a secondary market;
- sovereign risk (such as a government changing the terms of the contract);
- complex and expensive bidding processes including due diligence tailor made for each individual project;
- an insubstantial consideration and offering by super funds of annuities and other like products, meaning that the apparent advantages of infrastructure as a long term, cash-flow stable asset class are of less value to super funds than might be initially thought;
- lack of scale on the part of funds;

- insufficient internal expertise in infrastructure;
- lack of transparency about pipeline and investment opportunities and inadequate integrated infrastructure planning;
- difficulties with valuation and unit pricing;
- concern that trustees focus too much on short term returns and infrastructure returns are more variable in the short term; and
- concerns about liquidity brought about by the 30-day portability rule.

A number of submissions identified the main barriers as being difficulties in dealing with State Governments such as complexity and costs in dealing with bidding for major projects, a lack of certainty about the progression of projects and sovereign risk. This 'project' risk is a challenge for all investors, not just superannuation funds.

The Panel notes that the Commonwealth Government has taken some steps to address these issues. For example, the Government announced as part of the 2010-11 Budget, reforms to promote a deep and liquid corporate bond market and the development by Infrastructure Australia of a coordinated pipeline of infrastructure projects.

5.2.2 Participation by super funds

The Panel is fundamentally opposed to the government mandating super fund participation in any particular investment class or vehicle, including infrastructure.

Infrastructure is like any asset class in that infrastructure investments will not automatically be a good investment proposition. Each project must be assessed on its own merits, particularly the risks involved.

The Panel considers the current regulatory regime has not had a significant adverse impact on infrastructure investment. Funds have been able to invest significant amounts in infrastructure within the current regime. For the reasons discussed earlier in section 3.2.2 in relation to liquidity more generally in MySuper products, the Panel does not believe change to the current benefit portability arrangements is necessary for superannuation funds to invest in illiquid investments such as infrastructure. Changes to these arrangements, such as increasing the portability requirement to 90 days or longer across the board, would likely have little effect given the challenges of liquidating infrastructure assets quickly, and would affect all fund members, whether or not they have an exposure to infrastructure investment. The Panel also believes that the exception to the 30-day rule for investments in illiquid assets such as infrastructure is appropriate for choice products.

There might be barriers to superannuation funds acquiring the scale or expertise to invest successfully in infrastructure in a cost-effective fashion. Infrastructure Partnerships Australia has identified the need to create scale in the superannuation industry in order to facilitate greater investment in infrastructure.[46] The Panel has recommended that trustees of 'MySuper' funds should have an explicit legal obligation to ensure they have sufficient scale to optimise net returns to members. This requirement should help drive the necessary scale for infrastructure investments. An increase in scale and expertise should provide opportunities for superannuation funds to purchase direct domestic infrastructure investments either alone or in partnership with other funds.

Recommendation 6.18

The government should not mandate that superannuation fund trustees participate in any particular investment class or vehicle, including infrastructure.

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3 Government Response to SWG Recommendations, 28 October 2002 <www.treasury.gov.au/contentitem.asp?NavId=&ContentID=459>.
4 Mercer, ‘Operational risk reserves a grey area for super funds’, <www.mercer.com.au/summary.htm?idContent=1345390>.
5 For example, IFSA, Submission no. 382, pp 29-30.
6 For example, AIST, Submission no. 380, p 30; PricewaterhouseCoopers, Submission no. 356, pp 14-15; Towers Watson, Submission 367, p 12.
7 On 13 May 2010 APRA released a discussion paper entitled Review of Capital Standards for General Insurers and Life Insurers, in which APRA proposes to introduce an explicit capital requirement for operational risk as part of required capital for both general insurers and life insurers. The current life insurance capital requirements include a margin applied to the capital held in respect of investment-linked life insurance business that mainly relates to operational risk. This margin would be replaced by the proposed new operational risk capital charge.
8 Where a superannuation trustee is a member of a conglomerate group, APRA is proposing that the capital requirement for the group should cover the risks of the trustee’s activities. This capital would be the greater of: 0.25 per cent of funds under management on account balances not invested in life insurance policies or bank deposits of a related party; any regulatory capital requirement that applies directly to the trustee; or the capital requirement calculated by the trustee’s or group’s internal model. This capital may be held anywhere in the group as long as it is readily available to the trustee when required. Following consultation, APRA expects to finalise the prudential standards for conglomerate groups during 2011 with a view to commencement during 2012.
9 For example, Law Council of Australia, Submission no. 336, pp 11-12.
10 Australian Prudential Regulation Authority 2004, Superannuation Guidance Note 130.1 Outsourcing, APRA, <www.apra.gov.au/Superannuation/upload/SGN-130-1-Outsourcing.pdf>.
11 AAS, Superpartners and Pillar Administration, Submission no. 213, p 2
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SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 7
Retirement

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KEY THEMES

Issue

The retirement income product market has been under-developed, largely reflecting the relatively small balances that many retiring workers hold as a consequence of the quite recent introduction of the compulsory SG Act system (being less than 20-years old). Australians have historically favoured lump sum superannuation benefits, partly because that is all that most funds have offered.

Currently, the market is dominated by account-based products in which the risks associated with investment markets and inflation (and longevity) are directly borne by the member. There is a need with an ageing population for more retirement products to be available for members.

Proposed solution

The Panel proposes measures, including:

- requiring MySuper trustees to offer a retirement product to MySuper members;
- requiring MySuper trustees explicitly to consider longevity and inflation risks when developing investment strategies for post-retirement members; and
- requiring MySuper trustees to offer pro-actively advice periodically to members planning for, or already in, retirement.

Benefits for members

Members will benefit from these measures to improve the design and availability of retirement products as:

- members can use intra-fund advice when planning for retirement and selecting retirement income products (including income streams);
- the market may respond with more innovative products as trustees focus more explicitly on members' longevity risks; and
- members will have the ability to stay in one MySuper product while working and in retirement.

1 RETIREMENT

1.1 Retirement income as the primary rationale of the superannuation system

While much of the focus in superannuation is on the accumulation phase, the primary reason for the existence of Australia's superannuation savings regime is to provide income for Australians in their retirement. This is already reflected in the 'sole purpose test' — the statutory definition of the purposes for which a superannuation fund must be maintained.[1] More broadly, the Panel considers the government and the superannuation industry should be emphasising to members that the retirement phase of a person's participation in the superannuation system is the key purpose for the accumulation of superannuation savings.

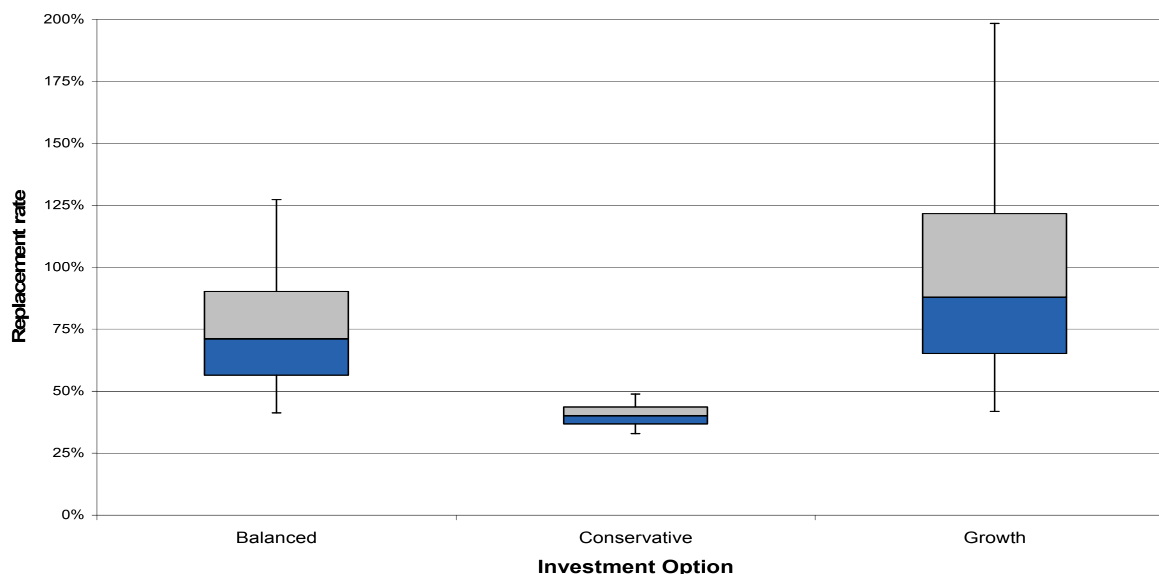
1.2 Superannuation as an element of the broader retirement system

The superannuation system is part of a broader 'retirement system'. Superannuation provides a government assisted capacity to generate private income, and this is supplemented by extensive direct public support for retirees (through the age pension, public health support, aged care provision etc), as well as other personal saving and assets, principally the family home. All of these factors help shape the retirement experience of individuals. It is important that these policies work in a coherent way to ensure that people have the right incentives and support to maximise their wellbeing in retirement. These are not matters within the scope of this Review. However, it is important that funds, members and advisers take account of these broader issues.

1.3 Managing investment risk up to retirement

As the great majority of Australians are in defined contribution schemes, their final superannuation benefit is substantially affected by investment returns and associated risk. This is shown in Figure 7.1 below.

Figure 7.1: Distribution of final superannuation benefits by investment option (based on 12 per cent SG contributions)

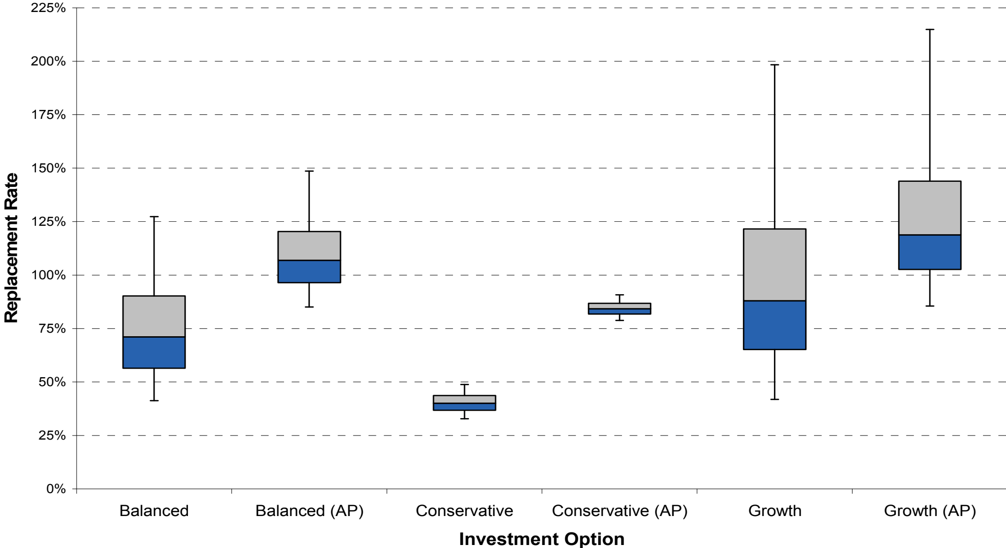


Note: Boxes represents interquartile ranges. The range represented by the line is from the 95th percentile to the 5th percentile of outcomes. The range represented by the grey box is from the 75th percentile to the 50th percentile, while the range represented by the blue box is the 50th percentile to the 25th percentile. The line in the middle of the box represents the median outcome. The replacement rate is the average annual CPI-deflated retirement income as a percentage of a person's final pre-retirement net income. The AGA modelling is based on a final pre-retirement net income of $50,000. Replacement rates are calculated using an assumption of constant earnings during the retirement phase and assuming a draw down such that capital is exhausted when the member reaches average life expectancy. Source: Australian Government Actuary.

This shows that there can be significant differences in superannuation balances at members' preservation ages depending on the investment option chosen, whether by the trustee in its MySuper strategy or by members in the choice environment. However, even for a given asset allocation, returns can vary substantially because of variability in asset performance over long periods of time. In other words, different 40-year accumulation periods can result in very different superannuation benefit outcomes.

While this shows that members face substantial uncertainty, the situation is substantially altered once the age pension system is taken into account. The age pension both increases retirement incomes for those who experience adverse investment outcomes from their superannuation during the accumulation phase and, due to the age pension taper rate, reduces the variability of retirement incomes. For low and middle income earners, the age pension increases retirement income whether or not they have adverse investment outcomes.

Figure 7.2: Distribution of final superannuation benefits by investment option, with and without the age pension (AP)



Source: Australian Government Actuary.

Another important consideration is that Australia does not require members to take their superannuation as an annuity on retirement. In countries with compulsory annuitisation, members of defined contribution schemes can be locked into lower income streams if markets fall shortly before their retirement as the value of the annuity is based on the value of their lump sum and market conditions on retirement day. In contrast, Australians can continue to invest in growth assets after retirement and thus potentially benefit from subsequent market upswings. The income guarantee provided by the age pension means that members experience minimal downside risk from an exposure to growth assets throughout their working life, while having considerable upside. This outcome has also been recognised by AustralianSuper, which recently reviewed its default investment option for pension accounts and decided to retain the balanced option as the default until age 75.[2]

While the age pension reduces the effect of investment risk on low and middle income earners, the Panel also considered other means of reducing investment risk in the pre-retirement phase; specifically life cycling investment options and reserving. However, the analysis suggested that there is not a strong case for mandating either lifecycle investing or reserving mechanisms to smooth investment returns. Submissions also argued against mandatory measures in this regard. Instead, the Panel believes the best approach is for trustees to consider carefully default investment options in the light of overall member needs and for members to consider their individual circumstances as they approach retirement.

2 THE RETIREMENT PHASE

While the ultimate purpose of superannuation is to provide benefits in retirement, the majority of the industry's attention to date has been paid to the accumulation phase. This is not particularly surprising given that the system is still maturing. It is only since 2002 that workers have had the benefit of the 9 per cent SG level. Accordingly, superannuation balances on retirement are typically

small and make a modest contribution to the total income an average worker will receive in retirement. The median superannuation balance for people aged 55-64 years old in the accumulation phase is only $72,000.[3]

A feature of Australia's system is the flexibility people have in how they take their retirement benefits. Unlike some other countries, people are free to take superannuation as a lump sum, whether to invest outside the super system, repay debt or for immediate consumption. For those who take their benefits in whole, or in part, as an income stream, the system is dominated by account-based products in which the risks associated with investment markets, longevity and inflation are directly borne by individuals to a greater extent than most, if not all, other comparable jurisdictions.

The market currently offers a range of retail and individual products to convert a lump sum to a retirement income stream. Examples include guaranteed lifetime or term annuities and account-based pensions. A common characteristic is that they do not accept contributions.

In Australia, account-based pensions account for about 88 percent of the post-retirement assets compared to guaranteed lifetime or term annuities which account for the balance.[4] Although account-based pensions provide a regular income stream, they cannot, on their own, guarantee the security of income over a member's lifespan in retirement though, as noted in section 1.3 above, the volatility of an individual's income is cushioned by the availability of the age pension.

However, the retirement product market is changing for three key reasons: increasing account balances as the SG system matures; an increasing number of people in the market with the retirement of the baby boomers; and higher life expectancies. These factors have led to a surge of new ways to deliver post-retirement solutions — and presented challenges to industry participants, regulators and the government to structure, manage and supervise these solutions.

Longevity risk is increasing given that life expectancies are increasing. As both the number of retirees and their account balances increase, the importance of managing longevity risk will increase substantially.

2.1 Size of the post-retirement superannuation system

The number and proportion of Australians drawing pensions from superannuation funds has increased substantially in recent years, although the proportion of total account numbers is still quite modest at around 2.3 per cent, as seen from table 7.1. However, as a proportion of the total population of pensionable age, the share is much more significant at around 23 per cent, and growing strongly. Treasury estimates that the number of people receiving some form of superannuation pension will roughly double to 1.4 million by 2035.

Table 7.1: Pension members in large APRA funds

	2004	2005	2006	2007	2008
No. of pension accounts	399,486	447,769	519,115	581,564	689,158
No. of super accounts	24,380,516	25,966,194	26,952,436	28,261,950	29,781,552
No. of people of age pension age	2,794,392	2,811,623	2,872,792	2,904,716	2,983,222
Pension accounts as % of all people of pension age	14.30	15.93	18.07	20.02	23.10
Pension accounts as % of super accounts	1.64	1.72	1.93	2.06	2.31

Note: Account figures exclude exempt public sector superannuation schemes.
Source: *2010 Intergenerational Report* and *APRA, Superannuation Fund Level Profiles and Financial Performance,* December 2009.

Pension accounts are typically of a much higher value than accounts in the accumulation phase so that the share of assets in the retirement phase, estimated at 20 per cent of all superannuation assets in 2009 (refer to table 7.2), is far higher than the 2.3 per cent share of all super accounts. This asset share will grow substantially. Analysis by Rice Warner Actuaries suggests that by 2024, post-retirement assets will comprise more than a third of total assets, up from a fifth at present and will be worth $1.5T in nominal terms. Similarly, Treasury estimates that post-retirement assets will more than triple by 2035 to reach $850B in real terms.

Table 7.2: Post-retirement market: assets

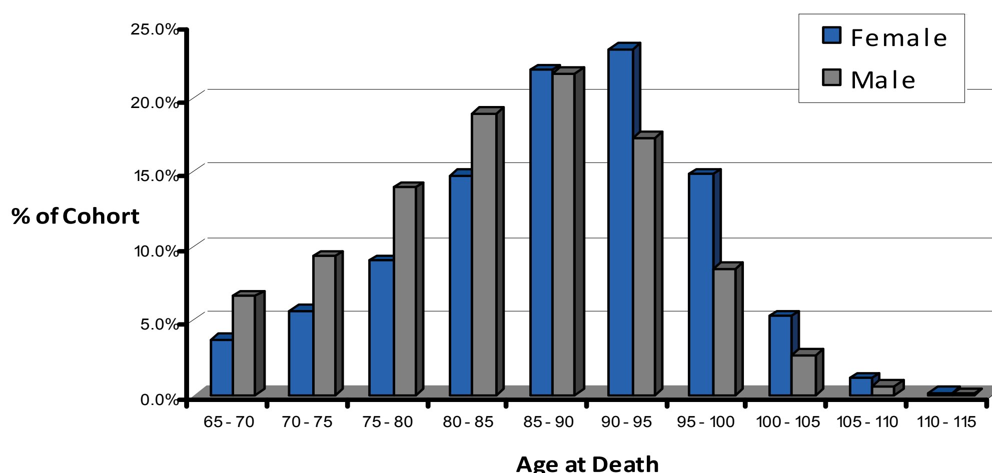
	2009		***2014***		***2019***		***2024***	
	$M	%	$M	%	$M	%	$M	%
Corporate Funds	7,030	3.3	6,514	1.4	3,012	0.3	1,239	0.1
Industry Funds	18,810	8.8	76,113	16.8	193,560	22.0	367,429	24.8
Public Sector Funds	32,353	15.1	49,950	11.0	74,382	8.5	113,304	7.7
Retail Funds	97,162	45.4	204,305	45.0	399,486	45.5	675,581	45.7
SMSFs	58,693	27.4	117,068	25.8	207,698	23.7	321,312	21.7
Total Post Retirement Market	**214,048**		**453,950**		**878,139**		**1,478,864**	
% of all Super Assets		**20%**		**25%**		**31%**		**35%**

Source: Rice Warner, *Surviving Longevity,* March 2010.

2.2 Managing the drawdown phase

Longevity risk is the uncertainty about how long a particular person (or group of people) will live. Figure 7.3 below shows the substantial variability in age of death, which makes it virtually impossible for a person to manage their own superannuation drawdown in an optimal manner. A retiree who aims to draw down their assets so as to deplete them on reaching average life expectancy has a significant risk of running down their superannuation savings too quickly or too slowly. If they die ‘early’, their remaining superannuation benefits will flow to dependants or to their estate. If they live longer than life expectancy, their superannuation savings will run out, leaving them fully dependent on the age pension. To help guard against the possibility of outliving their savings, retirees might draw down their assets too conservatively, resulting in them failing to enjoy the living standard during their retirement that they otherwise could have had.

Figure 7.3: Probability Distribution of Age at Death



Source: Rice Warner, *Surviving Longevity*, March 2010.

Life expectancy continues to increase at a significant rate. For example, the *2010 Intergenerational Report* projects an increase in average remaining life expectancy of 60-year olds from 23.4 years in 2010 to 29.2 years in 2050 for males and from 26.6 years to 31.4 years for females.[5]

Longevity risk is not the only reason why retirees might not draw down their superannuation savings optimally. Some retirees might simply want to enjoy their money now and find it hard to reduce their expenditure in retirement or defer access to their superannuation lump sum. There is also the potential for some to use their superannuation savings to pay off debt. On the one hand, it is quite sensible to use superannuation benefits to pay off debts on retirement, rather than continuing to pay interest. However, it would significantly undermine the superannuation system if people deliberately increased their pre-retirement indebtedness on the basis they could repay the debt with their superannuation. This practice would have an effect similar to allowing people to access their superannuation before retirement to fund current day consumption.

Retirees' incentives are also affected by the age pension and tax systems. Given the nature of the Australian age pension means test, people who exhaust their assets quickly can receive more age pension over their lifetime. On the other hand, people who use an income stream product benefit from the earnings tax exemption such that they can enjoy higher overall consumption.

The available evidence suggests that, at present, there is no systemic problem of retirees who start an income stream with their super drawing it down too quickly, with a view to intentionally 'double-dipping' into the age pension system. For instance, Lim-Appelgate and others found that part rate age pensioners are maintaining their wealth in a way that will be sustainable even if they outlive average life expectancy.[6]

The Australian Bureau of Statistics (**ABS**) has estimated that of the approximately 2 million living Australians who had received, or were receiving, a superannuation benefit in 2007, 55 per cent had taken their superannuation benefit entirely as a lump sum, 35 per cent as a pension and 10 per cent as a combination of the two.[7] In addition, ABS data suggest that the number and proportion of people who receive substantial lump sums (worth $60,000 or more) is relatively low (table 7.3).

Table 7.3: Retired persons, value of lump sum payments received in past 4 years

Value of lump sum payments received from superannuation	Number (000s)	%
$1–$9,999	45.1	21.8
$10,000–$19,999	34.5	16.7
$20,000–$39,999	46.0	22.2
$40,000–$59,999	31.3	15.1
$60,000 or more	43.9	21.2
Value not known	6.0	2.9

Source: ABS, Employment Arrangements, Retirement and Superannuation, Australia, April to July 2007, June 2009 (6361.0.55.004).

APRA data also show that the proportion of benefits being taken as income streams is increasing. In 1996-97, of the total $18.5B benefits paid, $4B was paid as pensions and $14.5B as lump sums. In 2008-09, of the total benefits paid of $62B, $30B was paid as lump sums and $32B as pensions. That is, the share of benefits taken as a pension has increased from around a fifth to over a half.

The fact that many in the community are able to conserve assets in retirement without using specific longevity products does not detract from the value of such products. For instance, Challenger analysis suggests a 65-year old with a $500,000 balance who wants to manage their assets on the basis they will live to 95, can buy a lifetime annuity and have an income of approximately $33,000 for the remainder of their life. In contrast, a person relying on an account-based product could have an expected income of only $23,000, depending on the way in which the account was drawn down.[8] Accordingly, it is important that there is a range of products available to help people manage longevity and investment risks in their retirement.

2.3 Product innovation in the income stream market

By far the most popular income stream product today is the account-based pension. People can use their lump sum benefit to start an account-based pension, formerly also called an allocated pension. People can choose what amount of money they wish to draw down each year, subject to a statutory minimum. Their account earns income from the underlying assets which may comprise of growth and/or defensive assets. Accounts can rise or fall in value depending on the performance of investment markets.

Account-based pensions have become more attractive relative to other retirement income stream products in recent years, including through the transition to retirement provisions and the removal of preferential treatment of certain lifetime annuities.

2.3.1 'New generation' retirement products

A number of industry participants have turned their minds to the challenge of product innovation in the post-retirement phase. The broad theme of these developments has been to explore ways to better manage the key risks (investment, longevity and inflation) to which people are directly exposed in the account-based pension framework.

Some of the key product ideas being advanced by different industry participants in this area, and reflected in submissions to the Review, include:[9]

- The conversion of retirement lump sums into lifetime or deferred annuities.

- The adaptation to the Australian market of 'guaranteed minimum benefit' or variable annuity products based on US and European precedents, under which investors retain access to their capital, but can still obtain a level of guarantee (either over a fixed period or for the remainder of their lives) that is underwritten by the offering institution and/or a third party reinsurer.

- Longevity risk pooling products, under which individual retirees opt in to a collective mechanism that is designed to equitably re-distribute the unspent savings of those participants who die before reaching their average life expectancy to those who outlive the average.

- The extension of 'lifecycle' investment options not just up to, but also beyond a member's retirement date, in an effort to minimise exposure to investment risks through gradual changes in asset allocation of a retiree's portfolio as they age, through some form of built-in 'glide path' or other mechanism.

- The development of 'collective pension schemes' along the lines of some European and North American multi-employer pension schemes. These schemes combine elements of both defined benefit and defined contribution structures, with the aim of providing stable and predictable retirement incomes for members without imposing open-ended liabilities on employers.

- The transformation of housing wealth into retirement income streams for example, via reverse mortgages. As noted in section 5.1, housing is an important factor in determining living standards in retirement and the ability to manage housing wealth can be significant.

Over recent months, there have been some high profile launches of new products by large investment institutions in this area.[10] The Panel expects that there will be more such activity in both the retail and not-for-profit sectors as more Australians move into the post-retirement phase and competitive market forces play out over coming years.

2.3.2 Role of government and regulation

A key question influencing the development of particular retirement income products is the degree of government support, through taxation, social security treatment or compulsion. These issues were explicitly considered in the Australia's Future Tax System Review (**AFTS Review**).[11]

The AFTS Review found that as people live longer, they will require more options to manage their assets over a longer period and the system will need to become more flexible so it can provide these options.

While arguing that annuities or longevity insurance should not be mandatory, the AFTS Review found that Government should support product innovation and better facilitate their provision by the private sector. It also argued that the private sector is better placed to develop products that meet the needs of retirees.

It found the main longevity product currently available in the market was a guaranteed lifetime annuity which is unpopular among retirees because it has been seen as not offering good value for money. Submissions to the AFTS Review and this Review argued that providers of retirement income products have been reluctant to develop new products due to the prescriptive rules that set out what an income stream is. These rules were designed to ensure that the earnings tax exemption on superannuation pension assets supports only products that deliver a genuine income stream.

To encourage product innovation, the AFTS Review recommended (recommendation 21) that:

- The Government should remove the prescriptive rules in the Superannuation Industry (Supervision) Regulations 1994 relating to income streams that restrict product innovation.[12] (It also recommended that this be done in conjunction with the recommendation to have a uniform tax on earnings on all superannuation assets.) For example, the current minimum annual payment rule prevents the development of products that defer payment of an income stream.

- The Government should issue long-term securities, but only where it is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance.

- The Government should make available the data needed to create and maintain a longevity index that would assist product providers to hedge longevity risk. Longevity indexes, known as LifeMetrics, have been established in the UK, the Netherlands, Germany and the US by JP Morgan.

It also recommended (recommendation 22) that the Government should consider offering an immediate annuity and deferred annuity product that would allow a person to purchase a lifetime income. However, it noted that the Government already takes on the overwhelming majority of longevity risk through the age pension.[13]

Submissions to this Review and the AFTS Review also raised the issue of coordination among regulators and between the agencies. Currently, product providers have to deal with many different regulators, including the ATO, APRA, FaHCSIA and ASIC. The AFTS Review noted that taxing fund earnings at a uniform rate would remove the need for there to be specific rules about what products are eligible for tax concessions, and hence remove the need for the ATO to be involved in the regulation of income streams.

While the Government has ruled out offering income stream products itself, it has yet to respond to the other relevant recommendations of the AFTS Review.

The Panel supports the emphasis in the AFTS Review on seeking greater flexibility within the system, including in relation to the prescriptive rules relating to income streams. The Panel also recognises the constraints raised in the AFTS Review such as tax integrity. Submissions to this Review were consistent in relation to reviewing or removing the prescriptive rules relating to income streams as the means of improving the availability of retirement incomes streams in the Australian market.[14]

In the context of the terms of reference of this Review, the Panel notes that post-retirement product innovation, while showing promising signs, is still at a relatively embryonic stage in Australia. At this stage, it appears unlikely that any one product type will produce a panacea for all of the risks and issues confronting Australian retirees and the public pension system that supports them. Consequently, it might unduly distort the market and the scope for further innovation to recommend that any one product type be favoured by regulation to the exclusion of others. At the same time, it will be important for regulators to avoid becoming inhibitors to innovation through unnecessarily rigid rules.

2.4 Net investment performance and fees

Investment returns continue to matter in the post-retirement phase. According to Treasury, around 40 per cent of total benefit (in nominal terms) can be expected to be derived from post-retirement earnings. Treasury estimates that for a person who retires aged 65, their total superannuation

benefit will be around 8 per cent higher if they can achieve a 1 percentage point per annum higher net return post-retirement.

Net investment return is a function of gross returns, less fees and taxes. Gross returns are mostly influenced by asset allocation. Asset allocation tends to be more conservative in the drawdown phase than the accumulation phase, which is unsurprising given that people place a higher value on return stability during their retirement years.

2.4.1 Fees for retirement products

In 2008, Rice Warner found that the average annual fee as a percentage of funds under management for allocated pensions (from for-profit funds) ranged from approximately 1 per cent to about 2.5 per cent, with an average fee of 1.86 per cent (table 7.4). While, typically, the fees charged by not-for-profit funds on such products are lower, the bulk of post-retirement assets are managed by the for-profit sector.[15] Chant West also notes that fees paid on post-retirement products in the not-for-profit sector are higher than those paid on accumulation accounts.[16]

Table 7.4: Fees for pension products

Allocated Pension Account Balance	Assets	Administration	Platform	Investment management	Adviser	Expense rate
	($M)	*(%)*	*(%)*	*(%)*	*(%)*	*(%)*
> $1 million	4,166	0.01	0.33	0.63	0.53	1.51
$500,000 — $1 million	12,633	0.01	0.38	0.68	0.53	1.60
$250,000 — $500,000	21,026	0.02	0.44	0.73	0.53	1.73
$100,000 — $250,000	25,435	0.05	0.51	0.79	0.56	1.91
$50,000 — $100,000	9,995	0.10	0.58	0.85	0.63	2.16
$25,000 — $50,000	2,802	0.22	0.67	0.92	0.73	2.54
< $25,000	465	0.99	0.77	0.98	1.17	3.91
Total allocated pensions	***76,521***	***0.05***	***0.48***	***0.76***	***0.57***	***1.86***
Guaranteed annuities	**10,392**	**1.25**	**-**	**0.20**	**0.25**	**1.70**
Total retail post retirement	**86,913**	**0.20**	**0.42**	**0.69**	**0.53**	**1.84**

Source: Rice Warner, Superannuation Fees Report 2008, December 2008

These fees are around 50 per cent higher than those in the accumulation phase and average fees for superannuation products as a whole, on a percentage of assets basis.

The main factors creating higher fees in post-retirement products seem to be advice and product complexity. In addition, and perhaps related, this segment is highly ‘retail’ and individualised in contrast to the accumulation phase where employers or other associations may bargain on behalf of employees.

It follows that the fees in this segment are broadly similar to those in the personal retail area. On most account balances, fees in the post-retirement phase are higher than for personal accumulation plans. It is not until account balances reach about $100,000 that fees become similar. However, as the average balance in post-retirement products is much higher, the average fee as a percentage of assets is lower.[17]

In common with other products, allocated pensions appear to experience significant reductions in investment management and advice fees as their average account balances increase. In other words, members benefit from economies of scale as their account balances increase.

As part of its research, Rice Warner estimated the average implicit fee for guaranteed annuities (because these products do not have explicit fees) at 1.70 per cent of assets under management in 2008.

Generally, advice fees are bundled with allocated pension products with fees ranging from 1.17 per cent of assets under management for accounts with balances less than $25,000 to 0.53 per cent for accounts with balances over $250,000.

The Panel doubts whether the higher fees for allocated pensions are justifiable. There may be some additional complexity in post-retirement products that justifies the additional fees. This could benefit from further examination.

The Panel considers there is scope for these fees to be reduced substantially. The following policy responses are designed to deliver these reductions:

- the introduction of MySuper products and the requirement that those products have a retirement income stream component should help build scale and place more emphasis on products' financial returns to members; and

- the Government's decision to ban commissions under the *Future of Financial Advice* package should help ensure planners recommend retirement income products that offer good value for money.

2.5 Managing investment risk during retirement

Investment risk in the post-retirement phase is particularly important because of two factors. First, the investment horizon is shorter, though still typically fairly long. Second, there is usually no or limited ability to offset poor returns with higher contributions or other income aside from the age pension which, over the income test taper range, increases by 50 cents for each dollar by which other assessable income falls.

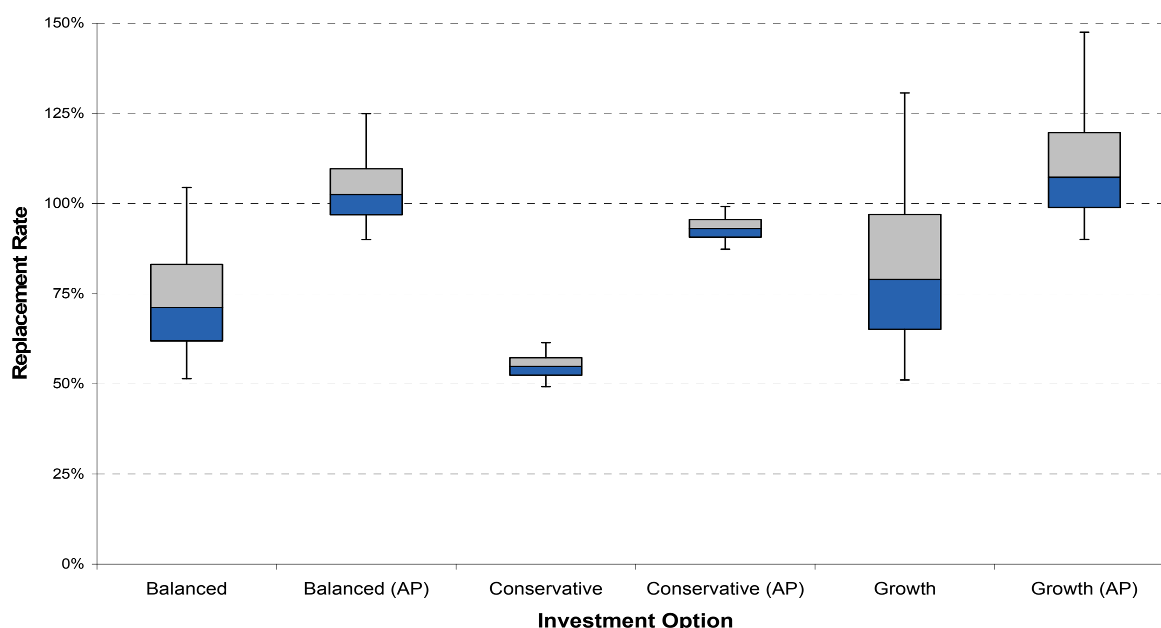
The thrust of submissions to the Review was that it should not be mandatory for trustees to manage pension assets separately from accumulation assets as a means of dealing with investment risk in the retirement phase. Common reasons cited included that to do so would dilute the benefits of scale — by pooling these assets trustees are able to have larger mandates and incur lower investment management costs. Concerns were also raised with respect to the risk of losing investment opportunities and the likely increase in costs.[18] Some submissions also argued that this risk was best addressed through the trustee offering pension members a range of investment options.[19]

Submissions generally did not favour diversification requirements or limits on member-level investment choices as a means of attempting to better ensure that post-retirement product distributions are paid. Some submissions argued strongly that decisions regarding the best way to structure their investments, having regard to the different tax treatment of accumulation and pension assets, should be left to trustees as part of their fiduciary responsibility. Submissions also argued that a range of investment options and member education were the most appropriate way to meet the needs of different members.[20]

The Review commissioned the Australian Government Actuary to examine the impact of different investment strategies on retirement benefits, including in the post-retirement phase.

Overall, the results indicate that the type of investment strategy undertaken continues to be important in the drawdown phase. Figure 7.4 shows that while returns are variable, this variability is tilted to the upside. In fact, the outcome for the 'growth' investment strategy exceeds that for the 'balanced' strategy 92 per cent of the time, the 'growth' strategy outcome exceeds the 'conservative' strategy outcome 95 per cent of the time and the 'balanced' strategy outcome exceeds the 'conservative' strategy outcome 96 per cent of the time. Even in the small proportion of time where a more aggressive strategy underperforms, that underperformance is itself relatively small (less than 12 per cent). Naturally, the age pension plays an important part in smoothing out the impact of investment performance on replacement rates.

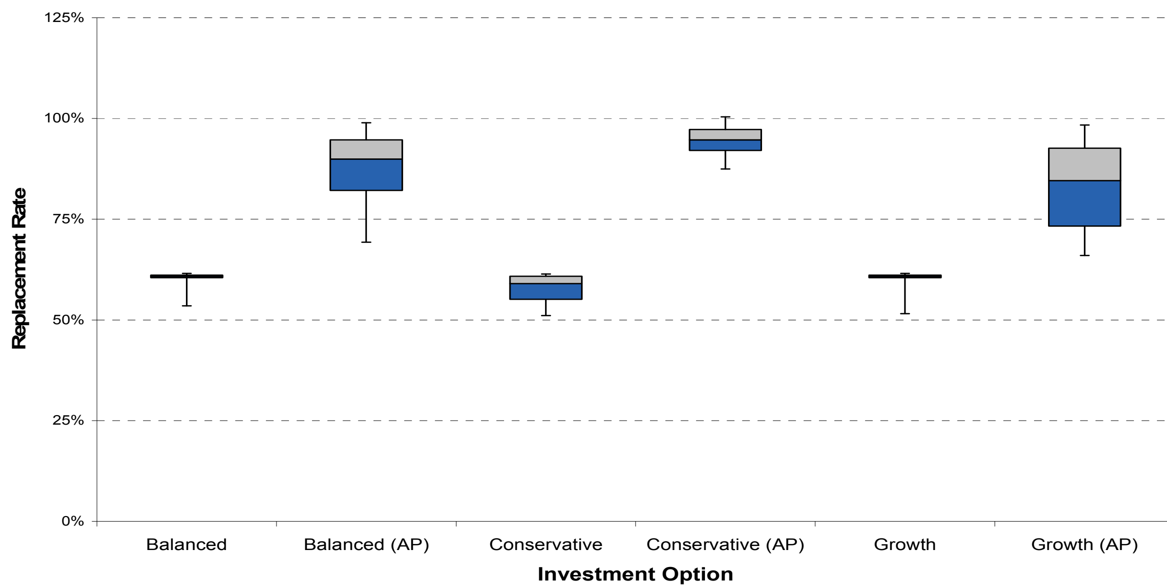
Figure 7.4: Replacement rates with alternative retirement investment strategies, with and without age pension (variable drawdown over 22 years)



Note: The AGA modelling is based on an account balance of $400,000 at retirement, average investment earnings of 6 per cent per annum and variable drawdowns over a 22 year period. Drawdowns are assumed to be the mid point of the former maximum and minimum allocated pension drawdown percentages.
Boxes represent interquartile ranges. For example, a balanced investment option without the age pension is expected to provide a median annual income of about 70 per cent of final pre-retirement income. In 50 per cent of cases it is expected to provide an annual income between 60 and 80 per cent of final pre-retirement income. In 5 per cent of cases it is expected to provide an annual income over 105 per cent of final pre-retirement income and in another 5 per cent of cases it is expected to provide an annual income of less than 50 per cent of final pre-retirement income.
Source: Australian Government Actuary.

The result above assumes that the amounts drawn down vary with investment performance so that during periods of higher returns, members draw down higher amounts, and vice versa. If it is assumed that members draw down a fixed dollar amount, the results are quite different (Figure 7.5).

Figure 7.5: Replacement rates with alternative retirement investment strategies, with and without age pension (constant drawdown over 22 years)



Note: Drawdowns are assumed to be constant (inflation-adjusted) and equal to the account balance at retirement divided by an annuity factor of 15.
Source: Australian Government Actuary.

In this case, a 'conservative' investment strategy can provide higher replacement rates than 'growth' strategy and with more certainty. This result occurs because, with a 'growth' investment strategy, a fixed drawdown can deplete assets quickly if there is a period of below-average investment performance. On the other hand, the fixed drawdown means replacement rates are not higher in the 'growth' investment strategy even if there is above average performance. The flipside of this result is that a constant drawdown will result in virtually no residual at life expectancy for retirees invested in 'conservative' strategies while often there will be a substantial residual for those invested in 'balanced' or 'growth' strategies. In reality, retirees face substantial longevity and investment risk and both these factors need to be taken into account in both investment and drawdown decisions.

These results suggest that determining a person's optimal investment strategy and drawdown behaviour can be complex, particularly in light of longevity risk. The degree to which members face investment risk depends on the nature of the underlying assets. Higher investment risk is associated with higher long-term returns on average and the appropriate balance between risk and return differs across investors. In addition, the age pension provides a significant dampening influence on investment risk for many people receiving income streams (for those in the taper range), and a minimum floor in the case of the full-rate age pension. People in the drawdown phase will also have varying abilities to access non-superannuation sources of income. For these reasons, different people might reasonably have quite different risk/return appetites and so wish to hold different underlying assets.

Accordingly, the Panel does not consider it appropriate to mandate any particular level of investment risk or asset allocation for retirement income products. Nor does the Panel consider that encouragement needs to be given to products with different investment risk characteristics as the market appears to be offering investors widening choice.

3 LIQUIDITY RISK

Liquidity risk is a particular issue for people in the post-retirement phase as they will typically need access to cash to meet day-to-day living expenses. The GFC demonstrated that assets that were thought to be liquid quickly turned illiquid. The Panel considers that good advice and appropriate 'defaults' are the best means of managing liquidity risk, along with APRA ensuring, as part of its regulatory oversight, that trustees take account of the heightened liquidity needs of members in the retirement when devising their investment strategies.

4 MYSUPER AS AN INTEGRATED RETIREMENT PRODUCT

The Panel believes that MySuper products should not just cover accumulation to retirement, but also the drawdown phase. The Panel views MySuper, in its ultimate form, as a whole of life product, and considers that this is a key part of the MySuper concept.

While the Panel acknowledges that there is not a 'one-size-fits-all' post-retirement product, it notes that allowing MySuper providers to provide multiple choices would increase the complexity of the product. With this in mind, the Panel has decided that a MySuper fund should only be able to offer one type of income stream product, noting that interested members are free to choose any other product in the choice sector.

The Panel acknowledges there would be a range of other issues that would need extensive consultation and development with industry. Options in relation to the types of post-retirement products appropriate for MySuper include products that retain exposure to growth assets after retirement, annuity products and other longevity risk hedging and a range of account-based pension products. The Panel recognises there is a great deal more work that needs to be done in this area. This work should begin as soon as practicable. A particular focus should be considering what, if any, default arrangements should apply to any MySuper income stream products. Of course, the enhanced fiduciary responsibility applying to MySuper providers outlined in chapter 1 would apply with respect to their retirement product.

Recommendation 7.1

MySuper products must include one type of income stream product, either through the fund or in conjunction with another provider, so that members can remain in the fund and regard MySuper as a whole of life product. The Government should consult comprehensively with industry before mandating the post-retirement arrangements to apply to MySuper products.

5 THE NEED FOR ADVICE IN MANAGING RETIREMENT INCOME

In view of the complexity of decision-making that surrounds transforming an accumulated lump sum benefit into an income stream that will ensure a comfortable retirement, the Panel considers that sound advice must play a key role for members.

5.1 Advice approaching retirement

As people near retirement age, they need to consider a wider range of superannuation-related issues. These include the age at which they plan to retire at, how much superannuation they will need to have to achieve the lifestyle they want, whether their housing will suit them as they age, whether they wish to transition to retirement by starting to work part-time and whether their superannuation investment strategy remains suitable. These decisions themselves are affected by not only the superannuation system and the balances they have accrued, but also the age pension and other government policies. These are complex matters which turn on individual circumstances. There is not a 'one-size-fits-all' solution. Most people need to revisit these issues and their choices as they age and their circumstances change.

Many people would benefit from having access to advice on these issues. Superannuation funds can help meet this need through intra-fund advice. Under the Panel's recommendations in chapter 1, MySuper products would be required to have an intra-fund advice facility. In addition to this the Panel believes that MySuper funds should proactively engage with members at an appropriate time before normal retirement age to offer advice so members can start planning to prepare for retirement. For instance, funds could contact members at age 45 and then at five-yearly intervals. The nature of the advice that funds provide would likely evolve over time and funds could link in with other sources of information and advice, such as the National Information Centre on Retirement Investments. The sole purpose test restricts the types of advice that can be paid from members' accounts. It is possible, therefore, that some of this broader advice provided by funds would need to be paid for separately.

While the Panel supports the provision of intra-fund advice to choice product members, it does not consider it necessary to mandate this.

Recommendation 7.2

Trustees should be required to offer intra-fund advice proactively to MySuper members as they approach normal retirement age. Over time, advice should be available on as broad a range as possible of the financial issues that members will face in retirement, subject to the requirements of the sole purpose test. In the near term, advice should address investment allocation and alternative retirement products offered within the fund.

5.2 Advice after retirement

Similarly, the Panel considers that trustees should proactively offer intra-fund advice to MySuper members in the retirement phase at periodic intervals (perhaps every five years). Again, while the Panel supports the provision of intra-fund advice to choice members, it does not consider it necessary to mandate this.

Recommendation 7.3

Trustees should offer intra-fund advice proactively to MySuper members in the retirement phase at periodic intervals.

6 ENHANCED TRUSTEE ROLE FOR RETIREMENT PHASE

At the current stage of industry evolution, the Panel considers that the best approach to promoting the interests of super fund members in the retirement phase is to ensure the accountability of trustees, in much the same way as the Panel has recommended for the accumulation phase. Trustees are best placed to understand the particular demographics of their funds' membership bases, to communicate with those members about the risks and options involved, and to mobilise their service providers to deliver the most appropriate retirement products.

The Panel notes that the duties of the trustee in relation to investments has received express legislative attention. The investment strategy covenant and operating standard serves to focus the trustee on its core duty to formulate and give effect to an investment strategy for the fund as a whole that has regard to factors such as risk, diversification, liquidity and the ability to discharge liabilities.[21]

While the breadth of these factors can cover post-retirement concerns, the Panel notes that the risk profile, tax treatment and liquidity needs of those drawing a pension from a superannuation fund are all likely to be different from those of members in the accumulation phase. That is, the notion of a single investment strategy for the fund might not be appropriate once post-retirement assets become substantial.

Accordingly, the Panel believes that the regulatory arrangements should also articulate new and specific duties for MySuper trustees in relation to post-retirement members. A key element of this is to ensure that MySuper trustees are responsible for devising an investment strategy not just for the fund as a whole, but for the assets held on behalf of post-retirement members. This should have regard to the existing factors — risk, diversification, liquidity and the ability to discharge liabilities, as set out in section 52(2)(f) of the SIS Act — plus two new factors — inflation risk and longevity risk. Trustees would work out how they propose to fulfil these new specific duties in the circumstances of their fund's particular characteristics.

Recommendation 7.4

Trustees must devise a separate investment strategy for post-retirement members in MySuper products which has regard to the factors as set out in section 52(2)(f) of the SIS Act as well as inflation and longevity risk.

7 COLLECTIVE PENSION SCHEMES

Collective pension schemes aim, but do not guarantee, to provide a certain level of benefit for employees while limiting employer contributions to a defined contribution. That is, employers pay a fixed contribution which is actuarially determined over time to provide a high likelihood of being able to pay a defined benefit of a certain amount. Ultimately, however, the benefit paid to employees will depend on investment returns. If returns are poorer than expected, the benefit to employees can be reduced and potentially vice versa. This differs from defined benefit schemes where investment risk (upside and downside) falls on the employer.

The Netherlands operates industry-wide collective pension schemes. Under their schemes, benefits are defined as an annuity. In Australia, UniSuper operates an industry-wide hybrid defined contribution/defined benefit scheme for employees of the higher education sector. The design of this scheme provides for a defined benefit payable as a lump sum (which can be subsequently converted to a pension) where employers contribute a fixed 14 per cent of salary and where there is scope for the benefits to be adjusted for significant swings in investment performance.

Under these schemes, periods of higher investment returns can result in surpluses which can be drawn down in periods of below-normal returns. In the event of sustained high returns, some or all of the surplus can be returned to members as higher benefits. In the event of sustained lower returns, benefits to members would need to be reduced. Accordingly, it is critical that members are aware of the scheme design and the potential risks that they bear. Nevertheless, the ability to pool risk over time can result in a higher level of certainty than a normal defined contribution scheme.

These schemes are likely to be more attractive where the expected benefits exceed the standard SG defined contribution rate. If the employer contributions of a collective pension scheme and a standard scheme are the same, then the expected returns to members are likely to be similar. For this reason, it seems appropriate that policy neither encourage nor discourage collective pension schemes. This seems to be the general result of the current regulatory rules so no change is suggested.

ENDNOTES

1 See section 62 of the SIS Act.

2 AustralianSuper 2010, Review of AustralianSuper's default investment option, February 2010, <www.australiansuper.com/resources.ashx/FormsAndPublications/855/File/BEFA48A6AE3EE0310A49D9B391B750CB/Default_option_update_26_Feb_2010%5B1%5D.pdf>

3 Australian Bureau of Statistics 2009, Trends in superannuation coverage, 25 March 2009 (4101.0) <www.abs.gov.au>

4 Rice Warner 2008, 'Superannuation Fee Report 2008', December 2008, <www.ricewarner.com>

5 Intergenerational report (2010), 'Australia to 2050: Future Challenges', Publications of the Commonwealth of Australia, January 2010.

6 Lim-Applegate, H, McLean, P, Lindenmayer, P & Wallace, B 2005, Part rate pensioners: characteristics and changes, Australian Government, Canberra.

7 Australian Bureau of Statistics 2009, Employment Arrangements, Retirement and Superannuation Australia, April to July 2007, 2 June 2009 (6361.0.55.004) <www.abs.gov.au>

8 Challenger, Submission no. 196, p 12. Both scenarios take the age pension into account.

9 For example, ASFA, Submission no. 320, p 6; IFSA, Submission no. 382, p 24; Tower Watson, Submission no. 367, p 2; FPA, Submission no. 329, p 14; IAA, Submission no. 332, p 9.

10 For example, ING's 'Money for Life', <www.ing.com.au/moneyforlife> ; AXA North's 'North Guarantee' www.north.axa.com.au; Macquarie Bank's 'Macquarie Lifetime Income Guarantee' <www.macquarie.com.au>

11 Department of the Treasury (Treasury) 2009, Australia's future tax system: Report to the Treasurer– Part 2 Detailed analysis, vol. 1, December 2009, Treasury.

12 Part 1A of the SIS Regulations.

13 Department of the Treasury (Treasury) 2009, Australia's future tax system: Report to the Treasurer Part 2 Detailed analysis, vol. 1, December 2009, Treasury.

14 For example, PriceWaterhouseCoopers, Submission no. 356, p 8; SPAA, Submission no. 400, p 16.

15 Rice Warner 2008, 'Superannuation Fee Report 2008', December 2008, <www.ricewarner.com>

16 Chant West, A pension – the 'must have' accessory for the modern super fund, 8 October 2008, <www.chantwest.com.au>

17 Rice Warner 2008, 'Superannuation Fee Report 2008', December 2008, <www.ricewarner.com>

18 For example, ASFA, Submission no. 320, p 7; NICRI, Submission no. 389, p 6; AIST, Submission no. 380, p 18; Professional Financial Solutions, Submission no. 399, p 2; SPAA, Submission no. 400, p 7; Rice Warner, Submission no. 404, p 14.

19 For example, NICRI, Submission no. 389, p 3; PriceWaterhouseCoopers, Submission no. 356, p 9; Greg Hurford, Submission no. 241, p 2.

20 For example, SPAA, Submission no. 400, p 7; Super Compliance Services, Submission no. 364, p 9.

21 See sections 52(2)(f) of the SIS Act and regulation 4.09 of the SIS Regulations.

SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 8

Self-managed super solutions

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KEY THEMES

Issues

The SMSF sector is largely successful and well-functioning. While significant changes are not required, there are still a number of noticeable issues, which, for the most part, do not directly relate to trustees and members, but instead to service providers and the wider regulatory framework. Trustees are often dependent on service providers whose current minimum standards of SMSF knowledge are inadequate. The level and quality of information available on SMSFs and the SMSF sector is inadequate given its significance.

The SMSF regulatory framework is heavily dependent on approved auditors. However, the approved auditor population has no minimum, consistently policed, competency and independence standards, which undermines the ATO’s ability to regulate the sector.

Proposed solution

The Panel proposes measures including:

- providing for the creation of an SMSF resource centre;
- simplifying legislation and trustee requirements;
- registering approved auditors and linking their registration requirements with ongoing minimum competency and independence standards;
- providing the ATO with a flexible penalty regime; and
- improving the SMSF registration process.

Benefits for members

Members will benefit from these measures to improve SMSFs as:

- access to greater resources will enable SMSF trustees to carry out their trustee responsibilities with improved competence;
- development of advisers with higher competency standards will improve the operation of SMSFs;
- greater certainty will result from simplifying legislation and having access to the ATO's binding ruling system; and
- increased confidence in participating in the SMSF system, as a strengthened regulatory framework will reduce the instances of fraud and enable the ATO to deal appropriately and proportionately with non-compliance.

1 INTRODUCTION

On 14 December 2009, the Review Panel released an Issues Paper titled 'Phase Three: Structure' calling for submissions by 19 February 2010 on a range of issues relating to SMSFs. On 29 April 2010, the Panel also released its Phase Three — Preliminary Report: 'Self-managed super solutions', which incorporated the Panel's preliminary recommendations. This chapter contains the Panel's views on the issues raised in Phase Three insofar as they relate to SMSFs and incorporates feedback received on its preliminary recommendations.

The SMSF sector is Australia's largest superannuation sector by number of funds and asset size. As at 30 March 2010, there were around 423,000 SMSFs, representing 99 per cent of all superannuation funds, with over 30 per cent of total superannuation assets. The sector has over 806,000 members or accounts, which comprises 2.5 per cent of the 32 million member accounts in Australian superannuation.

On the face of it, the SMSF sector performs at least as well as the large APRA fund sector.

SMSFs and their antecedents have been around for more than 30 years. The SMSF sector has seen rapid growth in recent years, increasing from $132B to $332B in the five years to 30 June 2009; an annualised growth rate of 20 per cent.

Compared to members of other types of superannuation funds, SMSF members are on average older, earn a higher income, and have larger superannuation balances.

Unlike larger superannuation funds, SMSFs are regulated only by the ATO which takes a compliance, rather than prudential, approach to regulation. As part of the regulatory framework, all SMSFs must have their financial accounts and compliance with the SIS Act audited annually by an approved auditor.

SMSFs are trust entities. The majority of SMSFs (71 per cent) are structured with individual trustees, though they can also be structured with corporate trustees.

SMSFs are restricted to a maximum of four members (with the majority being two member funds) and all members must also be trustees. Member/trustees are, therefore, ultimately responsible for their own decisions and for the adequacy of their retirement savings. As SMSF trustees have ultimate responsibility they can choose to be entirely self-directed and self-sufficient (that is make investment decisions and look after the SMSF's administration and compliance obligations) or they can delegate, part or all of, these functions (but not responsibility) down to service providers (for example accountants, financial planners and administrators).

Further background and statistical information on the SMSF sector is provided in the Review's earlier publication titled: 'A statistical summary of self-managed superannuation funds'.[1]

2 TEN GUIDING PRINCIPLES FOR SMSFS

In Part One of the final report, the Panel articulated a number of policy principles that it believes should apply to the superannuation system as a whole. While these are broadly applicable to the SMSF sector, the Panel recognises that the SMSF sector has a number of different and unique characteristics. Hence, as a starting point, the Panel articulated ten guiding principles that it believes

should underpin the regulation of SMSFs specifically. The principles have informed the Panel's recommendations on SMSFs and could have a longer term role in guiding policy-making in the SMSF sector.

Principle 1 — Ultimate responsibility

SMSFs are unique in Australia's superannuation system in that SMSF members have effectively assumed sole responsibility for their retirement savings. This affects a wide range of regulatory settings that are appropriate for SMSFs.

Principle 2 — Freedom from intervention

Given that SMSF members are entirely responsible for their own decisions (principle 1), the Panel sees the ability to be genuinely self-directed and self-sufficient as an important feature of SMSFs.

The Panel believes that trustees should not lightly be exposed to administrative and other burdens that are not directly relevant to building their retirement savings through sound investment practices.

Principle 3 — ... but not complete absence of intervention

All superannuation funds, including SMSFs, benefit from valuable tax concessions that are designed to encourage and help members to save for retirement. In addition, the government underwrites the risk of SMSF failure via the social security system. The Panel believes that this justifies *some* intervention in the way SMSFs are managed and that the community also has a right to a certain level of information about them. That intervention is currently reflected in a range of rules and restrictions in the SIS Act and associated regulations.

Principle 4 — Service providers

Consistent with the first three principles, trustees are not required to use a service provider when running an SMSF, other than the annual audit, which must be carried out by an approved auditor.

SMSFs might also choose to use a range of other service providers (for example, administrators, platform providers and accountants) and these service providers also play an important role in the SMSF sector. As a result, the Panel believes that government policies should be directed at ensuring service providers maintain a high standard of competency and compliance as part of the overall regulatory framework. Where appropriate, licensing should be used to achieve this, but only in a way that demonstrably adds value to the sector.

Principle 5 — Appropriate entry into SMSFs

The Panel believes that the viability of the SMSF sector is strongly dependent on the composition of its population. An influx of trustees who were less well-equipped to cope with the responsibilities and disciplines inherent in running an SMSF could lead to serious public policy concerns for the sector. Such a development could see a call for more severe regulatory restrictions on all SMSFs which would be to the detriment of all existing members and the sector as a whole. The Panel recognises that this Review could create an interest in SMSFs from people who would, in fact, be better off remaining in large APRA funds.

Within the choice architecture model, members have the right to choose; as such the Panel does not believe there should be artificial impediments to members entering the SMSF sector.

The Panel believes that members who wish to form an SMSF without advice should be able to continue to do so. However, the vast majority of people do so based on advice from professional service providers. Consequently, the Panel strongly believes that advice standards need to be high within a robust regulatory framework to ensure members are not being inappropriately advised into the product.

Principle 6 — Consistent treatment with large APRA funds where appropriate

The Panel believes that the norm should be that all superannuation funds are treated in the same way. For example, notwithstanding that outcomes might differ because of fund size, scale and other individual fund circumstances, the same tax legislation, sole purpose and preservation rules should apply across all sectors. This suggests that many rules for SMSFs will be the same as those applicable to large APRA funds and that is in fact the case.

However, there is no escaping the fact that SMSFs are different and that they call for different rules in a number of areas. It is not always appropriate or desirable that all superannuation funds should operate under precisely the same legislative framework. The Panel recognises that this runs counter to many submissions that argued their particular position on the basis of a 'level playing field'. However, the Panel has specifically taken the view that consistency with large APRA funds will not always be appropriate for SMSFs. This position also reflects the distinct supervisory approach necessarily applied by the ATO and APRA to their respective superannuation populations.

Principle 7 — Recognition of special risks in an SMSF environment

Extending principle 6, the Panel recognises that the SMSF environment creates some particular tensions in appropriately managing the personal preferences and lifestyle choices of the members (and their related entities). While trustee decisions for all funds are made within the framework of the sole purpose test, the Panel believes that it is appropriate to impose *some* additional restrictions on SMSF trustees (over and above the restrictions imposed on funds with an external trustee) given those tensions.

Principle 8 — Leverage

Leverage should not be a core focus for SMSFs. While views will differ on this issue, the Panel believes that there is room for leverage in SMSFs, but it should be ancillary to the main strategies employed to build retirement savings over the longer term.

Principle 9 — Compliance, rather than prudential, regulatory focus

An important element in the supervision of large APRA funds is ensuring that trustees are acting in members' best interests at all times.

In the Panel's view, a different regulatory focus is appropriate for SMSFs. The role of the regulator and key industry participants (such as auditors) for this sector should be legislative compliance, rather than a prudential objective.

Principle 10 — Pursuit of excellence

Given that SMSFs are widely dispersed and non-institutionalised, and that many SMSF service providers are also fragmented and lack scale, there is a challenge for the sector in investing in improvements such as technology, governance and investor education. The Panel believes that a sector that has such a large proportion of Australia's retirement savings needs an aggressive agenda aimed at pursuing excellence across all its activities.

The Panel believes that it might be worthwhile for government to consider measures to support, promote and champion the development of best practice among SMSF trustees.

3 THE PANEL'S VISION FOR SMSFS

The vast majority of submissions supported the view that the SMSF sector, with a few exceptions, generally works well. This view is shared by the Panel. The Review process has generally confirmed that the SMSF sector is largely a successful and well-functioning part of Australia's superannuation system, as reflected in the statistics.[2]

The Panel suspects that the most significant aspect of its work in the SMSF sector is that it has not recommended wide-ranging changes — a minimum SMSF asset size or specific trustee educational requirements, being two examples. The Panel's SMSF recommendations are not dramatic and largely relate to compliance, audit, adviser competency and like measures. These changes are aimed at ensuring that this growing sector can continue to prosper in an enhanced environment.

In making its recommendations, the Panel's vision for SMSFs is one where:

- trustees act diligently to build their retirement savings and are supported by highly competent and skilled service providers; and approved auditors and financial advisers have a greater 'gate keeping' role to ensure that those in the SMSF sector are more likely to be able to cope with its challenges;
- the sector is able to innovate quickly, is efficient, well-managed and largely free of asset-based or percentage fees;
- SMSFs are simpler for trustees to operate and manage; operating costs continue to decline through improved efficiency, greater use of technology and less reliance on paper-based accounting approaches; and SMSFs are subject to more effective regulation and better governance;
- trustees are supported with access to information that is relevant, reliable and comparable, enabling the costs of running SMSFs to be known, comparisons with other forms of superannuation to be performed and facilitating better decision-making;
- trustees are focused on investing for their retirement and not on related party or present day benefits; and
- SMSFs are safer, as the risk of illegal schemes and fraud have been mitigated.

4 STRUCTURE

Submissions overwhelmingly supported the retention of the trust structure for SMSFs. The Panel supports the trust structure in the large APRA fund sector and it sees no reason why the SMSF sector should operate under a different structure (such as a statutorily formed trust or a purely contractual structure) given its substantial size and history and the costs and challenges of replacing it.

While some submissions canvassed ideas such as the appointment of asset custodians, external trustees, mandated service providers (such as administrators or licensed advisers), mandated asset allocation and investment restrictions, most strongly rejected them. The ability to retain 'control' over all aspects of an SMSF is a very powerful and attractive feature for trustees. Submissions overwhelmingly supported the retention of 'control', as does the Panel.

Inherent in the 'control' concept is the recognition and acceptance that ultimate responsibility rests with trustees.

The Panel believes these 'control' features and acceptance of ultimate responsibility, which characterises the SMSF sector, have contributed to its sustained growth.

4.1 Membership size

The majority of submissions supported increasing the four member limit on the basis that it restricted the ability to involve all family members and that the limit was arbitrary. While there was no general consensus as to what the increased limit should be and some submissions even suggested there should be no limit, there was a general consensus that any increase should be restricted to 'family members'. Submissions varied on who constitutes a 'family member' — suggestions included: Part 8 associates,[3] relatives and the immediate family, to name a few.

Increased membership size, though, would introduce new complexity to SMSFs and might start to blur the line between SMSFs and APRA-regulated funds. If all members were still to be trustees, increased numbers would raise management, agency and control issues, which would place a strain on the SMSF model, given that it does not employ prudential supervision. Potentially, larger numbers could lead to member disenfranchisement and the possible need for external arbitrators (to resolve deadlocks between trustees). While these issues could potentially be mitigated by the appointment of representative trustees, this would lead to a fundamental change to one of the SMSF's guiding principles: that every member is a trustee and has ultimate responsibility for their retirement (principle 1).

While the Panel accepts the arbitrary nature of the limit and sees some of the attractions for wider family participation, the Panel is not recommending the existing SMSF membership limit be changed. It believes that the potential complications inherent in expanding the limit outweigh the possible advantages. The Panel also notes that more than 90 per cent of SMSFs currently have only one or two members and more than 95 per cent have three or fewer members.[4]

Recommendation 8.1

The current membership limit of four members for a SMSF should not be increased.

4.2 Minimum fund asset size

There has been a long-running debate about whether there should be a minimum SMSF asset size, with many industry participants questioning whether an SMSF with $200,000 in assets could be cost competitive with large APRA funds.

The Review's previous publication '*A statistical summary of self-managed superannuation funds*' identified a less than optimal picture of smaller-sized SMSFs ($200,000 or less). It showed that, on average, they lacked investment diversification, suffered higher relative costs and underperformed larger-sized SMSFs. Given this, the Review undertook further analysis on smaller-sized SMSFs, the results of which are set out in the Appendix.

A number of submissions highlighted that cost should not be the primary focus when establishing and maintaining an SMSF. According to CPA Australia, trustees need to consider the fund's break-even point, which would depend on how much work the trustees did themselves as against services that were paid for.[5] Submissions also supported the view that SMSF trustees know the costs of running their SMSFs because they pay them directly; it was also argued that this cannot be said for members in large APRA funds. The Panel accepts that this is one of the many significant differences between the two models.

While the Panel remains concerned about the number of small-sized SMSFs, it acknowledges that their existence is generally due to the conscious choice of members. The Panel also believes that the debate over the cost-competitiveness of small-sized SMSFs, over the last few years, might already have reduced the number of small-sized SMSFs.[6]

The Panel does not believe there is a need to mandate a minimum SMSF asset size which would only act as an artificial barrier to entry; within the choice architecture model members have the right to choose. With appropriate advice, disclosure and an increase in comparable data, people will be able to make more informed choices that are in their interests. The Panel believes this will ensure that SMSFs are established for a suitable purpose, resulting in a reduced instance of small-sized SMSFs.

4.3 Trustee structure (corporate v natural person trustees)

The number of SMSFs with natural person (member) trustees is much greater than those with corporate trustees and this trend appears to have been increasing in recent years. As at 30 June 2009, around 29 per cent of all SMSFs had a corporate trustee. However, for the 2008 and 2009 financial years, nearly 90 per cent of new SMSFs were established without a corporate trustee.[7]

The Panel and various stakeholders have expressed their surprise at this trend in various consultations and submissions. It is widely accepted by professionals and the ATO that a corporate trustee is superior. Some of these benefits, outlined in submissions, include:

- perpetual succession — the corporate entity cannot die, so it enables better control in the event of member death or incapacity;
- greater administrative efficiency;
- greater flexibility to pay benefits as lump sums or pensions;
- greater estate planning flexibility; and
- reduced risk of deliberate or accidental intermingling of fund and personal assets, in breach of the covenant in section 52(2)(d) of the SIS Act.

The trend towards individual member trustees could be due to limited advice or understanding of the benefits and the higher establishment costs of the corporate trustee option over the member trustee option.

Some submissions, recognising the benefits of corporate trustees, supported the use of a sole purpose corporate trustee. Submissions recommended that the ASIC company registration fee be reduced to $100 and the $40 ASIC annual review fee be removed. A number of submissions also suggested that all SMSFs should be required to have a corporate trustee.

The Panel is attracted to the potential benefits provided by the corporate trustee structure and is concerned about the large proportion of new SMSFs choosing not to use a corporate trustee. However, consistent with principle 2 regarding freedom from intervention, the Panel believes that the solution here is a better standard of advice, an aim which is addressed by other recommendations. The Panel is therefore not recommending any change on this issue.

4.4 Custody

Submissions did not support the concept of compulsory use of third party custodians. Submissions pointed out that this option would add to cost with arguably little benefit to compliance levels. The Panel agrees with these views and is not recommending any change in this area.

5 SMSF TRUSTEES — EDUCATION AND COMPETENCY

Risks associated with a trustee's lack of financial literacy or understanding of longevity risk are potentially magnified in an SMSF. While SMSF members face complexity in relation to their funds, complexity affects every superannuation member in one way or another.

The Panel does not accept suggestions that the levels of SMSF trustee knowledge are deficient and that compulsory education or other forms of accreditation are required. The Panel considers moves in that direction to be an attempt to create artificial barriers to entry.

Likewise, the Panel does not believe that SMSF trustees should be expected to become superannuation experts; that is simply not realistic. Increasing trustee knowledge and competency is desirable and was mentioned in many submissions. This is, of course, a view shared by the Panel.

The Panel, however, believes that increased knowledge and competency can be achieved through other methods rather than by requiring trustees to undertake compulsory education.

The Panel believes that improvements in SMSF trustee knowledge can be realised through:

- Increasing the minimum competency and knowledge levels of participants that service the SMSF sector, given that the majority of trustees engage some form of service provider. The overwhelming majority of submissions were of a similar view. This is further discussed in section 7.
- Increasing the provision of SMSF-orientated information and education to enable voluntary education. This is further discussed in section 9.4.

- The private sector is already starting to produce this type of education. For example, the Joint Accounting Bodies (ICAA, CPA, NIA) recently released a free online SMSF trustee education program.[8]
- While, in principle, the Panel does not favour compulsory trustee education, it is attracted to the idea of compulsory education for those who breach their SIS Act obligations. This is further discussed in section 6.1.

The Panel does not believe that any particular academic, professional or other qualifications requirement should be imposed on SMSF members. The Panel does not believe SMSF trustees should be mandated to undergo any form of initial or ongoing formal education, training or accreditation. Such decisions should be voluntary.

6 REGULATION

There are nearly 423,000 SMSFs with an average fund size of $947,000.[9] By contrast, there are only 429 large APRA funds, and for these the average fund size is $1.9B.[10] Further, the trustees of SMSFs are the members; there is no 'agency' issue at the trustee level. By contrast, large APRA funds either have a trustee, representative of employer-sponsors and members, or there is more of a commercial relationship between the fund and its members where the trustee and its directors are all part of a corporate group. It is clearly impractical to regulate the two sectors in an identical way.

Prudential supervision is designed to ensure, so far as is reasonably possible, that the trustee operates the fund in such a way as to meet its financial promise to members while also observing the government's retirement income policy objectives reflected in the SIS legislation. The logic is that SMSFs do not require prudential oversight because the trustees and members are one and the same people who have the incentive and responsibility to protect their own interests. This view was generally supported in submissions.

While some submissions suggested a change of regulator to APRA (and greater prudential supervision) most agreed that the ATO, with its compliance-based approach, was best placed to continue regulating the SMSF sector. The Panel agrees that regulation of the self-managed sector should stay principally compliance-focused to ensure minimum standards are met. Given this, and the large number of SMSFs, the Panel believes that the ATO remains the appropriate regulator.

6.1 ATO penalties

The Panel accepts that most SMSF trustees seek to operate their funds properly to secure their own retirement, and comply with the various obligations and standards set out in legislation. However, in any industry with 423,000 entities, there will be a proportion that disregards the rules. The ATO is not resourced to engage with each SMSF each year, and to do so would be costly and inefficient. It follows that intensive supervision must be based on a risk-based sample of the SMSF population, and that the regulator needs to have and apply effective, flexible and proportionate powers to address wrongdoing or non-compliance.

Those tools must be cost-effective for the regulator to use, and the consequences should be sufficient to deter SMSF members from repeating any misconduct, and to act as a deterrent to others.

The 'nuclear option' in the ATO's regulatory armoury is the power to make a fund non-complying for taxation purposes. This can be invoked if the ATO determines that the trustee has contravened the SIS Act or SIS Regulations and, having regard to the seriousness of the contraventions, the taxation implications of the decision and all other relevant circumstances, it decides to issue a notice of non-compliance. The consequences can be severe, as the accumulated assets of the fund are taxed at the top marginal income tax rate and the fund can no longer accept Superannuation Guarantee contributions.

A number of submissions supported the removal or reduction of the power to declare a fund to be non-complying for taxation purposes.

In relation to both SMSFs and APRA-regulated funds, the relevant regulator can apply to a court for civil penalties to be imposed for certain breaches of the SIS legislation. The Director of Public Prosecutions can also prosecute criminally for more serious breaches. However, both can be costly and time-consuming and the potential consequences can again be disproportionately high unless reserved for very serious breaches.

The ATO also has the power to accept a court-enforceable undertaking from trustees of contravening funds and certain other persons. As a preventative measure, the ATO can disqualify a person from being the trustee of an SMSF if they have been engaged in severe breaches of the rules.

The ATO uses this range of powers sparingly and in only the most severe cases of non-compliance.

Given the ATO's restrained approach in using its enforcement powers in relation to SMSFs, the Panel believes there is clear benefit in retaining this array of potential penalties, and the deterrence effect they can offer.

While the fear of being made non-compliant for taxation purposes acts as deterrent to significant non-compliance, its deterrence factor diminishes as the level of non-compliance reduces. In these circumstances, the ATO becomes less and less willing to impose severe penalties and it has few other sanctions to fall back on.

The Panel agrees with the views expressed in a number of submissions that the framing and application of the current penalty regime reflects an 'all or nothing approach' that is not optimal. The absence of graduated penalties results in the vast majority of contravening trustees avoiding any sanction by simply rectifying their contravention if and when it is detected. Rectification is, of course, appropriate, but it is not appropriate that trustees can continue to contravene and for their actions to have no consequences. This works counter to the principles of compliance and deterrence-based regulation and the Panel believes that credible and proportional penalties are required to support the ongoing integrity of the system.

The Panel considers that the existing penalty regime limits the ATO's ability to achieve optimal regulation. It believes that additional tools (both punitive and educational), in conjunction with its existing powers, are required to give it more flexibility.

6.1.1 A sliding scale of penalties

An overwhelming number of submissions supported the view that the ATO should be provided with a more flexible penalty regime that would enable it to tailor penalties that were commensurate with the contravention. The Panel believes that the development of a new administrative penalties framework should utilise the existing penalty provisions in the SIS Act as a base.

It could be modelled on the attributes of the *Taxation Administration Act 1953* penalty framework such as the application of penalty units, approach to remission, assessment, objection, amendment and review processes. This approach would enable the ATO to apply its existing tax practices, with which SMSF sector participants are generally familiar, to SIS legislation contraventions.

Alternatively, an administrative penalty approach could be directly modelled on the 'speeding ticket' concept applied under the *Financial Sector (Collection of Data) Act 2001* whereby a trustee that breaches an offence provision may be issued with an administrative penalty, the maximum amount of which is set by legislation. The trustee may seek internal review by the regulator of the decision to impose the penalty, and if dissatisfied with the result may contest the matter in a court as though the regulator had initiated criminal charges.

While the availability of an administrative penalty regime has most practical impact for the ATO as regulator of the SMSF sector, the Panel sees no sound reason why that flexibility should not be similarly extended to APRA in respect of funds within its purview. This is discussed further in chapter 10. If that were accepted, an approach based on the 'speeding ticket' model might be more suitable than one based on taxation practice.

Fines imposed under an administrative penalty regime should be payable personally by the trustees who have committed the breach and not drawn from the corpus of the SMSF.

Recommendation 8.2

Legislation should be passed to provide the ATO with the power to issue administrative penalties against SMSF trustees on a sliding scale reflecting the seriousness of the breach. The penalties should not be payable from the corpus of the fund, and may be applied jointly or severally against the trustees or trustee directors.

6.1.2 Transfer of control to a SAF trustee

The Panel contemplated recommending that the ATO be given the power, in certain circumstances, to replace an SMSF trustee with the holder of an extended public offer Regulated Superannuation Entity (**RSE**) licence, thus changing the SMSF into a Small APRA Fund (**SAF**). This concept was also supported in some submissions. The Panel envisaged this power could be used where trustees showed, through their actions, that they could no longer be entrusted with their retirement benefits; such as where they contravene related party provisions by lending money to themselves, or their related businesses.

The Panel recognises, however, that there are practical obstacles in transferring SMSF control to SAF trustees. For the process to work:

- it would have to be administratively simple yet not impinge on trustees' rights to natural justice. As trustees' rights need to be protected, the Panel does not believe a simple mechanism can be put in place that does not then effectively duplicate existing regulatory powers (that is the powers to disqualify, suspend, or remove a trustee and appoint an acting trustee); and
- there would have to be SAF trustees who were always willing to take on a transferred SMSF. The Panel recognises SAF trustees should have the right to decide what clients they accept and that problem SMSFs might not always be appealing.

The Panel is therefore not making a recommendation on this issue.

6.1.3 Power to give directions

Existing enforceable undertaking arrangements rely on SMSF trustees initiating the undertaking with the ATO. The ATO then has the option to accept or decline the enforceable undertaking that has been offered. This process can often be inefficient and time-consuming.

The Panel instead favours a more direct approach where the ATO is able to issue directions to an SMSF to rectify specified contraventions within a specified time period. Trustee rights can be protected through the implementation of appropriate objection and review procedures. Such a power would be more limited than the power to accept an enforceable undertaking, in that it would be restricted to directing rectification; while an enforceable undertaking could offer things like undertaking education, withdrawing from trusteeship for a period of time or compensating fund members or others whose interests had been harmed by the contravention.

Recommendation 8.3

SIS legislation should be amended to provide the ATO with the power to issue relevant persons with a direction to rectify specified contraventions within a specified reasonable time. A breach of a direction should be a strict liability offence.

6.1.4 Compulsory education

The Panel does not favour mandating trustee education across the whole sector. However, it does believe compulsory education can be an appropriate outcome where non-compliance with the SIS Act, especially of a lower-level nature, is detected. Compulsory education in these instances will assist to drive up trustee competence and engagement with their regulatory obligations. The Panel would also support further sanctions being imposed on trustees for non-attendance at compulsory education.

Education could be provided either through ATO-developed or externally-provided education courses. Some submissions pointed out that SMSF trustee education courses were already being developed.

Recommendation 8.4

The ATO should be given the power to enforce mandatory education for trustees who have contravened SIS legislation. Such education should be provided by a body (which could include commercial providers) approved by the regulator and would be at the cost of the trustees and not the corpus of the fund.

6.2 Dispute mechanisms

The Panel does not favour extending external dispute resolution mechanisms to SMSFs. Trustees should not be protected from the results of their own conduct and matters such as family law disputes have well-established mechanisms to address property entitlements and so on. Submissions were generally supportive of this approach.

The Panel's preliminary SMSF report supported extending the Superannuation Complaints Tribunal (**SCT**) role, in a limited number of scenarios, to SMSFs. In light of feedback, the Panel has reversed its view.

Feedback indicated that the preliminary recommendation would unfairly result in the majority of SMSFs, who would not utilise the SCT, cross-subsiding the few SMSFs who would use the services of the SCT. It was also argued that, in the majority of cases, disputes would not be limited solely to superannuation matters and would ultimately be decided in court. Access to the SCT for one part of the dispute would not increase efficiencies. The Panel agrees and is no longer recommending an extension of the SCT's jurisdiction to SMSFs.

6.3 The complexity of superannuation law

Superannuation law can be complex both for SMSF and APRA-regulated fund trustees. The Panel believes the current legislation is complex, confusing for SMSF trustees and service providers and contains elements that are not applicable to SMSFs. A view supported in many submissions.

While these complexities exist and add to costs, it does not seem to have impeded the growth of the SMSF sector. In recent years, the SMSF sector has grown rapidly, resulting in it becoming Australia's largest superannuation sector by asset size.

6.3.1 A separate Act or division of the SIS Act for SMSFs

Submissions expressed a desire for the removal of unnecessary and complex requirements that were adding to SMSF costs.

Dedicated SMSF legislation could ease the compliance burden and costs for SMSF trustees. This could allow for provisions to be presented in plain English and be structured with more clearly defined compliance requirements, which would help both SMSF trustees and service providers to understand the requirements. The ATO would then be better placed to develop effective guidance material based on that framework.

The Panel believes the 806,000 SMSF members would benefit from simplified legislation. The separation of SMSF legislation into a separate Act, or division within the SIS Act, would provide an opportunity to simplify and clarify the SMSF rules by removing inapplicable provisions. This is discussed further in chapter 10.

6.3.2 Binding rulings

There was broad support in the majority of submissions for the ATO to be able to issue binding SIS Act rulings to help trustees and service providers cope with the perceived complexities and uncertainty of the current legislation. The Panel is attracted to this view, especially in an environment where SMSF-specific legislation has been incorporated into a separate Act or separate division within the SIS Act (see chapter 10), believing a binding ruling system would provide for greater certainty and would also likely lead to technical issues being resolved more expeditiously.

However, the Panel notes risks with this approach, relating to:

- the need to ensure that binding rulings unambiguously apply only to the SMSF sector, with no potential for the position set out in the ruling to be imported by a court or tribunal to apply within

the APRA-regulated sector. To this end, the Panel considers that such rulings could be issued only in respect of elements of the Act that apply only to SMSFs;

- the enduring nature of binding rulings in the light of potentially changing circumstances; and
- given the number of people who have expressed a demand for binding rulings, there is a potential risk that the ATO might not have the available resources to cope with the additional workload or that work on rulings might be at the expense of other activities.

Recommendation 8.5

The ATO should be given the power to issue binding rulings in relation to SMSFs, subject to the implementation of the Panel's recommendation to restructure the SIS Act in chapter 10 of this report.

7 SERVICE PROVIDERS

The vast majority of trustees engage service providers to help manage their SMSFs. The main service providers include accountants, financial advisers and administrators.

Given the substantial size of the SMSF sector and the fact that SMSFs are not prudentially regulated, the Panel recognises that service providers also fulfil an important 'gatekeeper' role. Ultimately, the competency and professionalism of these service providers is critical to enhancing SMSF compliance and the efficient operation of the sector.

Submissions consistently supported the view that it was not the level of trustee knowledge, or compliance activity that needed to be increased; rather it was the qualifications, competency and professional standards of SMSF service providers. The theme of raising standards reverberated across submissions from all stakeholders groups (members, auditors, accountants, administrators and industry associations).

The Panel believes that the SMSF sector should be serviced by providers who are required to attain and maintain a minimum level of SMSF competency. Minimum standards would be aimed at greater consistency among service providers. More importantly, it would provide members with greater protection and reduce the risk of inappropriate advice.

7.1 Prescribed use of service providers

Many trustees are capable of looking after all (or at least a substantial part of) the affairs of their SMSF and in doing so can considerably reduce their costs and still comply with the law. The Panel acknowledges the strong sentiment in many SMSF trustee submissions that they should not be forced into using service providers where there was no need for them.

The Panel recognises that in the 'self-managed' sector, people are generally entitled to do just that, unless there is a countervailing public policy reason. Public policy already requires SMSFs to obtain an independent audit. The Panel also sees a potential countervailing public policy interest in

ensuring that SMSFs are established in appropriate circumstances (principle 5), but has erred on the side of not making any recommendation for change in this area.

7.2 Financial advisers

The competency and knowledge levels of licensed advisers are particularly important given their role in a substantially 'DIY' sector. Many submissions argued that adviser competency standards and qualifications are too low and that all advisers require specialist knowledge, in particular knowledge of the SIS Act, SIS Regulations and the tax law, and their application to SMSFs. The Panel supports this view.

The ASIC Regulatory Guide 146 (**RG 146**) expresses ASIC's policy about the level of training necessary for advisers. This imposes minimum requirements, requiring advisers to demonstrate that they have met both generic and specialist knowledge requirements relevant to their activities.[11] Among the 'specialist' knowledge requirements is 'superannuation'. Any person advising on SMSFs must complete, as a minimum, the training requirements for superannuation. RG 146 also recommends that advisers should undertake additional specific product training in relation to SMSFs before advising on these products; this, however, is not mandatory.

Some submissions argued that it was not necessary for competency standards to be increased beyond those specified in RG 146. However, the majority of submissions supported increasing adviser competency standards.

One submission pointed out that professional indemnity insurers are currently playing an instrumental role in raising professional standards for advisers giving financial advice to SMSFs. Policy terms have led to many advisers being required to undertake specialist SMSF training.[12]

The Panel also acknowledges the work that has been done by a number of industry participants, the Financial Planning Association and the Self Managed Super Funds Professional Association of Australia (**SPAA**), to increase SMSF competency by requiring advisers to complete specialised training before they can provide financial advice on SMSFs.

The Panel also notes the proposal within the *Future of Financial Advice* reform package announced by The Hon Chris Bowen MP, the Minister for Financial Services, Superannuation and Corporate Law, on 26 April 2010[13] to establish an expert advisory panel, which will review professional standards in the financial advice industry, including conduct and competency standards.

The Panel considers that competency standards for SMSF advisers need to be raised. The Panel believes ASIC should amend RG 146 to include a specialist 'SMSF' knowledge requirement that must be obtained before advisers can provide advice in relation to SMSFs. This could be developed by ASIC, in consultation with industry and the 'expert advisory panel' announced as part of the *Future of Financial Advice* reform package.

The Panel notes the press release by Senator the Hon Nick Sherry, Assistant Treasurer, on 23 April 2010 headed 'Coverage of tax agent services regime.'[14] The press release indicated that the Assistant Treasurer, the Tax Practitioners' Board (**TPB**) and ASIC are of the view that financial planners offer what amounts to tax advice. Consequently, industry consultation will take place to determine whether financial planners providing tax advice and services within the scope of their Australian financial services licence (**AFSL**) should be registered with the TPB or whether the AFSL regime offers the appropriate regulatory mechanism.

The Assistant Treasurer announced that he has “*determined to provide a one-year deferral to financial planners from the application of the tax agents’ regime.*”

This deferral period will enable consultation to take place to assess which of the following options should be applied to AFSL holders. The options available are:

- to investigate and implement what changes, if any, might be made to the AFSL regime or its enforcement to ensure that it provide a comparable level of regulatory supervision in relation to tax services provided by financial planners in comparison to the level of supervision imposed on the providers of tax services regulated by the TPB; or
- to bring financial planners permanently within the tax agent services regime and therefore be regulated by the TPB, but to do so in a way that minimised any additional compliance burden.

The Panel believes that the adoption of either of those options would ensure that regulation and oversight of financial planners providing tax advice is likely to be enhanced, which the Panel believes is an important consideration given the relevance of tax to SMSFs. As a result, the Panel is not making any recommendation on this issue insofar as it goes to tax, leaving the process announced by the Assistant Treasurer to run its course.

Recommendation 8.6

The Government should task ASIC, in consultation with industry and the ‘expert advisory panel’, to develop the SMSF specialist knowledge component of RG 146, which would focus on increased knowledge and competency with respect to the SIS Act.

7.2.1 SMSF establishment

The Panel believes that the establishment of an SMSF is one of the most significant steps a person can take in relation to their retirement savings. As noted above, the Panel remains concerned about the number of small-sized SMSFs (see the Appendix for more detail). The Panel also believes that establishing an SMSF cannot be viewed in isolation. Establishing an SMSF is, in the vast majority of cases, linked to decisions about the transfer of balances from large APRA funds and the direction of an employer’s Superannuation Guarantee and other contributions. SMSFs are not just one type of superannuation product in a range of products; they are the product that has the most fundamentally different roles and responsibilities for trustee/members.

The Panel explored some form of ‘gatekeeper’ mechanism aimed at allowing new entrants to the SMSF sector to assess whether they would be suited to its unique features and responsibilities and understand the need for a certain size of fund to make an SMSF cost competitive with other types of fund. The options the Panel considered included:

1. setting a minimum fund establishment size of $200,000;
2. requiring all new entrants to get advice from a licensed adviser about the consequences of forming an SMSF. The existence of the advice could then be incorporated into the SMSF registration process and verified by the approved auditor;
3. a requirement for all new entrants to get licensed advice if their minimum fund size at establishment was going to be less than $500,000;

4. requiring those in the business of providing establishment services in relation to SMSFs to hold an 'SMSF establishment AFSL' (that is a licence that would only authorise that activity). This would enable regulators to identify who is establishing SMSFs, but not everyone would be required to use them or to get financial advice; and

5. a requirement for prospective SMSF members to complete an online module on a government website which would take them through their possible suitability to participate as a member and trustee of an SMSF.

While the Panel initially saw some advantages with option 5, it has concluded that it is inappropriate to implement any form of entry level 'gatekeeper' mechanism. A 'gatekeeper' mechanism would not resolve the underlying problem of inadequate advice being provided at SMSF establishment by advisers. The Panel believes that the existing SMSF advice framework has led to people being inappropriately advised into SMSFs; a view expressed in a number of submissions.

The Panel believes that the Government's announcement to remove the accountants' licence exemption[15] provides an opportunity to improve the advice framework for SMSF establishment. This heightened framework should remove the necessity for an entry level 'gatekeeper', which is further discussed in section 7.3.

7.2.2 Adviser remuneration

Remuneration and fee structures employed by advisers (that is whether based on a percentage of assets or fee-for-service) can have a significant effect on the performance of an SMSF. Many submissions have advocated a fee-for-service model for all recipients of financial advice.

The Panel believes that the approach on adviser fees needs to be consistent across all superannuation sectors, including SMSFs. The Panel believes that commission-based remuneration practices for advice should be prohibited; this is discussed in chapter 1. Similarly, commission-based remuneration for risk insurance advice should also be prohibited and this is discussed in chapter 5.

7.3 Accountants' financial services licence exemption

Currently, accountants are able to establish and give background advice about an SMSF without any additional regulation, but not about financial products (that is, the investments to be made by the SMSF) unless they hold an AFSL from ASIC.[16]

Submissions expressed the view that this exemption was not working well, that it was confusing, might be leading to SMSFs being created unnecessarily and resulted in an unlevel playing field between accountants and financial advisers. It is clearly a quite artificial exemption. For example, if someone went to an accountant asking whether they should switch from a large fund into an SMSF, an accountant without an AFSL would not be able to give any advice about that person's existing fund or make any comparisons or recommend a switch. The accountant would be effectively restricted by the AFSL exemption to only saying 'yes' to the SMSF option without regard for any consequences involving the client's existing arrangements or how those arrangements compare with an SMSF. This is an unsatisfactory situation.

Some submissions argued for the continuation of the AFSL exemption by arguing that

> *an SMSF is not an investment product but rather the legal and tax structure in which investment or investment products are to be housed, similar to an investment company or trust that the individual may consider to setup.*[17]

Other submissions also supported the exemption and argued that it be broadened to enable accountants to provide structuring advice on all superannuation sectors and not just SMSFs.

Conversely, there were other submissions that supported the abolition of the exemption. The Institute of Chartered Accountants Australia (**ICAA**) believes that the accountants' exemption should be abolished because accountants (and their clients) find the exemption of limited value when it comes to advice on superannuation issues.[18] The ICAA suggests that, '*it is necessary to review the current education options and licensing framework to encourage more Chartered Accountants to operate in a licensed regime…*'[19] The Panel agrees with the ICAA.

Establishing an SMSF is, and should always be, a long term investment decision. It should never be entered into lightly and without the appropriate consideration of the members' financial position as well as the additional responsibilities, commitments and associated costs inherent in this superannuation product. It should also be recognised that once someone has established an SMSF, the cost of reversing their decision (winding up their fund, where they would need to dispose of their assets and crystallise capital gains and/or forgo the benefits of any prior tax losses) can often be substantial. The Panel believes that such factors are often not sufficiently considered when an SMSF is being established. Limited or poor advice at establishment can come at a cost.

Prospective SMSF members should have both the expectation and confidence that, regardless of the professional service providers they engage, they will get appropriate and comprehensive advice from well qualified agents who are acting in their long term best interest.

The *Future of Financial Advice* reform package announced by the Government included a proposal for the removal of the accountants' licence exemption following the implementation of a suitable transitional period.[20] The Government has also announced that it will consult on an appropriate alternative to the current licensing exemption.

The Panel supports the Governments move to abolish the accountants' licence exemption. As discussed previously, the Panel does not believe the current advice framework, surrounding SMSF establishment, is appropriate. While the Panel previously stated it would not comment further in this space, the Panel believes that it is imperative that the future advice framework, that will replace the accountants' licence exemption, be sufficiently sound, that it removes the need for a 'gatekeeper' mechanism, as discussed in section 7.2.1.

The Panel believes that all advisers should be uniformly licensed by ASIC to be able to provide advice on SMSF establishments and more generally. The Panel does not consider that other options, such as broadening the accountants' licence exemption, as many submissions recommended, or providing restricted licenses, would achieve the necessary standards and regulatory equality (for both advisers and members). The Panel believes the appropriate framework, for those providing advice in relation to SMSF establishment (and more generally) requires a 'true' level playing field, where all advisers (accountants, financial planners, SMSF administrators, etc) have the same level of responsibility and accountability. In the Panel's view, any exemptions or new concessions to these would create an inadequate level of assurance around this non-prudentially regulated sector.

Recommendations 8.7

Government should legislate to require advisers to hold an AFSL where they provide advice in relation to the establishment of an SMSF. The accountants' licence exemption should not be replaced by any new exemption or restricted licensing framework.

7.4 Competency of SMSF accountants and administrators

Accountants and administrators supply services to SMSFs such as the preparation of accounts, administration, lodgment of returns and other compliance functions. Accountants and SMSF administrators are often separate entities, potentially competing for the same clients. On other occasions, the accountant or SMSF administrator is the same entity and some accountants engage SMSF administrators to provide many of those services to their clients.

Neither accountants nor SMSF administrators are required by law to have any SMSF expertise. One submission asked whether a regulatory gap existed in relation to SMSF administrators given that 'other participants in the industry (auditors, accountants, financial advisers) [are] subjected to various forms of regulation.'[21] For those accountants with few SMSF clients, it will always be an open question as to how it could be economically viable to maintain the appropriate level of SMSF expertise. Issues of competency though are not necessarily limited to the small end of town.

The Panel is not recommending imposing further requirements on accountants or SMSF administrators, but there was wide support in submissions for increased competency standards. The Panel believes that the accounting professional bodies are currently best placed to achieve this (without further regulation) through the provision of further guidance to their membership. They could adopt an approach similar to that taken for approved auditors, where minimum competency requirements were introduced.

7.5 Approved SMSF auditors

Approved auditors are the cornerstone of the existing regulatory framework and are heavily relied on by the ATO to manage SMSF compliance. Their competence and independence should provide the level of assurance that a compliance-based regulatory framework demands.

The ATO estimates there were approximately 11,500 approved auditors who conducted an SMSF audit for the 2007 financial year. Auditors, on average, undertook about 35 SMSF audits each in 2008; significantly though, 51 per cent of auditors performed less than five audits in a year, covering around three per cent of the SMSF population. On the other hand, just over two per cent of auditors conducted more than 250 audits.[22]

The SIS Act requires every SMSF to appoint an approved auditor to conduct an annual financial and compliance audit. As at 30 June 2008, approved auditors qualified almost 4 per cent of their SMSF audits, due to either or both a financial and a regulatory compliance issue. Auditors are also required (based on ATO reporting guidelines or on their own professional judgment) to report compliance contraventions to the ATO through an Auditor Contravention Report (**ACR**). In the year to 30 June 2009, auditors lodged ACRs for nearly 6,500 SMSFs. These ACRs contained 15,000 reported contraventions.[23]

Under the SIS Act an approved auditor is required to be an individual who is currently either:[24]

(a) a registered company auditor;[25]

(b) a member of CPA, ICAA, or NIA;

(c) a member or fellow of the Association of Taxation and Management Accountants;

(d) a fellow of the National Tax and Accountants Association;

(e) the Auditor-General of the Commonwealth, a State or a Territory; or

(f) a SPAA SMSF Specialist Auditor.[26]

7.5.1 Timing of audits

The Panel believes that the annual audit provides a high level of assurance to members, regulators, government and the community more generally. Without this assurance, it would be unlikely the current 'control' features enjoyed by trustees could be retained.

Some SMSF trustee submissions recommended the removal of the audit requirement or for its frequency to be reduced. These submissions often cited cost and the belief that the audit was unnecessary. The Panel strongly rejects these views, noting that the extent of tax concessions for SMSFs justifies the public interest in independent assurance about the existence and value of fund assets, and funds' compliance with legislated requirements.

On the other hand, other submissions indicated that having less frequent audits would result in increased compliance costs and potentially a greater number of contraventions throughout the sector. The Panel agrees with these views and it also believes the annual audit acts to engage trustees with their superannuation.

Given the growing size of the SMSF sector and the importance of the audit role, the Panel believes that the current frequency of annual audits is appropriate and should not be reduced.

7.5.2 Role of SMSF auditors at SMSF establishment

The Panel is not recommending the scope of the auditing function be changed to include auditing SMSFs at their establishment. Submissions indicated this would have little or no impact on reducing instances of fraud and illegal early release and the Panel agrees with this.

7.5.3 Registration and competence of SMSF auditors

Given the important role that SMSF auditors have, and the reliance placed on auditors by regulators and other industry participants, it is critical for approved auditors to possess the necessary knowledge and skills required to undertake their duties, especially in relation to specific SIS regulatory requirements.

The assurance that an annual audit provides is significantly impacted when the competency or independence of the approved auditor is in question. The quality of the audit role in the SMSF sector has been questioned by industry, and by the regulator, as was noted in the CBA submission:

> *"Commissioner of Taxation, Michael D'Ascenzo, indicated that some auditors were 'focusing solely on financial issues and paying insufficient attention to regulatory requirements.'*[27] *The Commissioner identified the following specific issues with approved auditors: failure to follow basic auditing standards (including record keeping), failure to report contraventions and a lack of independence."*[28]

The accounting professions and the Australian Auditing and Assurance Standard Board (**AUASB**) have done a lot of work in the area of auditor competency. The AUASB issued a guidance standard for auditing SMSFs (GS 009) in October 2008 and the Joint Accounting Bodies released competency standards that have applied since 1 July 2008.[29] The standards articulate and clarify the skills required of SMSF auditors and stipulate the professional standards to be met by SMSF auditors.

As indicated by CPA Australia in its submission, failing to meet these requirements would result in disciplinary action by an auditor's professional body, with severe contraventions subject to potential monetary fines and loss of professional designation.[30]

However, not all approved auditors are subject to the same minimum competency standards, nor are they subject to the same potential enforcement actions. Each of the three professional bodies has its own disciplinary guidelines. Auditors who are not members of any of those bodies are not subject to the minimum requirements, but might be subject to some other standards or possibly none at all. As shown in the following table, auditors who are not members of any of the three professional accounting bodies did the audits on 4.3 per cent of the SMSF population. CPA Australia proposed in its submission that auditors who are not members of any of the professional accounting bodies should be subject to the same minimum requirements as apply to members.[31]

Table 8.1: Proportion of SMSF audits by auditor membership

	Company auditor	CPA	ICAA	NIA	Other	Total
Percentage of SMSFs audited	8.0%	28.8%	50.4%	8.5%	4.3%	100%

Based on the 2008 SMSF Annual Return.
Source: ATO unpublished data.

The Panel favours an approved auditor framework where all auditors operate on a level playing field and enforcement is consistently applied and not dependent on the individual assessment of up to seven different organisations. It believes compulsory registration, which is attached to ongoing competency requirements, would have a favourable impact on the professional standards across the whole industry. Registration of auditors was strongly supported by the majority of submissions.

The registration body should have the powers to set competency standards, develop and apply a robust penalty regime and have powers to deregister auditors. These powers and standards will ensure that minimum standards and enforcement are applied consistently. The Panel believes that the powers and standards of the registration body need to be developed in conjunction with industry, though the cost of registration should be borne by the auditor.

The Panel believes that ASIC is the most appropriate 'registration body' for approved auditors. ASIC already possesses much of the required infrastructure and expertise, as it already undertakes a very similar role as the registration body for company auditors. However, the Panel believes that the ATO — not ASIC — is best placed to police approved auditors. This recognises the ATO's existing

experience in this role. This also enables the ATO to leverage off its SMSF compliance role, providing it with a unique opportunity to assess approved auditor standards, which would be lost if the policing role were placed solely with ASIC.

This arrangement would require ASIC and ATO to work closely together and to share information. ASIC, as the registrar, would set the minimum standards for approved auditors. The ATO would then police those standards (as it presently does) and refer back to ASIC those identified as not having met the minimum standards. ASIC would then undertake the appropriate regulatory response, proportionate to the seriousness of the contravention.

The Panel believes registration would enable targeted communication and education leading to raised competency, especially on the compliance aspect of audits. This would also enable better targeting of non-compliance by the ATO as SMSF auditors would become identifiable through their unique registration number. A central, publicly accessible register of all SMSF auditors would also help SMSF trustees identify appropriately qualified auditors.

Recommendation 8.8

Government should:

(a) appoint ASIC as the registration body for approved auditors and give ASIC the power to determine the qualifications (including professional body memberships as appropriate) required for eligibility to be registered, set competency standards, develop and apply a penalty regime including the ability to deregister approved auditors. The registration requirements for approved auditors should be linked to minimum ongoing competency and knowledge standard; and

(b) task the ATO to police the approved auditor standards and enable information to be appropriately shared between ASIC and ATO so as to carry out their roles effectively.

7.5.4 Independence of SMSF auditors

Given the fundamental role auditors play in the SMSF regulatory framework, true independence of auditors is crucial for the efficient and effective operation of the SMSF sector.

Independence requirements relevant to auditors are those prescribed in Accounting Professional and Ethical Standard 110 — *Code of Ethics for Professional Accountants*, which requires that auditors must not only be independent in action, but must also be perceived to be independent. It is difficult to see how an auditor could appear to be independent when their firm provides advice, prepares the financial statements or provides other services to SMSFs or their members. Auditors who are members of the professional accounting bodies are professionally obliged to comply with the requirements of the Code. However, approved auditors who are not members of the professional accounting bodies are not.

Based on 2008 SMSF annual return data, auditors of 18 per cent of SMSFs provided some other services, such as acting as a tax agent, accountant, financial adviser or administrator.[32] The ATO's 2009 compliance activities targeting high risk approved auditors identified 29 per cent of auditors who were an SMSF's accountant and who had prepared a material part of its financial statements. Additionally, 28 per cent of auditors exhibited evidence of a relationship or conflict of interest that might impact the auditor's ability to be independent and had no safeguards to mitigate that risk.

A number of submissions expressed the view that auditing firms should not be providing SMSFs with any other services and should be completely independent. The Panel accepts this view, given the particular features of the SMSF sector. It also believes the auditor independence model needs to be wider than just requiring auditors to have no connection with services or advice provided to the audited SMSF. The Panel prefers an independence model where the auditor or auditing firm also has no connection to services or advice provided to the individual member/trustees or their family businesses (that is wider than just in relation to the SMSF itself).

Some industry participants have questioned why there is a need to mandate audit independence, arguing that it would be singling out SMSF auditors for treatment inconsistent with international auditing standards and practice. The Panel acknowledges this, but believes that different treatment is justified, given the unique features of SMSFs and their regulation (that is, there is no direct equivalent in any overseas jurisdiction that the Panel is aware of). The closely held nature of SMSFs requires both a traditional financial audit as well as a compliance audit. The compliance audit is unequivocally the central component of the SMSF regulatory framework and in this regard, government is arguably as much a stakeholder as individual SMSF trustees.

The Panel is consciously not proposing to extend this to APRA-regulated funds, as they are not closely held entities and are prudentially regulated, subjecting them to greater oversight. Additionally, the Panel recognises that the audit industry at the large APRA fund level is very different from that of the SMSF sector, as it is only contested by a small number of firms, whereas the audit pool in the SMSF sector is vastly bigger. Therefore, imposing higher independence standards would be achievable given the number of approved auditors in the SMSF industry.

Requiring true independence should not result in increased audit fees (unless cross-subsidisation within the accounting industry is actually occurring). It would, however, likely result in more specialisation and this could assist to reduce audit costs. The following table illustrates that greater scale already reduces the average and median audit costs for auditors who perform a higher number of audits compared to auditors who only conduct a small number of audits.

Table 8.2: Average and median audit fees relative to the number of audits performed

No. of audits performed by an auditor (2008)	Average fee	Median fee
1 fund	$865	$550
2 - 4 funds	$951	$570
5 - 10 funds	$911	$600
11 - 25 funds	$810	$550
26 - 50 funds	$686	$517
51 - 100 funds	$602	$495
101 - 250 funds	$540	$440
>250 funds	$413	$380
Total	**$664**	**$495**

Based on the 2008 SMSF Annual Return.
Source: ATO unpublished data.

Additionally, the following table also supports the view that the use of truly independent auditors is already a cheaper proposition for SMSF trustees.

Table 8.3: Auditor fees based on whether the auditor did or didn't provide other services

	Auditors providing other services		Auditors providing no other services		All auditors	
SMSF Size	**Avg**	**Median**	**Avg**	**Median**	**Avg**	**Median**
$0 to $50k	$841	$550	$571	$440	$627	$440
>$50k to $100k	$732	$539	$519	$440	$556	$440
>$100k to $200k	$772	$550	$541	$440	$580	$462
>$200k to $500k	$823	$550	$567	$462	$608	$495
>$500k to $1m	$922	$600	$599	$489	$649	$495
>$1m to $2m	$1,105	$660	$645	$495	$717	$500
>$2m to $5m	$1,379	$800	$746	$528	$839	$550
>$5m to $10m	$2,050	$1,100	$913	$532	$1,079	$550
>$10m	$2,740	$1,400	$1,433	$695	$1,634	$750
Total	**$954**	**$594**	**$608**	**$480**	**$664**	**$495**

Based on the 2008 SMSF Annual Return.
Source: ATO unpublished data.

Given the importance of the audit role in lifting system integrity, many submissions called for legislated independence, whereby firms who audit an SMSF cannot also provide non-audit services to that SMSF. The Panel agrees with these submissions and supports full audit independence. It believes that unless independence standards can be reliably enforced auditor behaviour will not change. The Panel believes this can be best achieved by adding specific audit independence requirements into the approved auditor registration process.

Recommendation 8.9

Subject to the Government implementing recommendation 8.8, ASIC should develop approved auditor independence standards, which auditors must meet as part of their ongoing registration requirements, as outlined in recommendation 8.8.

8 INVESTMENTS

The majority of submissions opposed any notion of restricting SMSF asset allocation or investments. The Panel generally supports this position.

Conceptually, the Panel agrees that those within the SMSF sector should have as much choice as members in the 'choice' sector. Curtailing investment options in the SMSF sector that are still available in the choice sector would be illogical, counterproductive and lead to inefficiencies.

Notwithstanding the above, the Panel believes that, where there are clear prudential or retirement income policy reasons to do so, the Government should be able to constrain investment choices.

Having said that, Australia's SMSF trustees need to stay focused on investing for retirement savings, rather than related party transactions, collectables, personal use assets and leverage. The Panel discusses these issues below.

8.1 Leverage

In principle, the Panel has concerns with the concept of direct borrowing within any superannuation funds, whether SMSFs or APRA-regulated funds. In principle 8, the Panel expressed the view that leverage should not be a core focus for SMSFs.

The original default position adopted in the SIS legislation was that superannuation funds should not engage in borrowing, other than in the very short term to address cash flow issues. The rationale for this stance was simply that leverage for asset acquisition amplifies both gains and losses and this was seen as placing fund members' retirement savings at too much risk. The Panel agrees with the original default position adopted in the SIS legislation.

On 24 September 2007, the SIS Act was amended to allow all regulated superannuation funds, including SMSFs, to invest in instalment warrants.[33] Initial interest in instalment warrants was modest, with only 0.9 per cent of the SMSF population having a derivative or instalment warrant at 30 June 2008.[34] There are, however, indications that this trend might have changed in recent times. Data from Investment Trends' surveys suggest that more than five per cent of SMSFs already invest in such instruments.[35]

While the number of SMSFs has increased greatly, so also has their average asset size and, by implication, their capacity to invest in more complex assets. SMSFs are nevertheless at greater risk than APRA-regulated funds, which are required to have licensed trustees and comprehensive risk management strategies. SMSFs do not have the mandated controls and risk mitigation strategies imposed on APRA-regulated funds.

The Panel is concerned that if direct borrowing had been more widespread before the recent GFC then a substantial amount of retirement savings could have been lost. The Panel therefore believes that the 2007 amendments to the SIS Act, which relaxed the borrowing provisions, are inconsistent with Australia's retirement policy.

The majority of submissions supported the retention of leverage in SMSFs. However, there was a general theme that the existing provisions are complex, create unnecessary confusion and require clarification. Some submissions suggested that recourse be restricted to the initial capital investment with no risk to a fund's assets as a whole or from personal guarantees from any SMSF trustees. Other submissions suggested introducing a maximum loan-to-valuation ratio.

Many submissions also called for greater regulation of borrowing in SMSFs. On 10 March 2010, the Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, released a press statement headed '*Financial services consumer protection framework extended to superannuation borrowing arrangements*.'[36]

The press release outlined the Government's proposal to amend the Corporations Regulations to provide that certain borrowing arrangements by superannuation fund trustees permitted by the SIS Act are 'financial products' under the Corporations Act. This proposal will extend the Government's consumer protection framework to instalment warrants and thereby assist to protect the savings of fund members. This means that only financial service providers with an AFSL will be able to offer these products to superannuation funds. On 26 May 2010, the Government also introduced further legislation clarifying the limited recourse nature of instalment warrants. This attempts to enhance the regulatory framework governing superannuation fund investments in leveraged products. As explained by the Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP in the second reading speech, the *"bill contains amendments that reduce the*

risk to superannuation fund trustees created through arrangements involving personal guarantees, on-lending or related borrowings, multiple assets and where the asset is replaced.”[37]

The Panel recognises that the 2007 changes are still recent and that the extra safeguards recently announced by Government have not yet been implemented. The Panel therefore does not intend to make recommendations to restrict the current borrowing framework; it believes the announced initiatives will need time to be implemented. The Panel believes, however, that the relaxation of the borrowing provisions and the impact of the new consumer protection measure need to be monitored to ensure that borrowing does not become a significant focus of SMSFs. The Panel proposes that the scale and extent of borrowing within superannuation be formally reviewed in the near future. The Panel also strongly believes that there should be no further relaxation of the current borrowing framework that would permit more direct borrowing within superannuation funds.

Recommendation 8.10

The 2007 relaxation of the borrowing provisions and the consumer protection measures that have recently been announced should be reviewed by government in two years’ time to ensure that borrowing has not become, and does not look like becoming, a significant focus of superannuation funds.

To assist in monitoring the levels of instalment warrant borrowings by superannuation funds, the Panel believes that credit providers should be required to collect and provide relevant data to APRA that would enable the RBA to publish statistics; in the same way that credit providers must currently report on the level of finance provided for residential purchases, margin loans etc. These statistics should be at a level that can distinguish the level of finance being provided to SMSFs and APRA-regulated funds.

Recommendation 8.11

Legislation should be passed to require credit providers to collect and provide relevant data to APRA that would enable the RBA to publish statistics on the level of finance being provided to superannuation funds.

8.2 Related party investments

Retirement policy is that superannuation savings should be invested for the sole purpose of providing retirement savings (together with certain approved ancillary benefits) and not for providing current-day benefits.

SMSFs are closely held entities and there is substantial opportunity for SMSF members to engage in behaviour that is inconsistent with government policy and the purpose of their fund.

In 1997, an Insurance and Superannuation Commission survey identified that around 20 per cent of ‘excluded funds’ (as SMSFs were previously known) invested in related trusts and around 13 per cent of funds leased assets to related parties, raising concerns that superannuation savings were not being appropriately safeguarded.[38] Subsequent amendments to the SIS Act in 1999, generally tightening the in-house asset (**IHA**) test and related party rules, have (with other changes) resulted in

the current reduction of these investments to less than 3 per cent of the SMSF population.[39] Nonetheless, these types of contraventions still account for 16 per cent of all the contraventions that auditors report to the ATO.[40]

The Panel accepts the argument that some related party investments are made in line with government policy and acknowledges that in some instances these investments have performed well. It also acknowledges that the majority of submissions have recommended no change to the current rules. Nonetheless, the Panel believes that the current exemptions still provide an avenue for potential abuse, which is inconsistent with government policy, and whose regulatory compliance costs across the superannuation system outweigh the benefits they bring to individual funds.

The Panel believes that non-prudentially regulated, closely held retirement vehicles, such as SMSFs, should not be able to make related party investments and they should not be in a position to inappropriately benefit from acquiring or disposing of assets with related parties.

8.2.1 5 per cent in-house asset limit

The purpose of the IHA test is twofold. It serves to protect fund members from the risk that, in the event of the employer failing, they lose both their source of income and their retirement savings. It also limits the extent to which business funding arrangements can be distorted, particularly in the small business sector, through access to relatively cheap, tax-advantaged working capital derived from a related SMSF.

The Panel believes that the 5 per cent IHA limit is appropriate within the APRA-regulated sector. Unlike SMSF members, there is generally no opportunity for APRA-regulated fund members to get direct benefits from these investments. Additionally, the 5 per cent limit enables large APRA funds to have limited exposure to an employer sponsor where its exclusion could limit the capacity of the trustee to invest in, for example, index linked funds where the employer forms a significant part of the ASX 200.

However, given the closely-held nature of SMSFs, the Panel believes that SMSFs should be prohibited from holding any IHA investments.

For those SMSFs with existing IHA investments, grandfathering or transitional arrangements would be required. Potential options to facilitate this could include:

- Existing IHA investments under 5 per cent could be grandfathered, in a similar manner to the 1999 grandfathering rules, whereby these investments could be retained and defined so as not to constitute an IHA investment. However, no new or further IHA investments would be permissible.

- Alternatively, SMSFs with IHA investments could be provided with a transition period, to convert their SMSF into a SAF or dispose of their existing IHA investments. No new or further IHA investments would be permissible during or after this period.

The Panel favours the latter option. This would result in the removal of all IHA investments from SMSFs and provides sufficient time for funds to consider their options.

The Panel believes prohibiting these IHA investments would have minimal impact on SMSFs, as the vast majority of SMSFs do not have IHA investments and should lead to reduced compliance costs for

the system overall. However, the Panel is not proposing to unwind the previous 1999 grandfathering arrangements or alter the existing IHA definition exemptions.

Feedback on the Panel's preliminary SMSF report indicated that reducing the IHA limit to zero percent would limit investment choice and diversification. The Panel does not consider that these arguments are valid when weighed up against the risks that IHA investments pose within closely held, non-prudentially regulated, entities.

The Panel would like to emphasise that the reduction of the IHA limit in SMSFs would not limit investment choice and diversification. SMSF members with existing IHA investments would still be able to retain their IHA investments by appointing an RSE-licensed trustee and converting the SMSF into a SAF. Likewise, into the future, all SMSF members would continue to retain their ability to invest in IHAs so long as they convert their SMSF into a SAF.

SMSFs and SAFs are very similar. Converting to a SAF has no impact on the existing fund structure or the members' entitlements. This arrangement does not result in the fund being wound up; the fund merely switches from being an SMSF, under the regulation of the ATO, to a SAF, under the regulation of APRA, and as such there are no tax consequences. Converting to a SAF does require the appointment of an RSE trustee. However, members keep the ability to be self-directed investors. While the appointment of an RSE trustee might add to costs, the Panel believes this is justified given the additional safeguards they bring to these investments.

Feedback on the Panel's preliminary SMSF report suggested that the transition period of up to 2020 that the Panel had proposed would be too long, causing ongoing uncertainty and differential treatment between funds with IHA investments and those without them. Given that funds could ultimately choose to keep their existing IHA investments by becoming a SAF, the Panel now considers a shorter transition period of five years would be more appropriate.

The Panel wants it to be understood that the current extent of IHA investments is not material in the overall context of the SMSF sector, but that the continued existence of the exemption has the potential to undermine confidence in the sector as a whole and should be eliminated.

Recommendation 8.12

SIS legislation, in relation to SMSFs, should be amended so that:

(a) the 5 per cent IHA investment limit be removed so that no IHA investments would be allowed;

(b) SMSFs with existing IHA investments be provided a five year transition period, in which to convert to a SAF or, alternatively, dispose of their IHA investments. No acquisitions of IHA investments would be permissible during the transition period; and

(c) APRA-regulated funds be exempt from these changes.

8.2.2 Acquisition and disposal of assets from related parties

The Panel believes that the off market acquisition and disposal of assets between related parties (where the guiding mind of both buyer and seller can effectively be the same person), does not provide transparency, is inherently risky and is open to greater abuse than non-related party

transactions. The Panel believes the current provisions relating to related party acquisitions and disposals are insufficient to mitigate the potential risk of transaction date and asset value manipulation to illegally benefit the SMSF or the related party (depending on the transaction).

While the Panel debated recommending prohibiting all related party transactions (to ensure that trustee retirement decisions were in no way affected by the personal tensions that related party transactions can present) it concluded that retaining the ability to conduct limited related party transactions was still a desirable feature. As previously mentioned, the Panel is not proposing to change existing exemptions to the IHA definition, such as the lease of business real property to related parties. The Panel recognises that, unlike the removal of the 5 per cent IHA investment limit, removing the business real property exemption would have a very significant impact on the SMSF sector and on a large number of individual SMSFs.

Given the longstanding nature of the business real property exemption, the benefits it provides to business and farmers (especially as it engages them with providing for their retirement) and the lack of reports of any significant abuse in this area, the Panel believes, that with additional related party safeguards, it should remain in place.

The Panel believes that any acquisition or disposal of an asset (including in specie acquisitions and disposals) to a related party where there is an underlying formal market or exchange (for example, securities quoted for trading on the ASX) must be conducted through that market. Where a market does not exist, then that acquisition or disposal must be supported by a current independent valuation from a registered valuer (for example, a business real property transaction will need to be supported by a valuation).

These changes will provide greater transparency to related party acquisitions and disposals, enabling approved auditors and the ATO to monitor this area more effectively. This will enhance the integrity of the SMSF system. While the Panel recognises these changes are likely to add to individual transaction costs, such costs will only be borne by those SMSFs that choose to engage in related party transactions.

Recommendation 8.13

SIS legislation relating to acquisitions and disposals between related parties in SMSFs (but not APRA-regulated funds) should be amended so that, either:

(a) where an underlying market exists, all acquisitions and disposal of assets between SMSFs and related parties must be conducted through that market; or

(b) where an underlying market does not exist, acquisitions or disposals of assets between related parties must be supported by a valuation from a suitably qualified independent valuer.

8.3 Collectables and personal use assets

While the Panel recognises and supports the freedom of investment choice that SMSFs afford their members, it believes that there are certain types of assets that should generally not be regarded as investments that build retirement savings and which consequently should not be available to SMSFs.

Such assets are broadly equivalent to 'collectables' and 'personal use assets' for tax purposes.[41] Examples include (but are not limited to):

- paintings, jewellery, antiques and stamp collections ; and
- wine, exotic cars, golf club memberships, race horses and boats.

The Panel accepts that some of these types of assets may appreciate in value over time and that investors with the appropriate specialist knowledge can profit out of them. However, the Panel points out that people who want to own such assets are free to do so outside the SMSF environment (either in a prudentially regulated superannuation fund or outside the superannuation system altogether). Again, the Panel accepts that the proportion of SMSF sector assets invested in collectables and personal use assets is modest. While there will be some SMSFs where the concentration of such assets is quite pronounced, this is not the core issue. The principal concern is that the cumulative regulatory and compliance complexities outweigh the potential benefits of allowing such a liberal investment menu to a sector that is not directly prudentially regulated.

Feedback to the Panel's preliminary recommendation to prohibit collectable and personal use assets within SMSFs again indicated that this would unfairly remove choice and the ability to diversify. Responses also argued that this prohibition would severely impact the art and numismatic industries.

Consistent with its response and approach at section 8.2.1, the Panel does not believe the 'choice' and diversification argument is a valid factor when considering whether collectables and personal use assets are appropriate investments for closely-held entities that operate in a non-prudentially regulated environment. Collectable investments pose particular issues in relation to the application of the sole purpose test. These assets lend themselves to personal enjoyment and a range of 'non-investment' factors and therefore can involve significant current day benefits being derived by those using or accessing the assets.

Likewise, the Panel does not accept as logical that the art and numismatic industries would be severely or even materially affected by the proposed changes. Members who believe that collectables are appropriate investments could continue to invest in them by converting their SMSF to a SAF and operating under a prudentially-regulated framework. New collectables investors would simply establish a SAF instead of an SMSF. Therefore, members retain the ability to be self-directed investors, however, they should also be in a position to show (through the RSE trustee) how acquiring assets of this kind involves a reasonable investment.

In line with its revised approach in relation to in-house assets, the Panel now considers a shorter transition period of five years, whereby SMSFs either convert to SAFs or, alternatively, dispose of their collectable investments, to be more appropriate.

Recommendation 8.14

SIS legislation, in relation to SMSFs, should be amended so that:

(a) the acquisition of collectables and personal use assets by SMSF trustees be prohibited;

(b) SMSFs that own collectables or personal use assets be provided a five year transition period, in which to convert to a SAF or, alternatively, dispose of those assets. No acquisitions of collectables and personal use assets would be permissible during the transition period; and

(c) APRA-regulated funds be exempted from these changes.

8.4 Investment resources

The Panel believes appropriate information and guidance on SMSF investments, such as the concepts of investment risk, diversification, liquidity and the different considerations of the accumulation and payment phase, should be made more widely available. This is discussed further at section 9.4.

9 SMSF INFORMATION

The level and quality of information available on SMSFs and the SMSF sector does not reflect the sector's position as Australia's largest superannuation sector by value. Given the scale of the sector, the government and the community as a whole have an interest in quality data on SMSFs.

The information needs for industry participants will vary significantly depending on their involvement. Information helps to:

(a) improve decision-making and choice;

(b) improve understanding; and

(c) enhance competition, analysis and monitoring of Australia's superannuation system.

Ensuring that there is reliable and relevant SMSF data is an integral part of the efficient operation of Australia's superannuation system. Achieving comparability of data between SMSFs and large APRA funds was viewed as a positive outcome in many submissions. The Panel is conscious of submissions warning that changing the information requirements for SMSFs should not overly burden SMSF trustees with additional data collection obligations, but the Panel is also optimistic that this can be managed once an enhanced data collection and publication regime is achieved in the large APRA fund sector.

SMSF data give trustees practical information to help them manage their fund. For example, it might be of assistance to see what the average audit fee is for the industry as a whole or for a similar-sized fund. Likewise, it could help a trustee to be able to see what the average long term returns or what the administration, investment, and advice costs have been for similar-sized funds with similar investments.

9.1 SMSF data provider

There is currently no organisation charged with producing information for the benefit of the SMSF sector.

While several organisations have released statistical reports on SMSFs in the past six months,[42] these summaries draw on information from different sources, are based on different populations and calculate key metrics differently. Also, the SMSF information in these reports is largely incomparable with large APRA fund data.

A number of submissions suggested that the ATO was the most appropriate entity to collect and provide data in the marketplace, while others suggested that APRA or the Australian Bureau of Statistics might be better placed to collect and provide data on SMSFs.

To improve the level of available information, additional data would need to be collected from SMSFs. While the Panel recognises this would have cost implications, it believes the long-term benefits to public policy-making and to the industry would outweigh these costs and so satisfy principle 3 in relation to government intervention. To achieve this, industry consultation would be required to identify the required data.

The Panel recognises the logic for the industry regulator to collect all the data needed for both regulatory and broader public purposes. As such, the Panel believes the ATO should be given responsibility for the ongoing production of SMSF statistical reporting that benefits greater market and member understanding of the SMSF sector and its performance.

Recommendation 8.15

Government should provide the ATO with a specific mandate to collect and produce SMSF statistics, the details of which be developed in consultation with industry, which provide greater understanding of the SMSF sector and its performance.

9.2 SMSF accounting

The Panel recognises that SMSF trustees report to themselves as members. Accounting standards, however, are not tailored for SMSFs. This can produce shortfalls in the information provided to members and the community (which has a valid interest in some of this information).

9.2.1 Asset valuations

Australian Accounting Standard 25 — *Financial Reporting by Superannuation Plans* (**AAS 25**) applies to 'reporting entity' superannuation funds, requiring them to value their assets at their net market value as at the reporting date. However, SMSFs are not reporting entities and are therefore not required to comply with AAS 25. The ATO's preferred valuation method, as outlined in its Superannuation Circular 2003/01, is for all SMSFs to use market values for all valuation purposes, but this is not mandatory.[43]

Asset valuation is a key component in preparing meaningful SMSF financial reports. It has an impact on the returns for members and, ultimately, SMSF sector performance as a whole. Currently, SMSFs are generally able to choose either the historical cost or market valuation accounting method to

value their assets; although SMSFs in the pension phase[44] or those with IHA investments, must value assets at market value each year.

The differing use of these valuation methods in the SMSF sector has a significant impact on a member's ability to ascertain current superannuation benefits, affects the reliability and usefulness of superannuation data, and compounds the difficulty in comparisons with large APRA funds (which use the market valuation methodology). Ultimately, market value accounting is essential for the reliability, transparency and accountability of Australia's superannuation system. It would also ensure that SMSF members are given a truer picture of their SMSF and their likely personal entitlements. As one submission pointed out:

> *"a requirement that SMSF financials be prepared at net market value would be useful and fair in regards to calculation of minimum and maximum pension amounts, members' roll ins and roll outs and consistent measurement of compliance breach amounts."*[45]

The majority of submissions supported the reporting of assets at market value. Submissions also supported the view that most SMSFs already use market valuations because trustees want an accurate picture of their fund's investment performance. The ICAA has suggested that the requirement for all SMSFs to value assets at market value be incorporated in the SIS legislation.[46] The Panel believes that the consistent use of net market valuation would benefit members.

The Panel considers that all SMSFs should value assets annually at net market value, though it does not believe that SMSFs should be required to prepare general purpose financial reports. This would make valuation principles consistent across all superannuation sectors. The Panel believes that implementation of market value accounting would not impose significant cost or burdens on SMSFs. The majority of SMSFs are already valuing assets at market and most SMSF assets (72 per cent) are 'market assets' and readily conducive to annual valuation (listed equities, cash, listed trusts and managed funds).[47]

Some difficulties may be faced when valuing certain assets, such as units in unlisted unit trusts. In these cases, guidelines on different asset classes could be provided by the ATO to ensure consistency of valuation and enable clear auditing of the requirements. It should also be recognised that formal (external) valuation would not be required every year, but rather at a suitable intervals developed in consultation with the accounting industry (say every three years as per the current standard). Trustee's valuations, with appropriate supporting documentation, would then be acceptable in the interim.

Recommendation 8.16

The Government should legislate to require SMSFs to value their assets at net market value.

Recommendation 8.17

The ATO, in consultation with industry, should publish valuation guidelines to ensure consistent and standardised valuation practices.

9.2.2 Disclosure to members

The Panel is keen to encourage further engagement by all trustees in the affairs of their SMSF, not just the dominant party (if one exists). The Panel believes there is some key information that SMSF trustees should provide annually to all SMSF members, beyond what the Corporations Act currently requires. This includes:

- whether or not a binding death benefit nomination is in place and if so, the name of the beneficiary(ies) and the date on which the notice will lapse (if applicable);
- notification as to whether a pension is in place and whether that pension automatically reverts to the pensioner's spouse on death;
- whether the member's death benefit includes any insurance and if so, the amount of that insurance;
- showing the member's balance divided between each 'superannuation interest' held for that member in the fund;
- the investment return (after fees and tax) achieved on each member's balance over the previous financial year; and
- where investment choice is exercised, how the member balances have been invested.

The Panel expects that some trustees are already acutely aware of this information and have no need for further prescription. The Panel believes, however, that requiring trustees to report on these items (in addition to the SMSFs annual financial statements and tax return) will prompt those with less involvement in the day-to-day running of the fund to be more aware of what is happening. This will also have the benefit of standardising the minimum type of information that services providers must consistently prepare and provide to SMSF trustees.

It might be appropriate to add to the above list of disclosure items following consultation with industry.

Recommendation 8.18

Government, after appropriate industry consultation, should amend the Corporations Act to ensure SMSF trustees provide all SMSF members with certain key information on an annual basis.

9.3 Administrative requirements

While the Panel supports specific disclosure items that add to member level understanding and engagement with their superannuation, it does not support unnecessary administrative burdens that are not directly relevant to helping members build their retirement savings.

As outlined in section 6.3.1 of this chapter, a restructuring of the SIS Act could provide an opportunity to remove provisions that are inapplicable to SMSFs. Irrespective of whether the Panel's recommendation at section 6.3.1 is accepted, the Panel supports the removal of unnecessary

administrative burdens on SMSF trustees, such as trustee minutes which require paper shuffling from the 'trustee' to the 'member'.

All superannuation entities, including SMSFs with two or more individual trustees and all directors of a corporate trustee, are currently required to prepare minutes of all meetings of trustees or directors at which matters affecting the fund are considered. This can be contrasted with the requirement for a single individual trustee simply to retain records of all decisions made.[48] The Panel considers that while there might be some specific areas in which a minute-keeping requirement of some form would be appropriate for SMSFs, it might be that minute-keeping in relation to most aspects could removed to reflect the existence and effect of records commonly maintained by SMSFs (for example bank statements, CHESS statements, contract notes and the like).

The Panel would like to see the administration of an SMSF align more with the rules applying to small and single member proprietary companies under the Corporations Act, where meetings, minutes and other formalities have been reduced to an absolute minimum.

The Panel believes that as part of the industry consultation (outlined in the above recommendation to increase member disclosure) that industry should also consider what unnecessary administrative requirements relating to SMSFs should be removed from the SIS Act.

Recommendation 8.19

Government, after appropriate industry consultation, should amend legislation to remove SMSF trustee administrative burdens that are identified as unnecessary.

9.4 Online SMSF resource centre

As indicated in section 5, the Panel believes that increased knowledge and competency can be achieved through methods other than requiring trustees to undertake compulsory education. Other methods include voluntary education, provision of SMSF operational guides and through a dedicated online SMSF resource centre.

The Panel believes SMSF trustees should have access to resources (such as general advice, statistics and educational material) that would help them build their knowledge and competency voluntarily. This would require all SMSF information to be brought together, catalogued and indexed, and incorporate an enhanced 'search tool' enabling information to be accessed and found easily.

The resource centre could provide further information on matters such as:

(a) **investments**: covering aspects such as asset allocation, diversification, liquidity and risk; it could provide investment strategy templates tailored to SMSFs, rather than the current 0-100 per cent investment range templates so commonly adopted that are of little or no value. Professional investment advisers could be engaged by government to provide recommended asset allocation templates, perhaps on a quarterly basis, based on member ages, risk tolerances and asset sizes;

(b) **compliance**: covering regulatory obligations in relation to both administration and investments;

(c) **regulatory changes**: listing of all key changes to applicable laws, regulations and standards; and

(d) **industry participants**: link to the ATO and a link to a 'SMSF service provider register' that enables SMSFs trustees to look-up and identify registered SMSF auditors and licensed advisers. ASIC's website already enables searches of registered company auditors and licensed advisers.

This centre would be developed as a central repository and access point for SMSF knowledge and information, similar to the Employee Benefit Research Institute for 401(k) plans in the United States.[49] This could be provided as part of a central government website on superannuation, which could be a 'one-stop-shop' for SMSF trustees and include all information and tools needed by trustees when carrying out their SMSF duties. The development of such a site and the inclusion of SMSF information listed above would facilitate increased trustee knowledge and competence.

The formation of a dedicated government website on superannuation was canvassed in the *Phase Two: Operation and Efficiency — Issues Paper,* and has been supported by the majority of submissions to Phase Two. Submissions have suggested that the website should be easy to use and have content that is both comprehensive and practical to SMSF members.

The Panel believes that a resource centre to house SMSF knowledge, information, statistics and other educational tools, should be developed for the benefit of SMSF trustees and the wider market. The Panel believes this centre should be developed as part of its recommendation in chapter 4 to develop the government superannuation website (www.super.gov.au).

10 IMPROVING INTEGRITY

Fraud and illegal early release schemes using SMSFs reduce participants' confidence in the integrity of the superannuation system and is currently causing difficulties in processing rollovers from large APRA funds to legitimate SMSFs.

The Panel believes that a single 'point of truth' needs to be established so that large APRA funds can quickly and efficiently establish whether or not an SMSF that is the subject of a rollover request is legitimate.

Schemes exist to facilitate illegal early release and fraud. Fraud can occur where unrelated parties dishonestly use a member's identity to move their benefits out of their superannuation fund without their knowledge or consent. With illegal early release, members participate with a promoter to access their benefits ahead of time. In either scenario, the funds are usually transferred from a large APRA fund to an SMSF that has been established so as to facilitate the scheme.

The Panel notes that there are well-established mechanisms permitting legal early release of preserved superannuation in clearly defined circumstances, such as proven financial hardship, or to meet legitimate expenses to address life circumstances such as medical expenses for life-threatening or chronically painful medical conditions where treatment is not reasonably available through the public health system.[50]

Key to making fraud and illegal early release schemes more difficult, and thereby improving the efficiency and integrity of the industry overall, is improving the integrity of the processes and information around the establishment and operation of SMSFs.

10.1 SMSF registration

SMSFs currently can be registered online or through a paper-based process. SMSF registration applications are processed by the Australian Business Register. Identity checks of the member/trustees are not part of the registration process; nor are there any records of whether the SMSFs are established through an adviser.

10.1.1 Member identification

The superannuation system as a whole needs to have confidence that members are who they claim to be. For the SMSF sector, this issue is magnified. Once superannuation savings leave the large APRA fund sector, there are few safeguards around the subsequent movement of assets. Reliable and effective SMSF member identification at registration is therefore essential.

The Panel considers member identification could be achieved with little to no additional burden placed on SMSF members as follows:

- The member/trustees establish the SMSF (signs trust deed etc.).
- The member/trustees then open the SMSF bank account and provide the 100 points of ID for all member/trustees. It is likely that the account would be internally frozen until the bank was able to confirm that the SMSF actually exists — that is verified to Super Fund Lookup or directly with the ATO. This would enable contributions or rollovers to be deposited, but would stop any withdrawals or transfers from the account.
- The SMSF trustees would provide the bank account details to the ATO as part of the registration process.
- The ATO verifies with the appropriate financial institution that the details provided on the SMSF registration form (both for the SMSF itself and the member/trustees) match the bank account records and confirms that 100 point ID for all member/trustees has been obtained.

The SMSF registration form would need to be designed so that the ATO is given authority to conduct this check so as not to infringe privacy laws.

Long term, an electronic portal could be created to allow all deposit taking institutions and the ATO to communicate and confirm details. In the interim, this could be potentially done manually.

- If the details do not match — either:

  (a) the registration application could be suspended until the problem can be resolved (for example, the trustees provide ID details to the bank for the missing member or amend the registration details etc.); or

  (b) The SMSF could be registered, but a suitable status is reflected on Super Fund Lookup that would not enable a rollover to occur. It would then fall on the members/trustee to correct the problem and have the ATO re-check with the bank.

The Panel prefers option (a) as providing greater security for the super system and being more efficient.

- If the details match — the SMSF is registered and appears on Super Fund Lookup as an SMSF that can receive rollovers.

This would enable the collected information (that all members have been identified and the confirmed SMSFs bank account) to be shared with, and verified by, large APRA funds to enable both secure and fast rollovers. Members would not be required to do anything they do not already do.

This would require systems to be built, given the need to interact with all financial institutions. The system costs could be re-couped as part of an initially higher supervisory levy for first year SMSFs.

For efficiency reasons, identification requirements should not apply retrospectively to existing SMSFs. The exception to this is where an existing SMSF is organising a rollover from a large APRA fund. In these instances, SMSFs could notify the ATO of its nominated SMSF bank account and the ATO could then verify the relevant details and update Super Fund Lookup, following the same process as previously articulated.

Recommendation 8.20

Government should legislate so that:

(a) proof of identity checks be required for all people joining an SMSF, whether they are establishing a new fund or joining an existing fund; and

(b) identification measures should not apply retrospectively except for existing SMSFs wishing to organise rollovers from a large APRA fund.

10.1.2 Adviser identification

The Panel is concerned to ensure that there is a simple process to monitor and regulate any potentially inappropriate advice in relation to establishing SMSFs, and to bolster the integrity of the SMSF registration system. The Panel recognises that the appropriate process will be dependent on the advice framework that is ultimately implemented to replace the accountants' financial service licence exemption, which was discussed earlier in section 7.3.

Recommendation 8.21

The Panel recommends that the SMSF registration process capture the details of the person who has provided advice in relation to the establishment of the SMSF and the service providers who establish the SMSF (if they are different entities). This information should also be available to ASIC to assist in regulating AFSL holders and form part of the risk assessment process for both ASIC and the ATO.

10.1.3 SMSF naming conventions

Currently, an SMSF can be registered with any name. In a few instances, an SMSF has been established with a name that mirrors an existing large APRA fund. This then allows cheque rollovers, intended for the large APRA fund, to be banked into the SMSFs bank account. Similarly, a person

could form an SMSF with a name suggesting a connection with a bank, an insurance company or the government.

A name registration system, along the lines of ASIC's national names index for company and business names, would stop this.

Recommendation 8.22

Controls should be put in place to ensure SMSFs can be neither established with, nor subsequently change their name to, the name of, or a name similar to, an existing large APRA fund and that other naming rules applicable to bodies corporate under the Corporations Act be applied to SMSFs.

10.2 Super Fund Lookup

The ATO recently announced measures to fight illegal schemes through tightening the SMSF registration process.[51] As part of this, APRA also provided advice to the funds it regulates on what checks the trustees should perform before processing rollover requests.[52] The Panel believes there is an opportunity to harness technology to improve the current process, which would not only strengthen the security of the registration system, but also enable rollovers to SMSFs to be processed from large APRA funds in a much more efficient and timely manner.

In section 10.1.1, the Panel outlined its proposal for the validation of the SMSF, member and trustee identities as well as the validation of the SMSF's bank account number. With this information, Super Fund Lookup (or a similar system) could be upgraded to provide large APRA funds with the following information:

- the SMSF member/trustee level details (such as the member/trustee names and date of birth);
- a status confirming that the identity of the member/trustees have been verified;
- the SMSF's validated bank account number; and
- member tax file number (**TFN**) validation. Large APRA funds could enter their record of the member's TFN into the Super Fund Lookup field that contains the member's records and the ATO system could then validate whether it matches its internal records.

Large APRA funds could check Super Fund Lookup on receipt of a request to rollover to an SMSF. Where the member and destination SMSF details provided on the rollover request match the Super Fund Lookup details, the rollover could be immediately processed and electronically transferred to the SMSF bank account. Where details do not match, the obligation would be on the SMSF trustees to update the SMSF details with either or both the ATO and their financial institution, as applicable.

Given the additional member level and SMSF bank account information now available, access to Super Fund Lookup (or a similar system) would need to be restricted to large APRA funds via secure systems.

Recommendation 8.23

Government should provide a system (Super Fund Lookup or an alternative) to:

(a) provide appropriate SMSF information to large APRA funds (which would include member level details, confirmation that identification of member/trustees has occurred and the SMSFs bank account number) to enable the large APRA fund to verify the details of SMSF membership before processing rollover requests to SMSFs; and

(b) require the large APRA fund, upon appropriate confirmation, to immediately process the request and electronically transfer the rollover to the validated SMSF bank account.

10.3 Penalties for illegal early release

10.3.1 Promoter penalties

Stronger sanctions must exist to deter promoters of illegal early release schemes from undermining the Government's retirement policy and harming members in the process.

Existing laws enabling the ATO to target and address illegal tax scheme promoters do not apply to the SIS Act. Currently, illegal scheme promoters are principally dealt with by ASIC which relies on its powers to take action against them, often on the grounds that they are providing unlicensed financial advice.

Submissions supported the ATO having extended powers to address those promoting and facilitating illegal early release. Rice Warner Actuaries suggested implementing a similar model to the existing tax promoter laws.[53] The Panel shares these views; it believes that the ATO is best placed to manage all players (promoters and participants) in illegal early release schemes.

Recommendation 8.24

Legislation should be passed to provide for criminal and civil sanctions to enable the ATO to penalise and discourage illegal early release scheme promoters.

10.3.2 Participant and member penalties

Depending on their overall assessable income, individuals who illegally release their superannuation early (through a scheme or otherwise) possibly face paying tax on the amounts released. Penalties might also be applicable if they do not declare these amounts as income. This, however, is the same for those who follow the law and get early release legally. The current position is therefore inequitable.

The Panel believes that those without an entitlement to early release should not benefit from their access. Presently, people who have their illegal withdrawals assessed will still have the benefit of what they are left with. For example, if someone releases $10,000 illegally and the tax on this is $1,500, they will keep the $8,500 balance. If their income is low enough, they will not pay tax at all. For some people, forfeiting a portion of their superannuation to tax (and promoter fees where

applicable) to access the remaining balance, years before they are legally entitled to, might be quite appealing.

Tax rates and penalties need to be amended to ensure there is both a greater deterrence factor and to ensure that those committing illegal early release do not enjoy the same treatment as those who legally get early release of their superannuation.

The Panel considers a standard flat tax rate, equal to the superannuation non-complying tax rate, should apply to all money illegally released. In addition, a sliding scale of penalties (with the potential to be remitted to zero under appropriate circumstances) should be applicable and take into account individual circumstances.

Recommendation 8.25

The Government should amend existing tax laws so that:

(a) amounts illegally early released be taxed at the superannuation non-complying tax rate; and

(b) an additional penalty, based on a sliding scale of penalties that takes into account the individual circumstances, should apply.

10.4 Use of superannuation for criminal purposes

Some functions of prudentially supervised funds are subject to the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (**AML/CTF Act**) as designated services, but trustees of SMSFs are excluded. The rollover of a superannuation benefit to another fund, including SMSFs, is not captured as a designated service under the AML/CTF Act because preservation requirements mean that the assets are retained within a regulated financial sector and therefore the transaction represents a very low risk of being used for money laundering or terrorism financing. However, because the trustees and members of an SMSF are the same, there is greater scope for assets, once received in the SMSF, to be diverted for illicit purposes. Introducing a new designated service, to apply to regulated superannuation funds when they roll over assets to an SMSF, will ensure consideration is given to the AML/CTF risk associated with the rollover of assets, and that appropriate customer identification and reporting obligations exist when assets exit the formal financial sector.

Recommendation 8.26

Legislation should be passed so that rollovers to an SMSF be captured as a designated service under the AML/CTF Act.

11 OTHER

11.1 Standard trust deeds

The vast majority of submissions supported the idea of an optional standard trust deed. The Panel was attracted to this proposition in that a standardised trust deed (either maintained by the ATO or applying on an opt-in basis like the Corporations Act replaceable rules) could provide SMSFs with upfront savings in their establishment and reduce ongoing administration costs. Standardised documentation could also provide for more uniformity across the sector, making it easier for trustees and their service providers (administrators, auditors etc) to follow, which could lead to further efficiency.

During industry consultation, most participants expressed in principle support for the idea and the benefits it could provide, however they believed SMSFs would still opt for tailored deeds in a large number of cases. This suggests that the time, effort and cost involved in creating, hosting and maintaining a standard deed could not be justified. The Panel therefore believes that some of the pressure to update trust deeds regularly (especially where there is a change in the law) could be reduced by introducing, into the SIS Act, provisions which would automatically deem anything permitted by the SIS Act to be permitted by SMSF trust deeds, such as stipulating that the following provisions are deemed to be included in the trust deed of each SMSF:

(a) notwithstanding anything in this document, if the SIS Act or a tax act prohibits an act being done, that act must not be done;

(b) nothing in this document prevents an act being done that the SIS Act or a tax act requires to be done;

(c) if the SIS Act or a tax act requires an act to be done or not to be done, authority is given for that act to be done or not to be done (as the case may be);

(d) if the SIS Act or a tax act requires this document to contain a provision and it does not contain such a provision, this document is deemed to contain that provision;

(e) if the SIS Act or a tax act requires this document not to contain a provision and it contains such a provision, this document is deemed not to contain that provision;

(f) if any provision of this document is or becomes inconsistent with the SIS Act or a tax act, this document is deemed not to contain that provision to the extent of the inconsistency; and

(g) if a thing is permitted to be done under the SIS Act or a tax act, this document is deemed to permit it unless it is expressly prohibited by another provision of this document.

Recommendation 8.27

The Government should amend the SIS Act so as to automatically deem anything permitted by the SIS Act or a tax act to be permitted by SMSF trust deeds.

11.2 Separation of assets — section 52(2)(d) of SIS

There is no effective power to enforce a separation of fund assets from those held personally by the trustee, an employer sponsor or an associate, because the obligation is established by way of a covenant deemed to be incorporated into the governing rules of the fund.

Breaches of the covenant occur with some frequency, such as where an SMSF is run through a member's bank account, rather than the SMSF's or where assets are recorded in one or more members' names, rather than that of the SMSF.

The ATO is unable to enforce compliance with covenants. It is limited to providing education on what would constitute appropriate separation of assets and then relies on the trustees to comply voluntarily — which for the most part they do.

The Panel believes that the ATO should be able to enforce such a fundamental concept, recognising that contraventions of the separation of assets covenant are one of the most commonly reported, both by number and value, in auditor contravention reports.[54]

The Panel notes that the requirement for a trustee to devise and implement an investment strategy for the fund appears as both a covenant under section 52(2) of the SIS Act and also as an operating standard for the purposes of section 34 of that Act. The Panel considers that appropriate separation of assets is of sufficient significance for the operation of SMSFs that an operating standard should be adopted, so giving the ATO a direct power to enforce the provision.

Recommendation 8.28

Legislation should be passed so that the covenant requiring separation of fund assets from personal or employer assets, as set out in section 52(2)(d) of SIS, be replicated in a SIS operating standard.

11.3 Insurance default

The Panel does not believe there should be an insurance default within SMSFs. SMSF trustees are expected to be self-reliant in determining the levels of insurance cover they might require, whether within or outside their SMSF.

As shown in the following table, ATO data shows that less than 13 per cent of SMSFs have insurance. However, the majority of submissions suggested that SMSF members were more likely to hold appropriate levels of insurance, or be able to hold insurance outside their superannuation, than members of other superannuation sectors.

Table 8.4: Proportion of SMSFs with insurance[55]

Proportion of all SMSFs with insurance	12.7%

SMSF Size	Proportion of SMSFs
$1-$50,000	4.7%
>$50,000-$100,000	7.3%
>$100,000-$200,000	16.0%
>$200,000-$500,000	30.1%
>$500,000-$1m	21.7%
>$1m-$2m	13.3%
>$2m-$5m	6.2%
>$5m-$10m	0.7%
>$10m	0.1%
Total	**100%**

Source: ATO unpublished data.

To ensure that trustees appropriately consider this issue, one submission suggested that the investment strategy operating standard (SIS Regulation 4.09) be modified so as to include the consideration of life and total and permanent disability (**TPD**) insurance.[56] The Panel agrees with this suggestion.

Recommendation 8.29

The Government should amend the investment strategy operating standard so that SMSF trustees are required to consider life and TPD insurance for SMSF members as part of their investment strategy.

12 SMSF ISSUES RAISED, BUT NOT PURSUED

This is a non-exclusive list of SMSF issues raised by the Panel in the Phase Three: Structure Issues Paper which it has considered and determined that no specific recommendations are warranted.

12.1 SMSFs later in life

Submissions were not supportive of restricting choice or control of SMSFs after members had reached a certain age. Understandably, because this challenges the ethos of SMSFs. Given the principle that SMSF trustees are ultimately responsible for their retirement outcomes, the Panel is not recommending any changes in this area.

12.2 Compliance coverage

Compliance coverage should ultimately reflect the level of risk. The Panel believes that this is best left to the ATO to determine.

The current levy collection arrangements are to be reviewed by the ATO no later than 30 June 2011. Ultimately, a number of recommendations made in this report might have some impact on this consideration which could prompt pressure for an increase. This will have to be judged according to the circumstances applying at the time.

12.3 Technology

Technology within SMSFs can be applied in a number of areas, such as administration, investing, reporting and compliance. The Panel believes that costs within the SMSF sector can be reduced by increased use of IT solutions, enabling fewer moving parts and greater automation. IT solutions could improve efficiency in operation and reduced reliance on paper-based accounting approaches.

The Panel's views on SMSF technology is shared by a submission from the NIA.

> *"Technology is a great tool for driving down costs and while SMSF do not have the scale in an individual sense, the large size of the sector as a whole provides a degree of scale that should be attractive to technological development … It would appear that there is genuine market interest in developing technologies that will drive down administrative and other costs of SMSF"*[57]

While submissions acknowledged the benefits of technology within the industry, many indicated that any government interference could potentially stifle future technology development which should therefore continue to be developed by the market.

Some submissions have recommended particular information technology developments within SMSFs. One submission recommended that industry and regulators support the Australian Payment Clearing Association's project to modernise the payments system to include superannuation in an industry-wide solution encompassing SMSFs.[58] Another submission suggested that the development of online facilitation and standard templates for data transfer protocols between service providers would assist financial planners.[59] The ICAA suggested that efficiencies could be increased and costs reduced if there were the "*ability to link and digitally transfer vast amounts of information from various sources*" within the SMSF sector.[60]

A submission from Rice Warner Actuaries recommended that,

> *"the CHESS system of the ASX could be modified to provide an SMSF administration and reporting facility … A standard form of investment administration though CHESS would simplify the system and aid accountants and auditors. The ATO (and APRA if appropriate) should be allowed viewing access to CHESS for the purposes of reviewing compliance of any SMSF"*[61]

The Panel supports the development of standardised data and transmission throughout the SMSF industry. Enabling transaction protocols and data standardisation ensures that SMSF data is comparable and consistent. Data standardisation would specifically help SMSFs and their service providers in the preparation of financial reports, including information on the fund's investment transactions, investment income, bank transaction statements, etc.

The Panel would encourage industry to consider further data standardisation that would enable the more efficient use of information. While standardised data and transmission would be broadly consistent with the recommendations proposed in chapter 9, the Panel does not believe the same underlying technological problem exists in the SMSF sector and therefore it is not making any recommendations in this area.

12.4 Investment strategies

Submissions reflected contrasting views about the importance of requiring that an SMSF's investment strategy be recorded in writing. While the Panel recognises the importance of a strategy, it also recognises that for 423,000 SMSFs, there will be great variations in SMSF investments and trustee investment knowledge, which a 'template' approach will not address. Some trustees would gain little or no benefit from having their strategy reduced to writing, while others might gain something from the experience. While the Panel believes that it is desirable for investment strategies to be in writing, it is not recommending that it be mandated.

The Panel does, however, believe there is value in providing guidance and tools to assist trustees in this area and has discussed this in section 9.4.

12.5 Rollovers

Many submissions expressed frustration over the current rollover process from large APRA funds to SMSFs. The Panel believes that its proposals on improving the integrity of SMSF identity data in section 10 should substantially address these concerns.

APPENDIX

SMSFs with $200,000 or less in assets make up 26 per cent of the SMSF population; approximately 108,000 SMSFs.[62] SMSFs with $50,000 or less in assets represent 36 per cent of that sub-$200,000 population (refer Table 8.A).

Table 8.A: (2008) Distribution of existing funds with $200,000 or less in assets

	$1 - $50k	>$50k - $100k	>$100k - $200k	All $200K and under SMSFs
Number	38,980	23,388	45,545	107,914
Percentage	36.1%	21.7%	42.2%	100.0%

Source: ATO unpublished data.

Of existing SMSFs with $200,000 or less in assets, almost all of them (97 per cent) were established within this range; few SMSFs that started with a greater asset size have fallen below this range in subsequent years (refer Table 8.B).

Table 8.B: (2008) Percentage of existing funds with assets of $200,000 or less that had $200,000 or less in assets in their first year of establishment

	SMSF Size			
	$1 - $50K	$50K - $100K	$100K - $200K	All $200K and under
Percentage of SMSFs	97.5%	98.6%	95.3%	96.7%

Note: the population is drawn from all SMSFs established since the 2000 financial year, where the ATO is able to identify SMSF balances at the end of their first financial year.
Source: ATO unpublished data.

As at 30 June 2008, SMSFs with $200,000 or less had on average been in existence for over six years (refer Table 8.C).

Table 8.C: (2008) Age of SMSFs with $200,000 or less in assets

SMSF age	Percentage of SMSFs with $200,000 or less in asset size
In 1st year of establishment	15.5%
Between 1 and 2 years	12.7%
Between 2 and 3 years	7.7%
Between 3 and 4 years	7.4%
Between 4 and 5 years	9.6%
Between 5 and 6 years	8.8%
Between 6 and 7 years	4.9%
Between 7 and 8 years	4.0%
Between 8 and 9 years	5.2%
Between 9 and 10 years	4.2%
Between 10 and 11 years	4.5%
Between 11 and 12 years	3.5%
Between 12 and 13 years	3.3%
Between 13 and 14 years	2.1%
Between 14 and 15 years	1.1%
Older than 15 years	5.4%
Average age*	**6.2 yrs**
Median age	**5 yrs**

* SMSFs older than 15 years are assumed to be 16 years old to simplify these calculations.
Source: ATO unpublished data.

On average, since 2000, it took approximately five years for an SMSF established with $200,000 or less to grow above $200,000. Over the same period, there have been, on average, almost 13,000 new SMSFs established every year whose asset size at the end of their first financial year was $200,000 or less. By the end of their second financial year, 77 per cent of these SMSFs still had $200,000 or less in assets. This percentage progressively reduces in subsequent years; almost half of these SMSFs were still within this range after the fifth year and over one third after the seventh year (refer Table 8.H).

Significantly, when one also considers their average expense ratios (refer to Table 8.D); a large number of members of these SMSFs will be potentially experiencing fixed costs well above what they might have experienced in large APRA funds. Though again, there are also a number of small-sized funds (that is $200,000 or less) that appear to be very cost effective, with over 28 per cent of those SMSFs still having an average annual expense ratio of 1 per cent or less.

Table 8.D: 2008 SMSF Average Expense ratios

Operating expense ratio	$1 - $50k	>$50k - $100k	>$100k - $200k	All $200K and under SMSFs	>$200k - $500k	>$500k - $1m	>$1m - $2m	>$2m	All SMSFs
0.25% or less	0.0%	6.3%	12.6%	8.1%	19.2%	34.3%	48.9%	62.1%	30.1%
>0.25% to 0.5%	4.9%	10.2%	6.3%	7.0%	12.6%	18.0%	16.4%	13.9%	13.4%
>0.5% to 0.75%	5.5%	4.5%	7.8%	6.4%	12.7%	11.2%	9.6%	8.7%	9.9%
>0.75% to 1%	4.4%	4.9%	8.8%	6.8%	10.4%	8.0%	7.1%	5.6%	7.9%
>1% to 1.5%	6.4%	11.2%	16.9%	13.0%	14.5%	12.3%	9.7%	5.8%	11.8%
>1.5% to 2%	5.5%	11.7%	11.9%	10.4%	10.3%	7.6%	4.2%	2.0%	7.7%
>2% to 3%	10.9%	17.8%	15.1%	14.9%	11.1%	5.4%	2.5%	1.1%	8.0%
>3% to 5%	16.1%	16.7%	12.1%	14.2%	6.3%	2.2%	1.0%	0.5%	5.6%
> 5%.	46.3%	16.7%	8.6%	19.3%	2.9%	1.1%	0.5%	0.4%	5.5%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: ATO unpublished data.

The data in Table 8.H tend to support the view that more recently established SMSFs are growing at a faster rate than older established SMSFs. For example, after the fifth year, 58 per cent of SMSFs established in 2000 were still within the $200,000 or less range, whereas this only applied to 42 per cent of SMSFs established in 2004. Likewise, SMSFs established in the 2007 financial year with $200,000 or less were twice as likely to have exceeded this threshold by the end of their second financial year compared to those SMSFs that were established in the 2000 financial year. However, the 2007 temporarily high one-off annual contribution limit of $1M has arguably driven this recent acceleration.

When comparing these smaller sized funds to the overall SMSF population, they are:

- More likely to be a two member SMSF. Nearly 78 per cent of small-sized SMSFs are made up of two member funds, which is 11 per cent above the overall SMSF average membership size distribution.

Table 8.E: Proportion of SMSFs by member size

Number of members	$1 - $50K	$50K - $100K	$100K - $200K	All $200K and under SMSFs	All SMSFs
1	16.4%	15.0%	15.7%	15.5%	23.0%
2	77.7%	79.4%	79.0%	78.9%	67.9%
3	3.3%	3.2%	3.1%	3.2%	4.5%
4	2.7%	2.4%	2.3%	2.4%	4.6%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Source: ATO unpublished data.

- Less likely to be in pension mode. Only five per cent are in full or partial pension mode. This is significantly below the SMSF average of 27.5 per cent. This tells us that the small-sized SMSF phenomenon is not explained by funds being at an advanced stage of decumulation.

Table 8.F: 2008 Proportion of SMSFs in accumulation or pension phase

Pension/accumulation, funds $200k and under	$1 - $50K	$50K - $100K	$100K - $200K	All $200K and under SMSFs	All SMSFs
SMSFs in pension phase	2.9%	3.2%	7.4%	5.3%	27.5%
SMSFs in accumulation phase	97.1%	96.8%	92.6%	94.7%	72.5%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Source: ATO unpublished data.

- More likely to have younger members. 51 per cent of the $200,000 and under SMSF member population is under 50 year of age, compared to 33 per cent of the overall SMSF population. This, coupled with the fact that the majority of funds are in accumulation mode, would indicate the majority of members are still attempting to grow their fund.

- More likely to have members with lower income levels. When compared to the overall SMSF members in their respective age ranges (apart from the <35 yr old range) incomes are lower than the average and median amounts in the SMSF sector overall. The lower income levels may present a real practical impediment to many of these SMSFs growing sufficiently, in the short term, to negate their fixed costs which leads to their considerably higher average operating expenses.

Table 8.G: SMSF member level demographics (ages, gender, superannuation balances and income)

	Members of SMSFs with $200,000 or less in assets						
				Super balance		Assessable income	
Age range	**Male**	**Female**	**Total**	**Average**	**Median**	**Average**	**Median**
< 35	7.1%	8.4%	7.7%	$22,371	$14,336	$58,565	$44,608
35 - 49	40.9%	46.2%	43.3%	$51,329	$42,500	$84,453	$58,761
50 - 59	30.2%	28.9%	29.6%	$60,475	$51,286	$68,792	$49,908
60 - 65	13.0%	11.0%	12.1%	$61,583	$51,683	$54,903	$37,018
> 65	8.7%	5.5%	7.3%	$67,743	$55,104	$46,299	$26,824
Unknown	..	..	..	-	-	-	-
Total	100%	100%	100%	$54,262	$43,087	$71,439	$49,338
All ages	55.2%	44.8%	100%				

	All SMSF members							Non-SMSFs members	
				Super balance		Assessable income		Assessable income	
Age range	**Male**	**Female**	**Total**	**Average**	**Median**	**Average**	**Median**	**Average**	**Median**
< 35	5.3%	5.5%	5.4%	$185,593	$106,153	$59,338	$44,905	$36,539	$31,989
35 - 49	26.7%	28.1%	27.3%	$175,462	$118,132	$115,523	$67,386	$58,330	$47,271
50 - 59	30.8%	32.4%	31.5%	$360,635	$252,364	$116,338	$64,996	$58,225	$46,879
60 - 65	20.4%	20.1%	20.2%	$556,654	$388,997	$92,474	$44,908	$49,946	$39,553
> 65	16.8%	14.0%	15.5%	$660,956	$450,781	$76,207	$31,928	$45,612	$32,418
Unknown	..	..	..	-	-	-	-	-	-
Total	100%	100%	100%	$467,453	$255,030	$101,426	$54,553	$49,280	$40,037
All ages	53.9%	46.1%	100%						

Source: ATO unpublished data.

Table 8.H: 2008 Time view of SMSFs established with $200,000 or less

SMSFs established with $200,000 or less		Percentage after 1 yr*		Percentage after 2nd yr		Percentage after 3rd yr		Percentage after 4th yr		Percentage after 5th yr		Percentage after 6th yr		Percentage after 7th yr		Percentage after 8th yr		Percentage after 9th yr	
Year	Number	$200k or less	wound up	$200k or less	wound up	$200k or less	wound up	$200k or less	wound up	$200k or less	wound up	$200k or less	wound up	$200k or less	wound up	$200k or less	wound up	$200k or less	wound up
2000	12,521	99.4%	0.6%	85.5%	1.8%	78.0%	3.8%	69.5%	5.7%	58.1%	7.6%	48.7%	9.7%	39.0%	11.5%	28.7%	12.6%	25.5%	13.9%
2001	9,732	99.0%	1.0%	85.4%	2.6%	76.0%	4.2%	64.7%	6.4%	53.8%	8.4%	43.9%	10.4%	32.6%	11.6%	28.4%	13.1%		
2002	11,353	99.3%	0.7%	82.3%	1.6%	68.5%	3.1%	56.6%	4.7%	45.9%	6.5%	33.8%	7.7%	29.2%	9.1%				
2003	17,310	99.4%	0.6%	80.1%	1.5%	68.1%	2.8%	55.5%	4.6%	42.0%	6.0%	35.0%	7.4%						
2004	16,230	99.0%	1.0%	81.7%	2.4%	67.3%	4.4%	50.2%	6.2%	41.9%	7.9%								
2005	11,572	98.4%	1.6%	75.9%	3.2%	56.8%	4.8%	46.6%	6.5%										
2006	11,211	99.0%	1.0%	59.9%	2.2%	47.9%	3.5%												
2007	13,168	98.5%	1.5%	65.5%	2.8%														
Average	**12,887**	**99.0%**	**1.0%**	**77.0%**	**2.3%**	**66.1%**	**3.8%**	**57.2%**	**5.7%**	**48.3%**	**7.3%**	**40.4%**	**8.8%**	**33.6%**	**10.7%**	**28.6%**	**12.9%**	**25.5%**	**13.9%**

* That is, the SMSFs' first annual return.

Note: the population is drawn from all SMSF established since the 2000 financial year, where the ATO is able to identify SMSF balances at the end of their first financial year. The percentages displayed under the '$200k or less' and 'wound up' columns represent distinct SMSFs, for example of the 12,521 SMSFs established in 2000 with a balance of $200,000 or less at the end of their first year, after the ninth year, 25.5 per cent of those SMSFs (3,193) were still actively operating (with a balance of $200,000 or less), while 13.9 per cent of the SMSFs (1,704) had wound up over the nine years.

Source: ATO unpublished data.

END NOTES

1 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.
2 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.
3 As defined in section 10(1) of the SIS Act.
4 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.
5 CPA Australia, Submission no. 324, p 11.
6 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.
7 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.
8 Online Self-Managed Superannuation Funds Trustee Education tool, <www.smsftrustee.com/cpa/htm/home.asp>.
9 APRA 2010, 'Quarterly Superannuation Performance', March 2010.
10 APRA 2010, 'Quarterly Superannuation Performance', March 2010.
11 ASIC, Regulatory Guide 146, 'Licensing: Training of financial product advisers', December 2009.
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13 The Hon C. Bowen MP, 'Future of Financial Advice information pack', 26 April 2010, <http://ministers.treasury.gov.au/Ministers/ceba/Content/pressreleases/2010/attachments/036/Future_of_Financial_Advice_Information_Pack.pdf>.
14 The Hon N. Sherry, Media Release no. 072 'Coverage of tax agent services regime', 23 April 2010, <http://ministers.treasury.gov.au>.
15 The Hon C. Bowen MP, Media release No. 036, 'Future of Financial Advice', 26 April 2010, <http://ministers.treasury.gov.au>.
16 Corporations Regulations 7.1.29A.
17 CPA Australia, Submission no. 324, p 16.
18 ICAA, Submission no. 396, p 25.
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20 The Hon C. Bowen MP, Media release No. 036, 'Future of Financial Advice,' 26 April 2010, <http://ministers.treasury.gov.au>.
21 ICAA, Submission no. 396, p 17.
22 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.
23 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.
24 Auditing and Assurance Standards Board, 'Guidance Statement GS 009 – Auditing Self Managed Superannuation Funds', October 2008.
25 Registered with ASIC.
26 Superannuation Industry (Supervision) Amendment Regulations 2009 (No 6) (SLI No 389 of 2009).
27 Speech to SPAA National Conference, Michael D'Ascenzo, ATO Commissioner of Taxation, 12 March 2008.
28 CBA, Submission no. 301, p 28.
29 Joint Accounting Bodies, 'Competency Requirements for Auditors of Self-Managed Superannuation Funds', February 2008, <www.charteredaccountants.com.au/files/documents/CompReqSMSF.pdf>
30 CPA Australia, Submission no. 324, p 18.

31 CPA Australia, Submission no. 324, p 18.

32 This figure is potentially understated. Anecdotal information from accounting professionals suggests that accounting practices are providing other services in addition to the audit service. It is thought that this is not disclosed in the SMSF annual return because those services are carried out by others in the practice. Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.

33 Instalment warrants are a form of derivative or financial product that entails borrowing to invest in an asset, such as a share or real property (the underlying asset), with limited risk to the investor. In its simplest form, the investor makes an upfront payment, which typically includes prepaid interest and borrowing fees. The underlying asset is held in trust during the life of the loan to provide limited security for the lender. The investor is required to pay one or more future instalments to the lender. <www.ato.gov.au/superfunds/content.asp?doc=/content/00132054.htm>.

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45 Williams Partners, Submission no. 373, p 1.

46 ICAA, Submission no. 396, p 3.

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48 Section 103 SIS Act.

49 Employee Benefit Research Institute, <www.ebri.org>.

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52 APRA letter to trustees of APRA regulated funds, <www.apra.gov.au/Superannuation/upload/IER-FINAL-LETTERTO-TRUSTEES-5-Feb-2010-Vn-2.pdf>.

53 Rice Warner Actuaries, Submission no. 404, p 44.

54 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009, table 31.

55 As determined by deduction claims in the 2008 SMSF Annual Return.

56 B. Alexander, Submission no. 261, p 5.

57 National Institute of Accountants, Submission no. 410, p 11.
58 IFSA, Submission no. 382, p 36.
59 FPA, Submission no. 329, p 28.
60 ICAA, Submission no. 396, p 19.
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62 Super System Review, 'A statistical summary of self-managed superannuation funds', 10 December 2009.

SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 9

SuperStream

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KEY THEMES

Issue

Today, much of the 'back office' of superannuation is characterised by manual transactions; a lack of industry data standards; inefficient processing of transactions; millions of 'lost' accounts and difficulties for members in consolidating multiple accounts. This inefficiency costs members and strains administrative resources.

Proposed solution

The Panel proposes measures, including:

- electronic transmission of linked financial and member data using standardised formats;
- use of the tax file number as a primary member identifier; and
- better alignment of pay and contribution cycles.

Benefits for members

Members would benefit from these SuperStream measures in the following ways:

- increased retirement savings because:
  - contributions would enter the system more quickly and efficiently and start earning returns sooner;
  - some of the reduced operational and administrative costs for super funds would flow through to members; and
  - lost accounts would be found and there would be much less chance of 'losing track' of super in the future;
- less time and effort would be spent consolidating multiple accounts; and
- improved confidence in the integrity of the system.

1 DEFINING SUPERSTREAM

1.1 Background

'SuperStream' is the name the Panel has chosen to describe its ideas about enhancing the current 'back office' of super. It includes new standards to improve the quality of data provided by employers, to allow the use of tax file numbers (**TFNs**) to identify members who might otherwise be 'lost' to the system and to require the use of technology to improve processing efficiency. SuperStream also includes improvements to the way rollovers are processed and the way contributions are made.

The component parts of SuperStream include:

(a) using industry-wide standards to improve the quality of data when members enter the system;

(b) electronic funds transfer (EFT) for all participants;

(c) better use of technology, including straight-through processing;

(d) e-commerce solutions to replace paper;

(e) extending the use of the TFN as an identifier throughout the system; and

(f) eliminating redundant processes, leading to simpler rollovers and consolidations.

Ernst & Young[1] and SuperChoice[2] both estimate that savings of up to $1B a year are achievable from reforms consistent with the SuperStream process. BT Financial Group estimate savings at 25 per cent of administration costs.[3]

1.2 Self-managed super funds

The Panel does not see the need to involve self-managed super funds (**SMSFs**) in the fund-specific elements of SuperStream, though those receiving employer contributions would benefit from improvements in the way contributions are made.

2 THE PROBLEMS SUPERSTREAM ADDRESSES

It has been estimated that the Australian super industry processes more than 100 million transactions annually,[4] which cost over $3.5B annually to process.[5] The costs include member support ($1B), contribution management ($1.25B), reporting ($250M), and benefit payment services ($1B).[6] The potential gains to the system from improved efficiency in contribution management are demonstrated by the estimate that 'straight-through' electronic processing of correctly provided member and financial data costs only five cents per transaction.[7]

The Panel has identified seven key problems with the current back office of super:[8]

(a) a lack of industry data standards;

(b) multiple technology platforms and proprietary systems;

(c) manual and disparate processes;

(d) the lack of a robust member identifier;

(e) a high number of employers (nearly one million) being required to make contributions to a variety of funds;

(f) misalignment of the contribution and pay cycle; and

(g) funds making member requests to switch or consolidate to another fund more difficult than necessary.

3 SUMMARY OF PHILOSOPHY

The key components of the philosophy behind SuperStream can be summarised as follows:

(a) First, the project needs to have some clear policy goals, rather than just a set of operational objectives; otherwise it will lack coherence and be hard to execute.

(b) There are technological solutions now available that provide the basis for substantial improvements in super back office processes, with substantial savings available to be passed on to members.

(c) Wherever appropriate, super should use or adapt generic e-commerce solutions and other techniques which have been demonstrated to work in other related sectors, rather than seeking to develop a super-specific solution.

(d) There should be no 'big bang' introduction of a centralised clearing house.

(e) After consultation, the more detailed design and implementation of SuperStream needs Government supervision in a staged implementation process, with sensible but short timeframes and regular re-assessment of progress.

(f) The solution needs to be sensitive to the large capital expenditures that have already been made on existing systems and hence to look for compatibility with existing components with a view to steady, but often incremental, improvements.

(g) Certain aspects of SuperStream will need to be mandated, but there should also be flexibility for different platforms to be used, at least in the near-to-medium term.

(h) The reality is that a world-class system will not be achievable easily or quickly and the cost of implementation will need to be carefully measured against outcomes including residual risk (that is, after mitigating factors) at each stage.

4 GOVERNANCE OF THE ADMINISTRATION PROCESS

While the focus of this paper is on the back office processes that underpin the effective functioning of the super system, the Panel emphasises that the obligation of trustees to act in the best interest of fund members extends to their strategic oversight of the administration function. There is a real

problem that some trustees and their staff have insufficient understanding of e-commerce and the opportunity costs of not adopting it. The Panel considers that there is a clear need for trustees to have a more active engagement with the intricacies of administration so that they are better equipped to make strategic decisions about it. A consequence of current arrangements is that many trustees have tended to focus excessively on the costs of administration, without sufficiently recognising the risks to members associated with inadequately resourced administrators.

In chapter 1, the Panel recommended that, in relation to MySuper products, there should be a statutory obligation on trustees to consider whether, over the year ahead, their MySuper product has a sufficient scale on its own (with respect to both assets and number of members) to provide optimal retirement savings for its members. One corollary of enhanced scale is a greater capacity for the trustee to engage meaningfully across all of its key accountabilities, including the administration of members' contributions and benefits.

5 QUALITY OF DATA

A key to reducing costs in the super industry, without reducing service, is for funds to get the correct contribution allocated to the correct member in a single account without manual processing.

5.1 Improving data quality from employers

Under the SG Act and the *Superannuation Guarantee Charge Act 1992*, employers become liable to pay a non-tax deductible Superannuation Guarantee Charge unless they have made specified superannuation contributions for the benefit of each employee. As well as transmitting contributions, employers are the originators of essential data — the details of their employees for whom they remit contributions.

The consensus of submissions was that the data required for efficient administration was not always understood by employers and that the data provided was often inaccurate or incomplete. This is in part because many employers perceive limited incentives to ensure that the transmitted data is accurate or complete — notwithstanding that fund follow-up to try to link member and financial data imposes significant costs on the employer as well as on the fund itself. Whether an employer that remits contributions but provides incomplete or inaccurate data in respect of its employees has satisfied its SG Act obligations has not been tested in the courts.

The data required will depend on the timing of the transaction. A significant amount of data will be required when establishing a fund membership for an employee or when an employer first makes a contribution for a particular employee. To facilitate electronic communication between fund and member, both mobile phone number and email address are highly desirable. Strong anecdotal evidence is emerging that the mobile phone number is the strongest form of personal identification and stays attached to the owner more durably than street addresses or other forms of identification.

Data requirements will vary between funds with defined benefit funds needing different information from accumulation funds, such as salary details and years of service. However, common data required for contribution processing includes the following:

(a) full name;

(b) date of birth;

(c) current address; and

(d) TFN.

Employers are currently required to provide this data to the ATO as part of the Tax File Number Declaration[9] for each new employee. The data set is similar to that provided to the ATO by super funds as part of the reporting of member contributions. Employers simply need to send data they already collect for the ATO or their own payroll purposes to the super fund.

For contributions made through a clearing house, for each employee the fund's name and Superannuation Product Identification Number (**SPIN**)[10] would be required, with the employee's fund membership number being highly desirable.

Accurate and complete member details need to be provided with each payment in order to enable the contribution to be allocated to the correct account.

Some submissions argued that trustees and administrators should not accept non-compliant (incomplete) member information. This would require the super fund to identify within each bulk contribution transaction those members for whom data was incomplete or inaccurate, and return the money and details for those members until the employer fills out the correct information while retaining the balance of the money and allocating it to the members for whom the fund has complete information.

The Panel considers this to be an unsatisfactory outcome.

The Panel is conscious that, in seeking to drive efficiency gains, it should not disadvantage members for whom insufficient information is provided for an account to be established. To this end, the Panel considers that inadequately identified money should not be returned to the employer. The preferred outcome is that arrangements should be developed whereby unallocated contributions are retained in the super system, though not by individual funds, with remittance of money and any available employer and member data to the ATO as an interim step.

Recommendation 9.1

Relevant legislation should be amended so that in respect of employees who are members of accumulation funds, an employer must provide to the superannuation fund (or clearing house) its ABN and at least:

(a) on first making a contribution in respect of a particular employee to that fund after the amendment comes into effect, the full name, date of birth, current address, email address (if known), mobile phone number (if known) and TFN of that employee, date of commencement of employment and the amount of the contribution being remitted in respect of that employee;

(b) for each subsequent contribution in respect of each employee, the employee's name, TFN and the amount being contributed for that employee. If the contribution is made via a clearing house, the fund SPIN should also be required;

(c) an employer that fails to meet the data requirements set out in (a) or (b) above becomes liable for an administrative financial penalty payable to the ATO in respect of each employee and each day it fails to meet the obligations. The ATO should have a measure of discretion about collection of the penalty. Alternatively, an employer that fails to meet the standards may be deemed to have failed to meet its SG Act obligations; and

(d) a fund should be prohibited from accepting as a member any person for whom there is not provided sufficient identification data (full name, address and date of birth) to provide a proper preliminary identification, and from accepting any contribution which cannot be reasonably identified as being attributable to a particular member.

The Panel considers that the ATO is better placed than a fund to enforce collection of a penalty. In addition, the ATO would be in a position to identify whether an employer was making similar shortfalls in providing accurate information in respect of several different funds to which it was contributing.

Recommendation 9.2

If, after having been provided a reasonable opportunity, the employee fails to provide a TFN or other required details to the employer, the employer's SG Act obligations are satisfied if the employer electronically provides such employee identification details as it has to the ATO together with the requisite contribution. The ATO would then treat the contribution as unclaimed money. On provision of the TFN, the ATO would remit the amount held for that employee to the employer's default superannuation fund, together with the employee's TFN, name, date of birth and, where provided to the ATO, current address, email address and mobile phone number.

The Panel notes that, under the terms of this recommendation, a member who failed to provide a TFN would receive no interest on the contribution made on their behalf, and could not have insurance arranged for them through the fund. In the Panel's view, so long as a person in their first job has had sufficient time in which to apply for and receive a TFN from the ATO, these are simply consequences of the employee's decision to not provide their TFN.

Recommendation 9.3

The ATO should establish an employment web page where an employer can both register the tax status of a new employee in lieu of completing the paper TFN declaration and simultaneously advise the fund to which super contributions would be paid. The ATO would then communicate the new member details to the fund electronically.

The Panel notes also that establishment of the recommended procedures would require further investment in infrastructure on the part of the ATO.

5.2 Standardising data transmission

While some submissions argued that it is enough for the data to be provided, a clear majority favoured mandating a uniform standard format for delivery;[11] that is, prescribing exactly the manner in which data is required to be provided. While this would promote confidence and clarity, the Panel is mindful of the cost involved in updating IT systems and existing member details to comply with any proposed changes.

Recommendation 9.4

APRA should convene a stakeholder group including at least the ATO, employers, payroll providers, super administrators and trustee representatives to devise online forms covering all the common processes between:

(a) the employer and the fund;

(b) the fund and the member; and

(c) different funds, such as occurs with 'rollovers'.

The Panel considers that such forms should be adopted by all APRA-regulated funds, including for transactions involving rollovers to or from SMSFs, by January 2012.

There would also need to be standards applying to the wholesale (peer-to-peer) transactions that occur from fund to clearing house, clearing house to clearing house and clearing house to fund.

Recommendation 9.5

The Government should be prepared to mandate the use of the forms, unless it is satisfied that there is near universal voluntary uptake.

One of the most popular ideas, supported by the majority of submissions, is the use of the TFN as the single identifier. The use of TFNs is discussed in more detail in section 9 of this chapter.

6 EFFICIENT USE OF TECHNOLOGY AND E-COMMERCE

The extent of the current failure to properly and promptly link contributions with the correct member account leads directly to delays in investing contributions, with an overall lower rate of return for the member.

The current process can be mapped as follows:[12]

Figure 9.1: Current Process

Source: Payment Adviser, Submission no. 250.

The strong consensus of submissions is that e-commerce — the linked electronic transmission of data and money — is a major potential source of efficiency gains, leading to improvements in members' retirement benefits. However, the lack of common standards, the lack of early adopter benefits, the lack of incentive for employers (and especially small employers) to participate and the narrow profit margins for administrators have hindered progress so far.

Employer take-up of electronic transactions for super is a particular impediment. Only around 61 per cent of businesses are aware that all super funds to which they make contributions allow electronic payments. However, fully 38 per cent of businesses use only cheques and 22 per cent use a combination of cheques and electronic payments. Sole use of cheques is generally higher among businesses with fewer staff and lower turnover. Of the 60 per cent of businesses that do not exclusively use electronic payment methods, 65 per cent can see that it would increase efficiency. Despite this, 45 per cent of those who do not exclusively use electronic payment methods prefer to use cheques.[13]

Figure 9.2: The processes involved in an effective e-commerce solution could be represented diagrammatically as:

Source: Payment Adviser, Submission no. 250.

While a small number of respondents favoured the development of arrangements unique to superannuation, the majority favoured the use of existing e-commerce facilities in place in the wider community.[14]

Submissions also indicated the positive environmental impacts of electronic solutions, dramatically reducing the carbon footprint and environmental inefficiency of the current paper-based super payments system.[15]

For efficiency to be achieved, it is essential that data and money be simultaneously transmitted — any separation will reduce outcomes dramatically.

Recommendation 9.6

The Government should consider imposing a prescribed fee to be paid by the employer to any super fund to which the employer contributes on behalf of a member when the contribution is made other than in electronic form accompanied by sufficient details to adequately identify the member. That is, the fee will only apply if the contribution is paid by non-electronic means (such as by cheque) or if any payment is not linked with adequate member details. In order to give employers and industry time to adapt, such a fee should come into effect after education and an appropriate transition phase.

Recommendation 9.7

A condition of holding a licence to administer superannuation funds should be the capacity to provide e-commerce facilities to employers of all sizes.

6.1 Electronic funds transfer

EFT facilities give consumers a convenient and secure way of paying bills and afford a more efficient collection service for billers and financial institutions. Each month, 18 million bills worth $11B are paid using BPay, and more than 84 per cent of these are paid on-line.[16] Many submissions have called for the greater use of EFT in super. In fact, some called for all super fund members and employers to be able to use EFT.[17]

One submission noted that funds that have successfully implemented payroll-timed electronic capture of contributions have enjoyed savings in the order of 20 per cent of annual total administration costs.[18]

The Panel believes that all APRA-regulated funds should have the capacity to transact with employers, members and other industry participants using EFT.

6.1.1 Straight-through processing

Straight-through processing (**STP**) is an initiative used by companies across the world to process and complete transactions (both data and monetary) from start to finish (that is, end-to-end processing) utilising electronic systems without any manual handling or intervention. STP optimises the speed at which transactions are processed by enhancing e-commerce between participants, eliminating manual data entry and preventing errors. STP involves the use of a single system to process or control all elements of the work-flow of a financial transaction, including what is commonly known as the front, middle, and back office and general ledger.

STP is currently being implemented by financial companies in an effort to decrease settlement risk by shortening the transaction-related processing time. In Australia, the first step toward the introduction of STP was to develop an interface between the Austraclear[19] and SWIFT[20] networks. This allowed users of both systems to send confirmation messages via SWIFT that are received by the Austraclear network and ultimately result in transactions in the Austraclear system without the need to re-key information. This has resulted in:

(a) reduced resource requirements within the back office;

(b) reduced manual processing errors; and

(c) faster settlement times.[21]

6.1.2 Advantages of using STP

In the traditional method, every transaction involves costly multiple data re-entry from paper documents and other sources that are susceptible to errors, discrepancies, delays and possible fraud. Further, the traditional methods of capturing and processing information by paper, phone, fax and email require human intervention which slows the entire cycle, introduces errors and delays settlement. STP enables orders to be processed, confirmed, cleared and settled in a shorter time period, more cost effectively and with fewer errors. Apart from compressing the clearing and

settlement time, STP also provides a flexible, cost-effective infrastructure, which enables e-business expansion through real-time processing and access to enterprise data. STP also streamlines back-office activities, leading to fewer failures, lower risks (although with potentially larger impact if operational risks are materialised) and drastically reduces costs per transaction. It embraces a set of applications, business processes and standards, which are set to revolutionise the settlement and processing standards within the capital markets industry.

The Panel considers that STP, conducted with appropriate risk controls, represents the ideal operational environment for super funds.

6.1.3 SwimEC

SwimEC is the superannuation, wealth and investment management e-commerce program developed jointly by the superannuation and managed funds industries. It aims to deliver industry-wide cost reductions and efficiency gains by promoting industry message standards for e-commerce.

The swimEC program:

(a) creates the standards, relationships and processes for the automated exchange of superannuation and managed funds information across all industry stakeholders; and

(b) assists members to roll out the finalised standards into production.

The implementation of the swimEC standards would enable participants to:

(a) increase efficiency by integrating systems with electronic gateways, automatic exchange of data and transfer of funds;

(b) eliminate the use of multiple, expensive proprietary interfaces for messages among industry organisations, and allow administrators, payroll providers and small and medium enterprises and financial advisers to focus on core functional delivery;

(c) decrease administrative costs by re-engineering internal business processes;

(d) decrease costs by eliminating errors due to data entry and the use of paper for the transfer of information;

(e) decrease the costs of responding to member and investor enquiries; and

(f) decrease the resources required for administration, enabling resources to be reallocated.

It was expected that the adoption of standards-based e-commerce could provide cost reductions in excess of 20 per cent for specific transactions,[22] or industry-wide cost savings of up to $660M with full-industry adoption of the swimEC standards.[23]

The adoption of the swimEC standards has been low across the industry because they are not mandatory. Reluctance to adopt the standards appears to be driven by the costs involved in implementing the standards; and the perceived lack of advantage in early adoption as the system depends on mutuality to generate cost savings. Also, the standards have been amended to incorporate the needs of many different industry participants resulting in many data fields that are only of relevance to a minority.

While swimEC was a worthy initiative on the part of the industry, it has not gained acceptance as the way forward for e-commerce in the super industry.

6.1.4 Standard Business Reporting

Standard Business Reporting (**SBR**) is an Australian Government initiative to reduce the burden of business to government reporting. Duplication of business reporting occurs across agencies and between jurisdictions, which means that the net reporting burden has continued to rise. SBR is a multi-agency initiative led by Treasury with ATO, ASIC, APRA and State and Territory revenue offices in partnership with software developers, business, bookkeepers, tax agents and payroll professionals. SBR is simplifying business-to-government reporting by:

(a) removing unnecessary or duplicated information from government forms;

(b) using existing business software such as accounting and payroll systems to automatically pre-fill forms;

(c) adopting a common reporting language, based on international standards and best practice;

(d) making financial reporting a by-product of natural business processes;

(e) providing an electronic interface to agencies directly from accounting software, which will also provide validation and confirm receipt of reports; and

(f) providing a single secure online sign-on for users to all agencies involved. [24]

SBR is focussing on financial reporting first, given that it affects most businesses. Forms-in-scope of the SBR program include the Business Activity Statement (ATO), financial statement (ASIC) and payroll tax forms (State and Territory Government revenue offices).

SBR is expected to save Australian business an estimated $800M per year once fully implemented, with phased roll-out commencing in July 2010. However, adoption of the SBR will be voluntary and no legislative changes will occur as a direct result of the initiative. As it will be cheaper, faster and easier to use, it is expected that there will be a large adoption of the SBR initiative.

While SBR will make business-to-government reporting easier, it will also enable the streamlining of the movement and use of financial information along the entire reporting chain, such as from business and intermediaries through to analysts, investors and regulators.

The SBR initiative to date has reduced the number of unique data elements used in government reports from 9,648 to 2,838, which represents an overall reduction of 71 per cent.[25]

6.1.5 Potential utility of the SBR approach for superannuation transactions

While the Australian version of SBR is restricted to business-to-government reporting, there is potential for its protocols to be developed to provide an e-commerce framework for super. Already, the Netherlands has extended their version of SBR to business-to-business transactions. For example, participating banks in the Netherlands provide loan discounts to businesses that report using the framework, as it allows them to monitor the businesses accurately and at low cost.

The current SBR project does not extend to business-to-business transactions and provides only for the transmission of data, not money, so the potential for SBR to be used in super would have to be

explored. The Panel sees considerable potential in the industry adopting the SBR data protocols, which will already be adopted by many employers and embedded in business software systems. By linking this approach with an existing electronic payment system such as BPay, employers would have a better, lower cost facility for engaging directly with funds or a clearing house.

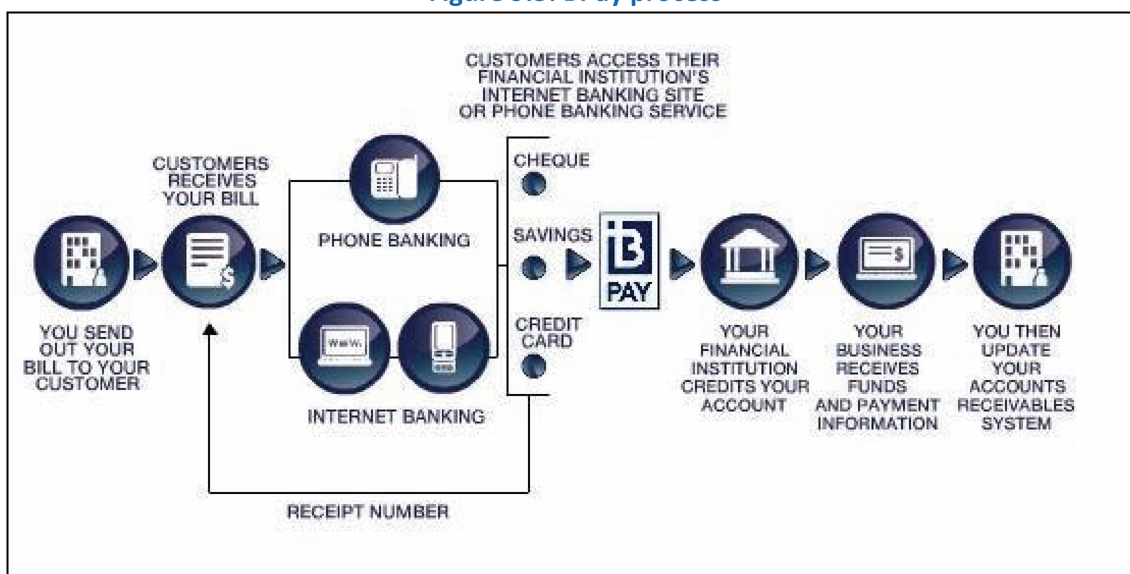
6.1.6 Assisting employers

In the same way that SBR is using existing business software packages to facilitate seamless reporting to government, the Panel notes that there are various products and portals already in existence that make it easier for an employer to make contributions to super. Examples include MYOB M-Powered Superannuation, Westpac's QuickSuper and Reckon Tools' SuperLink. The Panel considers that there is scope for these products to be modified as necessary to embody the SBR-type protocols it envisages applying to the super industry.

6.1.7 BPay

BPay is owned by the four major banks.[26]

Figure 9.3: BPay process



Source: BPay.com.au

BPay transactions incur a flat fee of 45.1 cents per transaction from a debit account, or 40.7 cents per transaction plus 0.297 per cent of the transaction value when paid from a credit card account.

BPay utilises multiple levels of data validation to ensure that receipted payments are reconciled on a 'straight-through' basis. First, a unique biller code is assigned to each billing organisation. This is much like the SPIN associated with each fund. Second, each individual bill is issued with a unique 'bill identifier'. To ensure the accuracy of the bill data, an algorithm check routine is run against all inward bill payments. This enables billers to receive clear funds for the value component, removes the need for costly re-work of dishonour, and also to identify the remitter of the payment.

While BPay is primarily a consumer bill-paying service, it has the potential to be further developed as a business-to-business payment system suitable for processing super contributions. In particular, BPay has flagged the development of a successor product, MAMBO (**Me at My Bank Online**), which will facilitate the secure, linked transmission of payments and information.[27] Many larger funds already provide facilities for members to make after-tax contributions by BPay.

6.2 Achieving e-commerce as the norm in superannuation

The Panel is convinced that major cost savings are available in the superannuation industry through a shift from the fragmented and largely manual processing of member accounts, contributions and rollovers to a standardised electronic approach.

While attempts have been made to devise industry standards to facilitate this, they have been voluntary and to date have failed due to excessive complexity and low take up. The Panel notes the recent announcement by three major fund administrators of agreement on a set of principles to govern the electronic processing of rollovers between participating funds. These are to be further developed consistently with standards to be adopted by the Medicare Australia clearing house and using an open governance structure along the lines of that provided by the Australian Payments Clearing Association for banking.[28]

Many administrators and clearing houses already engage with payroll providers to partially automate employer to fund transactions but, due to the lack of common standards across the industry, these processes often require funds to provide specific software to large employers and/or the application of proprietary middleware solutions to convert the output from payroll providers into a format useable by the fund administrator.

The Panel believes that a key pre-condition to fully effective e-commerce in super is the availability of a data base containing accurate and secure details of all funds other than SMSFs. Details to be incorporated would include, as a minimum, fund name, SPIN and bank account details including name, BSB and account number. To avoid the extraction of monopoly profits, this data base needs to be governed and administered on a cost recovery basis, either by a collaborative industry enterprise or by a government agency. Given that most of the required data is already held by APRA, and that APRA already has mechanisms for secure electronic communication with funds and the SBR hub, the Panel considers that APRA is best placed to develop and administer the data base.

Recommendation 9.8

Treasury should convene a working group comprising representatives of relevant segments of the financial sector to devise the process for development of SBR-compatible standards that provide for linked personal and financial data transmission and facilitate related software development. The standards should address transactions between employer and fund, fund and member, and between funds.

Development work should be financed through an industry levy.

All administrators and clearing houses should be required to adopt these standards as a licence condition.

6.3 Standards Australia

The move towards a largely automated back office for superannuation may lend itself to the development of a formal Australian standard registered with Standards Australia. However, the Panel considers this to be a matter which could be addressed in the future rather than needing to be resolved at this time.

7 ADMINISTRATORS

A few very large administrators have emerged over the past 20 years. Their role in the sector is critical to its success. The corporate failure of any one of them could create a very difficult position, while the operational collapse of one could create a real crisis.

The Panel has recommended in chapter 6 that administrators and stand-alone commercial clearing houses should be subject to licensing and prudential supervision by APRA.

8 CLEARING HOUSES

8.1 Single national clearing house

The Panel sought comment on whether there was the need for a single national clearing house for super transactions. The consensus from submissions was that clearing houses serve a valuable purpose, and that the recently announced government-funded service for small businesses was an important initiative. However, most submissions considered that there is currently an effective market in clearing house services which could be strengthened with the adoption of common e-commerce standards.

8.2 Small Business Superannuation Clearing House

On 26 November 2009 the Government announced that, from July 2010, Medicare Australia would provide free super clearing house services for small businesses with less than 20 employees.[29] The Small Business Superannuation Clearing House aims to assist small businesses to reduce the time and paperwork burdens involved in meeting their SG Act obligations. It will allow those eligible small businesses to pay their super contributions electronically to a single location.

Other key initiatives of the Small Business Superannuation Clearing House include:

(a) employers will be able to pass on choice of fund nominations to the clearing house for processing;

(b) small businesses that choose to use the clearing house service will have their SG Act obligation to make superannuation contributions discharged when payment of the correct amount is made to the clearing house rather than when it is forwarded on to the fund; and

(c) Medicare Australia has developed an online system for registration and on-going payments.

Small businesses have been able to register for the service since May 2010.

8.3 Required developments for clearing houses

Some submissions suggested that administrators must have the capacity to act as a clearing house as well as an administrator, that is, to be able to receive data and money in respect of super funds in addition to those that they administer. The Panel has recommended in chapter 6 that stand-alone commercial clearing houses should be licensed as a sub-set of administrators.

Alternatively, BPay or similar platforms could be employed by a super fund with a customer reference number attributed to each member. Contributions could be linked to member accounts which would reduce administration processing time and the need for external clearing houses.

There is currently an incentive for clearing houses to retain funds while clarifying member data with a contributing employer, as they can benefit from the interest earnings on the contribution pending its transmission to the fund. The time that money sits with a clearing house represents time out of the market for super fund members, and so works to their detriment.

Recommendation 9.9

As a standard licence condition, clearing houses (including administrators offering a clearing house service) should be required to provide linked member and funding data electronically to the fund within two business days of receipt of clean data.

9 TAX FILE NUMBERS

9.1 Background

The TFN is a unique number issued by the ATO to identify individuals, companies and others who lodge income tax returns. Members who do not quote their TFN to super funds are unable to make after tax contributions. While quotation of TFNs is not compulsory in super, industry sources have stated that around 90 per cent of member accounts have an associated TFN. The Panel has recommended that employers should be able to satisfy their SG obligations with respect to employees who fail to provide a TFN after being given reasonable opportunity to do so by remitting the amount to the ATO (see recommendation 9.2).

The Privacy Commissioner's TFN Guidelines regulate the collection, storage, use, disclosure, security and disposal of TFNs.[30] Part 25A of the SIS Act sets out requirements for the provision, storage, use and disposal of TFNs within the superannuation system. The *Taxation Administration Act 1953* also prohibits unauthorised requests for, recording, use or disclosure of TFNs. The *Data-matching Program Act 1990* and data-matching guidelines regulate data-matching records using the TFN between the ATO, Centrelink and the Department of Veterans Affairs.[31]

The TFN was designed to improve the service and administrative efficiency of the tax system, including data-matching.

9.2 Office of the Privacy Commissioner, Privacy Act and TFNs

The Office of the Privacy Commissioner is an independent statutory body whose purpose is to promote and protect privacy in Australia. The Office is established under the *Privacy Act 1988* (**Privacy Act**) and has responsibilities for the protection of individuals' personal information handled by Australian government agencies, large private sector organisations, private health service providers and some small businesses.

The Privacy Act largely protects the personal information of individuals through binding privacy principles. Personal information is defined generally as information or an opinion that identifies an individual.[32]

The handling of TFNs in the superannuation context is already allowed under the TFN Guidelines. The current TFN guidelines last amended in March 2004, relevantly say that:

(a) the rights of individuals under taxation, assistance agency or superannuation law to choose not to quote a TFN shall be respected;

(b) the TFN is not be used to establish or confirm an individual's identity, obtain information or match data about the individual for any purpose not authorised by superannuation law; and

(c) TFN information shall only be used or disclosed by TFN recipients as authorised by taxation, assistance agency or superannuation law.[33]

As indicated in the Privacy Commissioner's submission to Phase Two of the Review, TFN data-matching by super funds for purposes such as:

(a) more efficient handling of inactive superannuation accounts;

(b) automatic consolidation of multiple accounts; and

(c) reduction of incidents of lost accounts by re-uniting 'lost members' of super funds,

would amount to an extension of the TFN's current use, rather than a completely new application.[34]

Interestingly the Privacy Commissioner's notes in the TFN guidelines indicate that,

> *"the purpose of the tax file number is to facilitate … superannuation administration"' and "the tax file number can only be used or disclosed by tax file number recipients for reasons necessary to administer or comply with … superannuation law."*[35]

While the Privacy Commissioner's notes provide an interpretation of the TFN guidelines, the annotations do not form part of the law. Therefore it appears that adopting the TFN as an identifier within the super system for the purposes of improving administration can be achieved if those TFN requirements were included in the superannuation law. This is supported by the Privacy Commissioner in its submission to the Super System Review, as follows:

> *"The Office understands that generally, TFN data-matching by super funds would only be permissible under the TFN Guidelines where such activities are authorised under superannuation law. If the Government were to consider such a proposal it would need to determine whether current superannuation law provided the necessary authorisation or if amendments to existing law are required.*
>
> *Legislative amendments which clearly authorise specific matching activities would provide appropriate certainty for super funds and regulators."*[36]

The Privacy Commissioner is not opposed to promoting efficiency in the super system through limited and clearly articulated use of the TFN, provided such a proposal is measured and accompanied by strict privacy safeguards to protect personal information and choice, and is based on the likelihood of strong individual benefits.[37]

This approach reflects the Government's intention regarding the use and protection of unique identifiers. This intention was indicated in the Government's first stage response to the Australian

Law Reform Commission report titled *For Your Information: Australian Privacy Law and Practice,* recommendations 30-2.[38] [39]

Recommendation 9.10

Having regard to the extended use of personal information proposed in SuperStream, Treasury should be tasked with preparing a Privacy Impact Assessment to help identify and assess any privacy impacts of the 'SuperStream' proposals adopted by the Government.

9.3 Proposed extended use of TFNs in superannuation

There is widespread consensus in the industry that the lack of a unique member identifier, which can be used to link accounts with contributions and to identify multiple accounts held by the same person, is a significant impediment to major cost savings in the industry. The Panel endorses those concerns. The Panel also notes that the great majority of member accounts already have an associated TFN.

The Panel considers that, where a member has consented to the use of their TFN for the purposes of the superannuation legislation, it would be consistent with the intent of that consent for the TFN to be used for administrative purposes designed to reduce costs and so maximise member retirement benefits.

Recommendation 9.11

Relevant legislation should be amended to permit superannuation fund trustees and their agents to:

(a) use TFNs as a primary search key to link contributions and rollovers with member accounts;

(b) seek confirmation from the ATO in relation to each new member that the quoted TFN is correct;

(c) seek confirmation from the ATO in relation to each requested rollover to a SMSF that the member holding the quoted TFN is a member of that SMSF; and

(d) exchange the TFN with other trustees to identify accounts in multiple funds held by the same individual, and hence permit the trustee of the fund to which contributions are currently being made to invite the member to initiate consolidation of the accounts.

10 PORTABILITY, SMALL/INACTIVE ACCOUNTS, LOST MEMBERS AND ERFS

10.1 Background

The sixteen eligible rollover funds (**ERFs**) form a unique segment of the superannuation system.[40] These funds were intended to be a temporary repository for the benefits of members who have lost connection with their super, and to protect those members. In practice, ERFs also accept rollovers

from super funds for a number of other reasons where the member has not actively made a choice about their superannuation.

ERFs are obligated to receive payments from another super fund, an approved deposit fund, or a Retirement Savings Account (**RSA**). An ERF must also treat each member, regardless of their account balance, as a 'protected member'. For all other super funds, a member is only 'protected' if they satisfy the conditions in SIS Regulation 1.03, primarily members whose balance is below $1,000.

ERFs have not achieved the intended objectives because:

(a) Some funds do not send small inactive accounts to ERFs.

(b) Some ERFs appear to have made little effort to re-connect people with their super. There is little incentive to align members with their money because of the cost of matching and because ERFs continue to collect ongoing fees on these 'inactive' accounts. Rice Warner estimated that, for the year ended 30 June 2008, the average fee for ERFs was 2.49 per cent,[41] although this figure equates to an average of $23.16 per account per year because of the predominance of small accounts in ERFs. However, because of the very low level of activity inherent in the operation of an ERF, the member account perspective is less relevant than in a normal super fund.

(c) There has been no unique member identifier to aid the process.

(d) Matching lost members with unclaimed super is costly. Ultimately, the cost of running the exercise depends on the volume of matches. In 2008, one ERF undertook cross-matching of three million accounts, leading to approximately 104,000 accounts (with a total value of $39M) being matched; an average of $400 per account. This exercise cost approximately $625,000, being $79.93 per 1,000 records, plus a cost of $3.68 per successful match.[42]

Legislation has been passed to give effect to the Government's 2009-10 Budget announcement which will require superannuation providers to transfer to the Commonwealth all 'lost member' accounts that have a balance of less than $200, and all those accounts that have been inactive for more than five years and for which there are insufficient details to identify the owner. This will come into effect from 1 July 2010, and is expected to reduce the number of lost and unidentifiable accounts by about 40 per cent with consequential administrative savings for funds. It is expected that approximately $238M will be transferred to the Commonwealth over the next three years.

The general approach of this measure was canvassed in the November 2008 discussion paper '*Superannuation Clearing House and the Lost members Framework*'. Other lost member issues canvassed in the discussion paper, such as the definition of a lost member, trustee obligations and automatic consolidation, are subjects of the Review's consideration.

Even when members are not lost, many have multiple accounts. As at June 2008, there were in excess of 32 million member accounts in the super system despite the total Australian population being only 22 million.[43] While there are some individuals who have sound reasons to hold more than one super account — for example, to have one account providing a transition to retirement pension and another to receive contributions, or to maintain access to certain insurance benefits — each duplicate account incurs administration costs. In many cases, this is simply a deadweight cost to the individual and the system overall.

When a member wishes to consolidate accounts, it is often a time-consuming and frustrating process. One provider reports that only 6 per cent of members who started a consolidation process actually completed it.[44] Many small balance accounts are abandoned even if not lost, with the benefit being eroded due to fees and charges. This contrasts with consumers wishing to change banks or mobile phone providers, where the receiving entity is authorised to contact the former provider on the customer's behalf and implement the change.

10.2 Facilitating account consolidation

If the SuperStream recommendations are implemented, it is expected that over time the problem of lost members will diminish significantly. However, wider use of TFNs with other electronically available identifiers can accelerate the process of reducing the number of lost, inactive accounts.

Other measures can be put in place to make it easier for members to consolidate their superannuation accounts when they wish to do so.

The automatic consolidation of all of an individual's accounts across a number of funds would become feasible, subject to implementation of the SuperStream recommendations, and subject to specific legislative change to authorise it. However, this presents specific problems because:

(a) some people hold inactive accounts so that insurance cover will continue. (This rationale does not warrant maintaining an ERF account because they cannot provide insurance cover); and

(b) lack of identifiers leads to cases where apparent similarity of detail results in inappropriate merging of accounts. On the other hand, minor differences in detail result in the creation of multiple accounts in the first place.

10.2.1 Auto-consolidation within the same fund

In some cases, members can have multiple accounts and be paying multiple fees within the same fund. This can happen, for instance, when the member has had a succession of different jobs within a certain industry and has been enrolled into the same default fund on different occasions, perhaps with different home addresses or other identifying details. In cases like these, the loss of insurance is not likely to be a relevant factor, because the member would generally retain insurance cover through the account that was currently receiving contributions.

However, it is obviously detrimental to the member, and a source of significant inefficiency across the industry, that members in this situation are having multiple sets of fees deducted through inertia and/or an inability to use a common identifier to consolidate them into a single account. The Panel recognises that there will be cases where the member has positively elected to hold multiple accounts within the same fund — for example, as is now reasonably common for example with members utilising a transition to retirement facility — but at an overall industry level the vast majority of duplicate accounts appear to have arisen from the administrative inertia described above, not from positive choices exercised by members.

Consequently the Panel considers that a reduction in multiple account holdings will strip unnecessary costs out of the system and, all else being equal, will lead to a reduction in administration costs as a percentage of assets under administration. It acknowledges, however, that spreading fixed administrative costs over a smaller number of accounts may lead to an increase in the weekly amount needing to be charged to those remaining accounts.

Recommendation 9.12

Necessary legislation should be enacted to permit the trustee to auto-consolidate accounts without prior reference to the member, where multiple accumulation accounts within a single fund share a common TFN and member surname and the multiple accounts have not been established by deliberate elections by the member concerned.

10.2.2 Optional account consolidation across more than one fund

Difficulties with automatic account consolidation could be overcome by having mechanisms permitting the member to opt in or out of the consolidation process, whereby data matching across funds identifies members with multiple accounts and then auto-generates a message to the member asking them to nominate a single account. The member could choose to keep them all open or, if the member did not advise the trustee within 60 days of a decision to retain some or all of the accounts, the accounts could be automatically consolidated into the fund with the most recent contribution.

The critical step, missing in the system at present, is to draw the issue of multiple accounts to the member's attention, and then make it easy to resolve them. The ATO, through its SuperSeeker website, enables members to search for accounts where the fund has reported the member to the ATO as being lost. However, many members with multiple accounts are not recorded as lost, and there is no current facility which would enable members or funds to identify, from a single site, all of a person's super accounts.

The Panel sees advantages with both the opt-in and opt-out approaches to account consolidation across funds, but considers this a matter for further consideration in the implementation phase.

Recommendation 9.13

The ATO should develop electronic means to display all the super funds of which an individual logging on is currently a member. Similarly, the ATO should provide an electronic facility to include all member accounts for which it holds TFN identification.

10.2.3 Rollovers/switching funds

The current requirements for members wanting to change funds are triangulated. Members need to contact their employer to have future contributions redirected and also need to contact their existing fund to have their existing balance transferred to their new fund. A simpler way is needed.[45]

In its submission, the consumer group CHOICE was strongly critical of the ATO's standard choice form NAT 13080 saying that it acted as a barrier to choice and mobility.[46,47]

The Panel agrees that it is too difficult for members to consolidate multiple accounts to their chosen fund because of the onerous requirements placed on them by funds to roll their money out. Despite the introduction of a standard form by way of Schedule 2A to the SIS Regulations, the information required by this form is overly-detailed, the identification requirements are onerous and the process becomes simply too difficult. [48] In addition, even when a person completes the current standard form, many funds reject this in favour of the fund's own form.[49]

Recommendation 9.14

To facilitate consolidation of multiple accounts:

(a) **procedures should be established between the ATO and administrators and clearing houses so that when an employer seeks to enrol a new member, the fund administrator (or clearing house if one is used) must validate the TFN provided with the ATO to ensure that it is the number for the individual named; and**

(b) **at the same time, the ATO should be required to check its data base to see whether it holds unclaimed money for that member. If so, it should advise the administrator and transfer the money. The ATO should also determine whether the member has more than one account. If the member has more than one account, the administrator of the new fund should be notified and then determine with the member whether they wish to consolidate their accounts.**

Recommendation 9.15

Relevant legislation should be amended to:

(a) **remove from super funds the current exemption from initial customer identification requirements under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* when a member exercises a choice to join that fund, or to roll into that fund the whole or part of a benefit from another fund. Risk-based customer identification would ordinarily be satisfied if the member has provided their TFN to the fund and the trustee has confirmed with the ATO that the TFN is correctly associated with the details for that member or the trustee has confirmation from its own records or another APRA-regulated fund that they have previously provided that level of identification;**

(b) **enable the trustee of an APRA-regulated fund, with the authority of a member, to initiate a rollover of all or part of that member's benefit from another fund as though the member had initiated the request to the exiting fund, without further proof of the member's identity being required;**

(c) **require the trustee of any fund receiving such a request to normally remit the member's balance electronically to the new fund within two clear business days, subject to a capacity for APRA to provide relief from this provision when prudential considerations require it;**

(d) **amend the choice of fund form to make it more user-friendly and to enable the member to tick a box requiring all super accounts to be consolidated, with the nominated APRA-regulated fund to action as above. In view of the greater engagement of most SMSF members, and risks identified in the use of SMSFs for illegal early release of superannuation, this facility should not be extended to the trustees of SMSFs at this stage; and**

(e) **override any provision in the governing rules of any fund with a defined contribution component that would otherwise prevent the consolidation of member accounts.**

10.3 One national ERF

A majority of submissions opposed a single national ERF and the Panel recognises that there may well be constitutional difficulties in seeking to implement one.

The Panel considers that if the proposed cross-fund matching rules and the use of the TFN reduce the number of lost accounts, there is likely to be a consolidation in the sector. Also, regulatory changes could address remaining problems with ERFs; in particular, the Panel's intention that ERFs should operate under a model very similar to that for MySuper should lead to a reduction in costs in that sector. These matters are further discussed in chapter 10.

11 CONTRIBUTIONS

11.1 Regulation of contributions

The ATO currently has regulatory responsibility for SG Act contributions, concessional and non-concessional contributions and the government's co-contribution. The ATO also has responsibility for monitoring the aggregate level of member after-tax contributions. On the other hand, APRA has administrative carriage of section 64 of the SIS Act, which requires employers to make timely remittance to a fund of employees' after tax contributions made through the employer. There are no regulatory requirements about the timely remittance of salary sacrificed contributions. If an employer fails to remit salary-sacrificed contributions to a fund, or to do so in a timely manner, the employee's only recourse would be by way of civil court action. The Panel believes this is clearly inadequate.

11.1.1 Frequency of employer remittance of contributions

Currently, there are two payment periods in place for contributions — one (quarterly) for SG Act contributions and one (monthly) for member voluntary after-tax contributions. Under the SG Act, members' salary sacrifice contributions are regarded as employer contributions and count toward the employer's SG Act obligations even though they are before-tax contributions being paid by members from their pay.

A number of submissions suggested more frequent remittance of contributions would enhance efficiency; for example, monthly or in-line with payroll arrangements.[50] The Panel notes the recommendation in the Review of Australia's Future Tax System (**the AFTS Review)** that SG contributions should, over time, be paid at the same time as wages.

Increasing the frequency of contribution would improve the compounding periods of returns to members and, consequently, would potentially improve member superannuation savings. In its submission, Cuscal cited an estimate by Rice Warner Actuaries that members could earn an additional $2.2B over 10 years if member contributions were invested sooner via electronic means.[51] While this is highly desirable from a member perspective, the Panel also has regard to the impact of any abrupt change to contribution frequency on an employer's cash flow.

The Panel also notes the Government's intention that SG contributions should be increased to 12 per cent over the period 2013-14 to 2019-2020. As near universal adoption of electronic remittance of contributions via SuperStream should lead to a reduction in employers' costs of administering superannuation, the Panel considers that it would be appropriate to delay any change in the frequency of SG Act contributions until SuperStream has been implemented.

A number of submissions recommended that salary sacrifice contributions be remitted monthly as if they were after-tax contributions. Adopting this suggestion would mean that other SG Act contributions should also be made monthly as there is no reason to distinguish between the two. Otherwise, some employers might discourage salary sacrificed contributions because they are required under the SIS Act to remit them more frequently than SG Act contributions.

The Panel notes and endorses the AFTS Review recommendation that employers should report to employees when a superannuation contribution is made on their behalf. It considers that, if that time differs from the time at which salary payments are withheld to fund the super contributions, or an SG amount becomes due, those amounts should be reported to the employee on his or her payslip.

11.1.2 Roles of ATO and APRA

While most submissions consider the ATO the logical overseer of SG Act contributions, there were many comments about the ATO's performance in enforcing the SG Act.[52] Concerns were noted about the extent to which the ATO enforces the SG Act with respect to independent contractors and follows up complaints by employees about deficient payments by employers.[53]

Recommendation 9.16

Relevant legislation should be amended so that:

(a) an employer is required to remit salary sacrificed and SG Act contributions no less frequently than it is required to remit a member's after-tax contributions;

(b) the timing of payment of SG Act contributions should be adjusted after SuperStream has been implemented so that SG payments align with employers' payroll cycles;

(c) the employer is required to report on each payslip issued to an employee the amount of superannuation to be paid to the employee's fund, whether SG, salary sacrificed or after tax contributions;

(d) the ATO is specified as the sole regulator generally responsible for compliance with all aspects of superannuation contributions, other than those relating to compliance with industrial awards. APRA should retain responsibility for overseeing the solvency of defined benefit plans and any action needed to restore a DB fund to a satisfactory financial position; and

(e) when an employee makes a complaint that an employer is not meeting its SG Act obligations, the ATO should continue, on a risk-assessed basis, to assess the employer's compliance with its SG Act obligations for all employees in the particular workplace, and not only the complainant.

12 OVERSEEING THE IMPLEMENTATION OF SUPERSTREAM

It will be critical to have in place an on-going governance structure to oversee the development and mandate the implementation of the standards that are central to SuperStream. One possible reason why existing proposals such as SwimEC have failed to get significant traction is that they have lacked an appropriate governance (and legislative) framework.

The Panel has considered the Payments System Board (**PSB**) as one possibility. The Panel notes that the PSB has commenced a strategic review of innovations in the Australian payments system. Given its focus on structural innovation where competing industry providers need to engage on developments that improve the overall system, the Panel sees this as a useful vehicle to give consideration to issues surrounding the implementation of SuperStream.

In theory, SuperStream could be declared a 'payments system' by the PSB under the *Payment Systems (Regulation) Act 1998*. Doing so would mean that the PSB could:

(a) determine rules for participation in that system, including rules on access for new participants, drawing on expertise from the Australian Competition and Consumer Commission;

(b) set standards for safety and efficiency for that system. These may deal with issues such as technical requirements, procedures, performance benchmarks and pricing;

(c) direct participants in a designated payment system to comply with a standard or access regime; and

(d) arbitrate on disputes in that system over matters relating to access, financial safety, competitiveness and systemic risk, if the parties concerned wish.

Other possibilities include a role for Standards Australia, a wholly new body or the Australian Payments Clearing Association.

On balance, however, the Panel considers that Treasury is best placed to oversee and drive the initial implementation phase for SuperStream, given the extensive coordination needed between: Treasury itself, as the government's primary economic policy adviser; the ATO; other regulators; industry; and other stakeholders.

Recommendation

The Government should task Treasury with coordinating the initial implementation phase of SuperStream, and with advising on sustainable governance and oversight arrangements for the system into the future.

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SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 10

Regulatory settings

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KEY THEMES

Issue

The superannuation regulatory regime must be fully effective if the Review is to achieve the efficiencies it seeks for the industry. Efficiency concerns include having more than one regulator involved in superannuation, gaps in the powers currently provided to APRA, tax and legislative impediments to rationalisation of legacy products and the complexity of the SIS Act.

Proposed solution

The Panel proposes measures, including:

- expansion of APRA's mandate and giving APRA a standards-making power in superannuation;
- improved cooperation between ASIC and APRA and adequate measures for the ATO to carry out its new SuperStream function;
- the Productivity Commission to review the effectiveness of the implementation of the Panel's recommendations five years after the Government's response to this report;
- re-write and restructure of the SIS Act to address the different sectors of the choice architecture model; and
- helping the industry in rationalising legacy products.

Benefits for members

Members will benefit from these measures as:

- making the regulatory regime more effective will avoid duplication and the consequent increased costs for members;
- a greater focus is being placed on member outcomes; and
- there will be an improved confidence in the integrity and stability of the system.

1 MAKING IT ALL WORK

1.1 Regulator efficiencies

The Panel is mindful that the successful implementation of its recommendations depends in large part on the regulators who are charged with overseeing the superannuation industry. Accordingly, the Panel has considered whether the current regulatory regime itself needs to be made more efficient and the regulators themselves better resourced in order to achieve the important changes that the Panel has identified.

Submissions highlighted that there are a range of practical issues which arise from APRA, ASIC, the ATO and AUSTRAC all having roles in superannuation. A common example was regulatory overlap in reporting obligations to multiple regulators in relation to identity fraud, regulatory breaches, changes in directors, officers and details, and audited accounts. Another example was duplication and significant costs in time and administration for trustees arising from the collection of similar data from the same entity by different agencies. This can arise in the performance of different regulators' supervisory or review functions.

Submissions also highlighted some areas where a particular aspect of the trustee's operation is overseen by more than one regulator and each has a different approach and emphasis. Examples included: proof of identity requirements; the definition and nature of a 'superannuation interest'; what constitutes an 'income stream'; and the management of conflicts.

Several submissions considered that the removal of regulator overlap as a point in favour of having only a single regulator for the superannuation industry. However, other submissions commented on some of the problems of having more than one regulator, but still preferred the status quo.

1.2 Suggestions for enhanced regulatory efficiencies

The Panel considers there is a powerful logic in seeking better efficiency through the enhanced alignment and coordination of the main superannuation regulatory agencies and their regulatory requirements. This would complement the range of efficiencies to be derived from the recommendation in chapter 9.

The Standard Business Reporting approach currently under development by the Commonwealth Government, an initiative to reduce the business-to-government reporting burden, should substantially assist as there will be a single portal for trustees to meet all reporting obligations.[1] However, there was also a significant theme in the submissions that in, general, all issues needed to be reviewed and addressed through one process or one body. Suggestions included:

- a joint forum, expanded from APRA and ASIC to include the ATO and AUSTRAC, with greater transparency to industry;
- three-yearly assessment of the performance of regulators by an independent body such as the Australian National Audit Office;
- an oversight body that includes industry representatives and practitioners; or

- an independent consultant.

The Panel considers that, while these suggestions have merit, it favours a slightly different approach, based on the following four ideas:

1. a wider APRA mandate, with increased powers to oversee the efficiency of the system, particularly MySuper, including a standards-making power in superannuation;

2. a closer working relationship between APRA and ASIC, including a possible co-location of superannuation capabilities and cooperation agreement for APRA and ASIC;

3. ensuring adequate resources for the ATO with respect to its role in the superannuation system; and

4. an examination of the Panel's recommendations by the Productivity Commission five years after the Government's response to this report.

Each of these ideas is discussed in turn below.

2 INCREASED APRA MANDATE — STANDARDS-MAKING POWER

Through its recommendations, the Panel has highlighted that a major aspect of the solution to the issues it has identified is enhanced regulatory supervision. APRA's role as the prudential regulator has been developed over time in a piecemeal way. As a result, there are gaps in its mandate. The Panel believes that there needs to be a new role for APRA, expanded and deliberately designed to carry out what the Panel has recommended and to be in accord with the super policy principles (see Part One of this report) that have guided the Review.

The Wallis Report expressed the view that a prudential regulator with respect to superannuation was at the 'lower end' of intensity. While the Panel does not want to re-open that issue, it is of the view that, based on what the Panel has recommended, APRA needs to be given a role that is more focused on improving outcomes for members. This also results from a recognition that APRA needs to drive the changes to achieve efficiency in the industry as members are not in a position to drive the changes themselves.

Accordingly, the Panel is recommending that APRA be given a broader mandate, with an additional role directed primarily towards overseeing and promoting the overall efficiency and transparency of the superannuation system, to the ultimate benefit of members. The Panel does not envisage APRA's role as extending to intervening in the trustee's decisions. Instead, APRA would give consideration to issues such as the cost structures in the operation of the fund, including investment costs, tax management and administration (and other issues detailed in chapter 4).

At the core of these new responsibilities, the Panel believes that the role proposed for APRA in gathering and publishing additional investment and cost-related data, and ensuring standardised investment option level reporting by trustees (also discussed in chapter 4), would facilitate market responses to constrain costs. APRA would also be required to administer the MySuper reforms and much of the SuperStream development and implementation as well as take responsibility for the licensing and regulation of administrators as covered in chapter 6.

The Panel expects that APRA's routine fund reviews would extend to matters such as trustees' approaches to meeting their new duties in relation to their MySuper product (chapter 1); the extent to which they meet the standards set out in the proposed Code of Trustee Governance (chapter 2) and their level of compliance with the principles of outcomes transparency explained in chapter 4.

2.1 Standards-making power

The need for a more finely calibrated capacity for APRA to supervise and regulate the superannuation industry in ways that extend beyond prudential issues raises the question whether APRA should have standards-making powers similar to those which it has in relation to Authorised Deposit-taking Institutions (**ADIs**) and in the insurance sector. The relevant legislation governing ADIs, life insurance and general insurance companies give this power to APRA.

After some deliberations, the Panel believes that APRA should be given a general standards-making power in relation to superannuation.

Operating standards are not the same as prudential standards because operating standards are a form of subordinate legislation (like the SIS Regulations) made by the Executive Council. Prudential standards, on the other hand, are made directly by APRA (although both give APRA a way of providing additional detail to an industry on prudential matters).

For example, the information that APRA currently sets out in its practice guides to the industry would have the force of law if that guidance were instead issued as a prudential standard. As subordinate legislative instruments, prudential standards (like regulations) are disallowable in the Senate, subject to scrutiny by the Standing Committee on Regulations and Ordinances and require extensive industry consultation. The Panel believes that APRA needs to be given a standards-making power in superannuation that encompasses, but goes beyond, prudential matters. The power needs to be focused on transparency, efficiency and outcomes; a power unique to the issues facing the superannuation system. In chapter 4, the Panel has called standards that could be made in these areas: 'outcomes reporting standards'. This is not intended to limit the areas in which APRA should be able to make standards.

Standards can be made and varied more quickly than regulations which means that, if required, the law can be quickly adjusted to respond to developments in the industry. Further, complete topics could be addressed under a single standard whereas, at present, a topic may be found in several places in the SIS Regulations. As mentioned in chapter 2, the Panel believes that it is important that trustee duties not be sprinkled across several places but, rather, be readily available to trustee-directors in one place. This also means that a standard has the capacity to leave less room for uncertainty than the promulgation of regulations on the same topic.

Recommendation 10.1

APRA's mandate should be broadened to include the task of overseeing and promoting the efficiency of the funds it regulates and the system in which they operate.

Recommendation 10.2

APRA should be given general standards-making power in relation to superannuation (including prudential matters) in order to address the recommendations in this report and to drive efficiencies in the industry.

2.2 New trustee duties

As part of the MySuper proposal outlined in chapter 1, and the trustee governance and investment governance proposals in chapters 2 and 3, respectively, the Panel has recommended that trustees be given new duties specifically tailored towards achieving the outcomes the Panel believes will be necessary in order for MySuper and its other reforms to produce the necessary benefits for members. These would involve APRA having a broader range of regulatory functions that might call for new skills, resources and perspectives.

2.3 Regulating for scale

2.3.1 MySuper requirements

The Panel has recommended in chapter 1 that, as part of the grant of a MySuper RSE licence, a MySuper trustee would have to demonstrate to APRA that the product had sufficient scale or, if a new entrant to the industry, that there was a credible path to building the necessary scale. Further, on an annual basis, a trustee would have to determine whether it would continue to have sufficient scale in relation to its MySuper product (with respect to both assets and number of members) to deliver optimal benefits to members.

The Panel has also recommended in chapter 1 that scale would be part of APRA's ongoing review of MySuper products. The way the scale concept is administered would, of course, need to deal with a fund's individual circumstances, features particular to certain occupations and to allowing competition from new entrants to the market. The aim would be to see those funds that were providing sub-standard outcomes to members, due to their lack of economies of scale, being the subject of sanctions or other regulatory intervention.

The interaction between the trustee's duty and APRA's regulatory role is obviously important.

2.3.2 Why is scale important?

There were 429 large APRA funds at 31 March 2010.[2] A submission from Chant West pointed out that, at 30 June 2008, 70 per cent of large APRA funds had less than $1B in assets and collectively accounted for only 7 per cent of the total net assets of all large APRA funds.[3] The submission said:

> *"for most small funds, merging with larger funds will provide even better value for members"* and that small funds *"should be required to demonstrate to APRA why they should remain stand-alone funds".*

The Panel shares these views.

The cumulative effect of the advantages that large funds have over small funds is significant. These include lower investment fees, in-house investment expertise, private placement capabilities, ability to spread investment risk through diversification, reduced administrative unit costs, and enhanced availability of education, information and service.[4]

Keith Ambachtsheer, director of the Rotman International Centre for Pension Management, believes that increased scale expands the capabilities of pension funds, while also enhancing their operations and lowering costs. He says that larger funds:

- have investment advantages in that they are able to invest in asset classes like direct real estate, infrastructure and private equity and earn a genuine illiquidity premium that is not available to smaller funds; and
- can do things internally as they can afford to hire talent (which he believes is cheaper than outsourcing).

He has identified the scale 'sweet spot' where a fund starts to see these benefits is over US$25B (A$28B). By contrast, at 30 December 2009, the average Australian fund size was $1.86B[5] and at 30 June 2009, only four Australian superannuation funds (that is, less than 1 per cent of funds), had achieved a scale close to or over the $28B mark.[6]

The Deloitte report into the MySuper proposal also highlights the significant impact that scale can have on reducing total operating and advice costs to members.[7] Investment management costs are not included in this particular analysis because they will differ according to the investment strategy selected (although investment management costs still show scale benefits as the Deloitte work shows).

Deloitte estimated that, for members with an average account balance of $25,000, the operating and advice costs per member could be reduced from 50bps per annum in a medium-sized ($2B) fund to 30bps in a large ($20B) fund. In dollar terms, this would be a reduction from $125 to $75 per annum. Equivalent figures across a range of account sizes and fund scales are illustrated in Table 10.1.

Table 10.1: Illustration of the potential impact of scale on operating and advice costs per member

Estimated total operating costs for MySuper products of varying sizes (basis points for varying account sizes) & inclusive of cost of intra-fund advice							
Fund size: $M	<100	500	1,000	2,000	5,000	10,000	>20,000
Fund size: Membership*	4,000	20,000	40,000	80,000	200,000	400,000	800,000
Account size							
$10,000	262	210	162	125	98	86	74
$25,000	105	84	65	50	39	34	30
$50,000	52	42	32	25	20	17	15
$100,000	26	21	16	13	10	9	7
$250,000	10	8	6	5	4	3	3

Note: * Membership based on an average account balance of $25,000.
Source: Deloitte, Default Fund costs under the MySuper proposals.

The Panel recognises that throughout 2009/10, a number of superannuation funds have announced intentions to merge, citing the benefits to members of greater scale.[8] While the Panel believes that the benefits of scale are being more widely recognised, and does not propose mandatory

consolidation of funds, it is keen that all trustees of MySuper products formally consider this issue on a regular basis.

2.3.3 APRA powers to assist in regulating scale

The Panel believes that several of its recommendations would help APRA in guiding trustees as to what is a reasonable scale for funds in order to effect savings for members. For example, the outcomes reporting standards (chapter 4) will help identify whether a fund is achieving optimal outcomes, given its scale. In addition, APRA will be able to assess capital requirements on a risk-weighted basis (chapter 6) so that if risks are regarded as having increased because of the size of a MySuper product, APRA will be able to respond with an adjustment to capital.

2.4 Data collection, publication and research

The Panel considers that APRA needs to be charged with the responsibility of providing more in-depth data and analysis on the superannuation sector. For example, under the *Financial Sector (Collection of Data) Act 2001* (**FS (CoD) Act**), APRA collects data from a variety of sources, but is not presently charged with analysing or using the data to drive efficiency in the industry or increasing the level of knowledge about how the data could be more effectively used. One aspect of the analysis that would be important is determining what level of scale is optimal in the Australian superannuation industry (much like that set out in table 10.1 above) and equipping trustees with that knowledge so that trustees can better assess the situation of their fund. There are many other issues affecting superannuation where good quality data and analysis would improve outcomes for members and the system as a whole.

The Panel has been surprised, on occasions, at the lack of quality data available on a range of issues relating to aspects on which APRA does not currently collect data, particularly at the member level. This is not a criticism of APRA, but rather a reflection of its mandate. As a prudential regulator, it is not concerned, for example, about data regarding fees charged to members or insurance premiums paid. The Panel believes that this needs to change and much higher quality data on aspects relevant to efficiency, price competition and member outcomes needs to be collected and published.

Another issue is the need to quantify and understand the investment performance of superannuation funds. Investment performance measurement and attribution have been subjects of considerable research over the past decades.

The use of high quality data will help to further improve investment performance analysis, leading to better information for all users. As advances in investment performance analysis are made, new types of data collection may be required. The Panel recognises that investment performance methodologies are not static knowledge, but are dynamic and evolving. There is therefore a need to encourage further investment performance research.

In addition to just publishing data, APRA needs the mandate and resources to research and analyse the data for the benefit of the system as a whole. An example of an organisation that fulfils a similar role is the Employee Benefits Research Institute (**EBRI**) in the United States.[9] Formed in 1978, EBRI is a not-for-profit, non-partisan organisation that carries out objective research into retirement-related issues.

Recommendation 10.3

That APRA's mandate be broadened to include the collection and publication of data aimed at the efficiency and outcomes of superannuation funds and research into issues arising from that data to assist trustees in achieving better outcomes for members.

2.5 Graduated enforcement powers and regulatory sanctions

In any regulated environment, there will be a temptation for a minority of players to push the boundaries to the limit. Even when the primary regulatory model is based around consultation and suasion, a credible enforcement capacity and willingness on the part of the regulator is a precondition for ongoing regulatory effectiveness. On the other hand, enforcement has to be proportionate and appropriate to have maximum impact.

Enforcement must clearly be a tool for achieving a desired outcome, rather than ever being an end in itself, and it is valuable for regulators to have a wide range of potential responses available to them. They also need the ability, supported where necessary in legislation, to use them flexibly according to their assessment of the risk inherent in the behaviour being addressed.[10] Analysis of risks, selection of the appropriate regulatory tools — of which enforcement is usually the least used in a principles-based regulatory environment — and effective application of the optimal tool are all key elements in effective regulation.[11]

A contributor to efficiency for both regulator and regulated entities is that enforcement powers should be flexible and operate at as low a cost as possible for both parties, consistent with achieving the necessary regulatory outcome.

In chapter 8, the Panel has recommended that the ATO have access to infringement notice penalties to respond to certain breaches in SMSFs, rather than being forced to disregard a breach unless it was of such seriousness as to warrant the removal of all tax concessions by way of making the fund non-complying, or recommending that the Director of Public Prosecutions initiate criminal action.

Similar considerations apply in the APRA-regulated sector. APRA has already demonstrated the effectiveness of comparable powers under the FS (CoD) Act where the capacity to levy a modest penalty (contestable in the court if the institution objected) resulted in a substantial improvement in the timeliness of lodgement of regulatory returns. The power has only been exercised on a handful of occasions, and no penalty has been contested. Had prosecution been required, both APRA and the affected trustees would have been faced with substantial legal and other costs.

Recommendation 10.4

Legislation should be amended to give APRA an administrative power to impose fines, contestable in a court, as an alternative to criminal prosecution in relation to selected SIS Act provisions.

2.6 What would be the enforcement lever for efficiency?

APRA's standard supervisory approach is to engage with trustees to secure an improved outcome for members before emerging problems in a fund become severe. This is appropriate in considerations of fund efficiency as well as fund safety. Should a trustee not respond effectively to this approach, APRA would have available to it the standard set of regulatory tools, including variations to licence conditions. In the most severe cases, depending on the construction of relevant legislation, it would be able to withdraw a trustee's licence, or initiate appropriate court action.

In addition, the Panel envisages that APRA would collect and publish a large amount of high quality data specific to each MySuper product so that there would be a much higher level of transparent and accurate data available than is currently the case. The Panel believes that this transparency alone would be one of the most powerful regulatory tools available.

3 CLOSER COOPERATION BETWEEN APRA AND ASIC

As discussed above, submissions identified that sometimes the division of duties between APRA and ASIC has led to inefficiencies and different approaches to matters in the industry.

Accordingly, the Panel believes that closer cooperation between APRA and ASIC is imperative for many reasons, including ensuring the effectiveness of MySuper and the Panel's recommendations relating to transparency, communications, disclosure and outcomes. The Panel believes that both APRA and ASIC want to assist the superannuation industry in becoming more efficient and transparent and are willing to coordinate their activities in an effort to do so. Better coordination and cooperation between the two could be achieved in a number of ways, ranging from the modest and simple to the more complex. For example:

- a memorandum of understanding and secondment arrangements aimed at closer cooperation in relation to superannuation functions;
- an operational merger with or without a co-location in major offices, effectively merging their superannuation capabilities in an operational sense, while preserving the existing separate agencies and regulatory mandates; or
- delegations of certain powers from the respective organisations to staff of the other and arrangements in relation to premises, security and confidentiality.

Any of these arrangement could be for a limited duration (which could then be reviewed for effectiveness) or, alternatively, could be made permanent. Further, any of these proposals would make progress toward achieving a 'one-stop-shop' for trustees of large APRA funds in dealing with ASIC and APRA.

Recommendation 10.5

The Government should explore with APRA and ASIC ways in which the two regulators can work more closely together in discharging their superannuation mandates, in particular in implementing the Review's recommendations in relation to MySuper and increased efficiency more generally.

4 ATO ROLE

The ATO carries a range of responsibilities in relation to superannuation, covering traditional tax collection, assessment of contribution limits, administration of the co-contribution, administration of the superannuation guarantee, maintenance of the lost member register and supervision of SMSFs. These functions need to compete for resources with other ATO priorities, particularly broader revenue collection.

The Panel notes the ATO has a critical role in implementing the substantial microeconomic reforms in the SuperStream proposals, and the savings in relation to systemic enhancements to the 'back office' of superannuation have been estimated in several submissions to be in the order of $850M to $1B per annum.[12] This implementation may place greater pressure on existing capacity in the ATO. Stakeholders are also vitally interested in the ATO following up with employers to ensure thousands of Australians receive their SG Act entitlements every year and in appropriately supervising SMSFs (which account for a very large and growing proportion of Australia's superannuation assets).

Therefore, the Panel is of the view that the ATO needs to be adequately resourced to ensure that the industry-wide benefits embodied in SuperStream and other Panel recommendations are realised, while also continuing the ATO's existing superannuation functions.

Recommendation 10.6

The Government should ensure that the ATO is adequately resourced to continue its existing superannuation responsibilities, including the new functions it will administer under SuperStream and other Panel recommendations.

5 REVIEWS BY THE PRODUCTIVITY COMMISSION

The Panel has made recommendations for a wide range of changes that aim to ensure the superannuation system has a focus on efficiency and on producing better outcomes for fund members. Of course, all the intended benefits would not all accrue immediately and many depend on subtle changes in behaviour brought about by increased transparency. There would be an implementation/transition phase in relation to the Panel's recommended changes. The Panel also recognises that there would be a period over which the intended benefits of the recommended changes should begin, collectively, to emerge and become consistent features of a more efficient superannuation system. At the same time, elements of the new system might need fine tuning in the light of experience in order to optimise outcomes for super fund members.

The Panel believes the Government should review the implementation and outcomes of the Panel's recommendations, at a future time when the intended benefits of My Super and SuperStream should have become observable. It would also be timely to examine the market for retirement products.

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. It is also the Government's principal advisory body on all aspects of microeconomic reform. The Productivity Commission can bring economic and community perceptions to an examination of the delivery of the outcomes intended by the Panel.

There is precedent for establishing from the outset a plan to assess the progress of outcomes intended by a major review into retirement systems. In March 2000, the UK government asked Paul Myners to review the quality of institutional investment decision-making. When Myners issued his report in March 2001, he recommended the adoption of principles for investment decisions made by institutions, including pension plans.[13] Part of that recommendation was that there be a review, two years after implementation, as to whether the principles had been effective in bringing about behavioural change in the industry. HM Treasury in the UK duly followed up two years later and issued a report in December 2004 summarising its views on progress that had been made and recommending some amended principles.

Recommendation 10.7

The Government should consider arrangements for the Productivity Commission to assess, in relation to the Review's recommendations implemented by the Government, five years after the Government's response to this report:

(a) the implementation and impact of the MySuper regime;

(b) the implementation and impact of the SuperStream changes; and

(c) the functioning of the market for retirement products.

6 FUTURE REGULATORY SETTINGS

A number of submissions supported the idea of a distinct entity with responsibility for all, or certain aspects, of the super system. Industry Funds Forum and QSuper expressly supported the concept.[14] Rice Warner Actuaries suggested a new data publishing body.[15]

The Panel's four ideas (in section 1) do not include an over-arching body or single regulator for superannuation. However, the Panel is at least partly sympathetic to that idea.

It is true that the superannuation system seems to lack a place in the institutional framework of the economy. At first blush, this seems like an odd proposition for a system that currently has at least six government agencies performing various functions around super.[16] However, there is no single body charged with fostering and improving the superannuation system as a whole. The super system lacks 'systemic governance' and many of the problems the Review has identified (back office situation, poor investment return information, conflicts of interest and inadequate accounting standards) could be seen to flow from this deficiency in one way or another. The system has so far lacked a body that

could pursue a range of themes aimed at improving its efficiency and outcomes. The Panel believes its increased mandate for APRA and the closer cooperation it proposes with ASIC could be the most cost effective and efficient way of achieving this.

One of the biggest criticisms of the Australian super system is that it is liable to constant and often incoherent or conflicting changes, such that confidence in the overall concept of superannuation is undermined. This problem was repeatedly referred to in submissions and the dialogue surrounding the Review. While any complex system needs regular maintenance and realignment with its goals, the superannuation system seems susceptible to amendment to the point of it affecting its overall integrity. As the size and significance of the savings pool grows, this problem becomes even more acute.

A recent independent review into pensions in Ontario called for a new government agency — a 'Pension Champion' — that would assume responsibility for collecting and disseminating reliable information about the pension system, for thinking creatively about new pension strategies and policies, and for working with stakeholders to improve the pension system.[17]

As the superannuation industry grows to its projected size of $6.1T (in nominal dollars) in 2035, it has to be asked whether the current regulatory division between trustees regulated by the SIS Act and fund managers regulated under the 'light touch' provisions of the Corporations Act will be adequate or whether a regulator responsible for all entities 'that look after other people's money' would be more effective. One of the key advantages in doing this would be to see the regulation of trustees and fund managers under the one roof. This would be more likely to see the appropriate specialist skills and uniformity of approach housed in one organisation. It is possible that in the longer term there would be grounds for the complete integration of APRA and ASIC's jurisdiction over defined contribution super funds (leaving defined benefit funds with APRA in its traditional prudential capacity) but the Panel does not see a sufficient justification at the moment.

In the Panel's view, the regulatory settings issues which it has identified in the course of this Review are in line with those raised in the Australian Financial Centre Forum report on Australia as a Financial Centre (the November 2009 Johnson Report).[18] That report (at recommendation 4.2) expressed the opinion that Australia needs to ensure that its financial services regulatory system remains 'best practice' in order to promote Australia as a regional financial services hub and to demonstrate that Australia is competitive at an international level.

The Panel believes that the Productivity Commission's assessment of the superannuation industry's regulatory framework as suggested in this report would be a valuable contribution in this regard.

Recommendation 10.8

The Government should have the Productivity Commission assess and advise on possible improvements to the regulatory framework for superannuation five years after the Government response to this report.

7 ONGOING RATIONALISATION ISSUES

7.1 Legacy products

The term 'legacy products' is generally used in the financial services industry to refer to issues arising from historic products that have been purchased and which cannot be rationalised for a variety of reasons. Consequently, 'legacy products' are drivers of increased cost and operational risk. IFSA has estimated that 25 per cent of all funds under management (super and non-super) are in legacy products.[19]

However, the Panel has been made aware that in some instances providers with legacy products actually prefer to keep the products in existence because the fees are quite high and are used to subsidise lower fees in other products. The high fees are then justified by reason of the personal attention and manual processing that is required.

On 14 December 2009, Treasury issued a 'Proposals Paper' regarding 'Product Rationalisation of Managed Investment Schemes and Life Insurance Products'. Superannuation products were carved out from the Paper's considerations and the Paper says, among other things, that this is because the "*successor fund transfer process is generally appropriate for the superannuation industry*" and that "*legacy products are not as significant an issue in superannuation*"[20]

However, submissions to the Review have complained that the successor fund mechanism is not of assistance in many cases and actually hinders rationalisation of superannuation legacy products.

Further, the tax treatment of legacy fund assets upon transfer has also been uniformly identified as a barrier to rationalisation and consolidation.

The consolidation and rationalisation of legacy products can provide benefits to members, including:

- better product disclosure and clearer reporting to members;
- lower costs — as cost savings will be passed on to members;
- enhanced and newer features, for example, BPay, internet/online transactions, investment choice, unbundled offerings, more transparent and easier to understand products; and
- improved service standards through better administration, greater flexibility, fewer systems and processes.[21]

Such benefits result principally from greater economies of scale and transfers to more modern and flexible products and systems.

7.1.1 Successor fund transfers

As mentioned previously, a number of submissions maintained that the 'successor fund transfer' mechanism provided under Regulation 1.03 of the SIS Regulations is not sufficient in respect of many superannuation legacy products. This is because a transfer can only occur if the trustees of both the transferring and the receiving funds agree that 'equivalent rights' are provided to the transferring members in the receiving fund after the transfer. APRA Superannuation Circular I.C.4 sets out APRA's interpretation of what 'equivalent rights' requires and the superannuation industry has tended to

follow the Circular closely. In an abundance of caution, most trustees will not agree that there are 'equivalent rights' unless the transferring fund's governing rules are replicated in the receiving fund's governing rules.

Consequently, successor fund transfers result in product complexities and other undesirable features being perpetuated and, as a result, legacy products are not rationalised. Trustees are careful to protect members' rights and also to protect themselves from any accusation that they did not act in the members' interests. Even where successor fund transfers can be achieved, this is often by subsuming the complex terms of a corporate fund into a new sub-plan within a master trust, meaning that the administrative benefits of increased scale cannot be achieved.

In the Panel's view, in order to deal satisfactorily with legacy products in superannuation, there needs to be a mechanism available to industry participants in addition to the successor fund transfer as such transfers cannot always address legacy product issues where 'equivalence' cannot be achieved.

This change could also be of use for trustees who may decide that their MySuper product does not have sufficient scale but cannot achieve 'equivalence' in order for a successor fund transfer to occur.

Unlike other sectors of the financial services industry whose obligations to clients are based on contract, a super fund trustee needs to obtain judicial assistance to be released from its obligations to members. Accordingly, the Panel believes that there should be an expedited mechanism with specialist jurists to address rationalisation of legacy products (and other situations) where a successor fund transfer cannot be achieved. The Panel is of the view that only a court will properly protect members' interests and appropriately address trustees' liability for the rationalisation. The standard against which the court must assess the proposed rationalisation or merger would be prescribed in legislation.

To further assist in this regard, the Panel considers that the SIS Act requirement of 'equivalence' with respect to successor fund transfers could be changed to a test of 'no overall disadvantage' without adversely affecting the legal protections afforded to transferring members. Generally, 'no overall disadvantage' would mean that, on balance, the total package of rights and entitlements that the member has in the existing fund must not be diminished in the new fund. This change would also mean that the test for rationalisation of superannuation products is in accord with the test recommended in the 'Product Rationalisation of Managed Investment Schemes and Life Insurance Products' Proposals Paper.[22]

Recommendation 10.9

The SIS Act should be amended so that the successor fund transfer test is one of 'no overall disadvantage' rather than 'equivalence'.

Recommendation 10.10

The Federal Court should be given new jurisdiction to determine and facilitate product rationalisation in the superannuation industry where the successor fund transfer regime (as amended by the recommendation made in this Review) still does not fulfil legacy product rationalisation objectives.

7.2 Capital gains tax relief

One of the Panel's main goals is to encourage efficiency throughout the superannuation system. As has been mentioned, a way of achieving this goal is through fund mergers and successor fund transfers as well as product rationalisation which contribute to meeting economies of scale.

Currently, superannuation funds have capital gains tax (**CGT**) rollover relief to protect losses in successor fund transfers and other asset transfers between funds.[23] That is, the current CGT relief only applies to losses and not gains. Further, the relief is only in place until 30 June 2011. The current CGT relief was provided in the context of the GFC — where the majority of funds had significant unrealised capital losses. If a transfer proceeded without such relief, funds would forgo the future benefit of those losses. This potential negative impact can result in some funds foregoing merger plans which would otherwise result in medium-to-long term benefits to the members and industry more broadly.

As part of the move to RSE licensing in 2006, CGT rollover relief was provided to superannuation funds and applied to gains and losses under the *Tax Laws Amendment (2005 Measures) Act 2005*. The government afforded this relief (between 30 June 2004 and 1 July 2006) to trustees that did not seek to be licensed and that, as a result, were required to transfer fund assets to other superannuation funds.[24] Given that the Act's relief extended to gains and losses, a significant number of successor fund transfers occurred during that period.

The Panel believes that the current CGT rollover relief should be amended to afford the same CGT relief provided to the industry in conjunction with RSE licensing during 2004 to 2006. Specifically, the current CGT rollover relief should cover gains as well as losses and should be permanently available to the industry.

Recommendation 10.11

CGT rollover relief should be given to superannuation funds in the terms previously afforded by the *Tax Laws Amendment (2005 Measures No.2) Act 2005* and should be permanently available to the industry.

7.3 Particular products

There are several products created by statute that are widely available, but which no longer are required to fulfil their original policy objective.

7.3.1 Retirement Savings Accounts

At 30 June 2008, there were approximately 120,000 Retirement Savings Accounts (**RSAs**) with $1.2B in assets, making up 0.32 per cent of assets in the retail sector.[25] The asset base jumped dramatically to $6.2B by June 2009 due to the attraction of their capital guaranteed nature during the global financial crisis. Currently, there are ten institutions offering RSAs, most of which are credit unions.[26]

RSAs have generally not been a success because they are a capital guaranteed product and there is currently no scope in the RSA framework for adding a market-linked investment where the risk of

loss is borne by the holder. RSAs are thus suitable only for individuals with an extremely low risk tolerance, and are essentially unsuitable for much of the accumulation phase of retirement saving.

The interest rate spreads used as a measure of the implicit fee in an RSA as the explicit account keeping fee is usually very low (typically between $0 and $30 a year).[27] Implicit fees for balances less than $5,000 are, on average, 1.2 per cent and generally fall as the account balance increases.

Rice Warner estimates RSA expense charges for the year to 30 June 2008 to be 2.3 per cent of assets. Of this, 0.60 per cent is attributable to administration and 1.7 per cent to investment management.[28] Rice Warner explains the relatively high costs as a reflection of the low average account balances of RSAs.

The Panel considers that there has been little market demand for this product and they seem not to meet the low-cost objective for which they were originally intended. As such, the Panel believes the RSA product should be phased out and no new RSA should be established once MySuper products are available.

Recommendation 10.12

New Retirement Savings Accounts should not be allowed to be established after MySuper becomes effective and a mechanism should be considered for facilitating existing RSAs to be transferred to MySuper or other superannuation products.

7.3.2 Approved Deposit Funds

At June 2008, there were only 140 Approved Deposit Funds (**ADFs**), of which 136 were single member ADFs. At March 2010, the number of single member ADFs had fallen to 105.[29] Total assets in this class are less than $0.1B.[30]

The Panel does not believe that ADFs serve any residual purpose as the reason that they were necessary no longer exists (that is, super funds were previously prohibited from holding members' funds after they ceased employment in certain circumstances). Their dramatic decline over the years is a strong indicator that there is no demand for ADFs as they have been superseded by other products on the market. There seems to be no policy reason to revive them and they should be phased out.

Recommendation 10.13

New Approved Deposit Funds should not be allowed to be established after MySuper becomes effective and a mechanism should be considered for facilitating existing ADFs to be transferred to MySuper or other superannuation products.

7.4 Member protection

Member protection, the rule under which members with an account balance of less than $1,000 cannot have that balance eroded by fees greater than the earnings accruing to their account, was introduced at a time when the SG Act contribution rate was only 3 per cent, and average wages were substantially lower than is the case today. In the current environment, any employee on a minimum

wage, but working more than 10 hours a week, would have more than $1,000 in super after their first year of employment.

There are direct costs to funds in terms of cross-subsidising such low balance members. REST,[31] which has an unusually high proportion of low balance members due to the youth and casual employment characteristic of its members, estimates that this protection costs between $7M and $17M in any given year. Further, every fund needs to provide for member protection in devising its administrative systems and procedures, adding both complexity and cost. REST's position was also supported by a number of other submissions.[32]

The Panel considers that member protection operates as a disincentive for members to consolidate small account balances, is administratively inefficient and has outlived its usefulness.

For a member with an $800 balance and typical administration fees of $1.50 a week, a subsidy will occur if fund returns are anywhere between 0 and 9.75 per cent (that is, a very large proportion of the time). The argument for abolition goes to considerations of both efficiency and broader equity. The population which could benefit from it is both small and fluid, in that generally only those in the very earliest stage of workforce participation have balances as low as $1,000. However, the cost to the system overall of being able to track those members and apply member protection if/when needed is substantial.

Recommendation 10.14

The Government should legislate to abolish the member protection rules.

8 ELIGIBLE ROLLOVER FUNDS

8.1 Background

The 16 eligible rollover funds (**ERFs**) form a unique segment of the superannuation system.[33] These funds were intended to be a temporary repository for the benefits of members who had lost connection with their superannuation, and to protect those members. In practice, ERFs also accept rollovers from superannuation funds for a number of other reasons where the member has not actively made a choice about their superannuation.

ERFs are obliged to receive payments from another super fund, an ADF, or an RSA. An ERF must also treat each member, regardless of their account balance, as a 'protected member'.[34] For all other super funds, a member is only 'protected' if they satisfy the conditions in SIS Regulation 1.03, primarily members whose balance is below $1,000. The Panel is recommending that member protection be abolished — see section 7.4.

ERFs have not achieved their intended objectives because:

(a) some funds do not send small inactive accounts to ERFs;

(b) some ERFs appear to have made little effort to re-connect people with their superannuation. There is little incentive to align members with their money because of the cost of matching

and because ERFs continue to collect ongoing fees on these 'inactive' accounts. Rice Warner estimated that, for the year ended 30 June 2008, the average fee for ERFs was 2.49 per cent,[35] although this figure equates to an average of only $23.16 per account per year because of the predominance of small accounts in ERFs. However, because of the very low level of activity inherent in the operation of an ERF, the member account perspective is less relevant than in a normal super fund;

(c) there has been no unique member identifier to aid the process of re-uniting members with their accounts;

(d) matching lost members with unclaimed super is costly. Ultimately, the cost of running the exercise depends on the volume of matches. In 2008, one ERF undertook cross-matching of 3 million accounts, leading to approximately 104,000 accounts (with a total value of $39M) being matched; an average of $400 per account. This exercise cost approximately $625,000, being $79.93 per 1,000 records, plus a cost of $3.68 per successful match;[36] and

(e) ERFs have adopted a wide range of investment strategies, from very conservative to very aggressive. Individual ERFs generated average annual rates of return over the three years to 30 June 2009 ranging from a low of -14.9 per cent up to 4.2 per cent.[37] In conjunction with high fees as a percentage of assets, these investment strategies do not effectively preserve the balance of lost members.

Legislation has been passed to give effect to the Government's 2009-10 Budget announcement that will require superannuation providers to transfer to the Commonwealth all 'lost member' accounts that have a balance of less than $200, and all those accounts that have been inactive for more than five years and for which there are insufficient details to identify the owner. This will come into effect from 1 July 2010, and is expected to reduce the number of lost and unidentifiable accounts by about 40 per cent with consequential administrative savings for funds. It is expected that approximately $238M will be transferred to the Commonwealth over the next three years. It will also remove the lowest value accounts from ERFs, making them somewhat more cost effective.

8.2 ERFs and choice architecture model

The Panel has adopted the view that MySuper members should enjoy the benefits of traditional trusteeship, with the trustee having more extensive responsibilities than apply in the choice sector. In similar terms, the Panel considers that the most disengaged members, whose retirement savings are held in an ERF, should have the benefit of at least that standard of care.

Therefore, the Panel considers that ERF trustees should be subject to the same duties and principles as apply to MySuper trustees; namely:

(a) The trustee must provide members with a single, diversified investment strategy at an overall cost aimed at optimising their financial best interests;

(b) An ERF trustee must form the view, on an annual basis, that its ERF has sufficient scale on its own (with respect to both assets and number of members) to provide optimal retirement savings for its members; and

(c) There would be no entry (contribution) fees charged for an ERF, including on rollovers. Exit fees could only be charged on a cost recovery basis.

In addition, ERF trustees should be under an obligation at least annually to seek to match its account holders with any active account held by that person. Subject to Government agreement to the extended use of TFNs for member matching proposed in chapter 9, ERF trustees could seek the assistance of the ATO (as well as other funds) in undertaking this matching.

To facilitate implementation of these requirements on ERF trustees, the Panel considers that there should be a separate licence class for RSE licensees that act as trustee of an ERF.

Recommendation 10.15

The SIS Act should be amended to create a specific RSE licence class for trustees of ERFs. ERF trustees should be subject to very similar duties as apply to MySuper trustees (bearing in mind the different functions and characteristics of ERFs).

Recommendation 10.16

In order to have ERFs more effectively fulfil their intended function:

(a) the RSE licence for each trustee of an ERF should be subject to the condition that they actively cross match with any active fund seeking the service. All ERF licensees must provide an online facility for people to search for lost super; and

(b) all funds should be required to cross match with ERFs for a new member.

9 SUPERANNUATION COMPLAINTS TRIBUNAL

If a member has a problem with their superannuation, the first place for them to go is to the fund's trustee. Sometimes, all the member needs is clarification, but sometimes the member wants to lodge a complaint about a decision of the trustee. Under section 101 of the SIS Act, the trustee must have an internal complaints process for members.

If a member is not happy with the decision of the trustee in relation to a complaint, the member has two avenues of recourse. The member can seek to have the matter heard by a state court or the Superannuation Complaints Tribunal (**SCT**).

As part of the reforms instituted in 1993, the SCT was established under the *Superannuation (Resolution of Complaints) Act 1993* (**Complaints Act**) to provide members of superannuation funds with a low cost forum for having their complaints against trustees heard. The SCT is not a court and, in fact, its processes lead to a much speedier resolution of matters than would be possible in a court. Members or trustees who are dissatisfied with the SCT's determination can appeal to the Federal Court on matters of law only.

The Financial Ombudsman Service (**FOS**) is a voluntary complaints service for the financial services industry. It does not hear complaints about superannuation that are within the jurisdiction of the SCT, but it is available to hear complaints which the SCT cannot entertain; for example, a complaint about advice given to the member by a trustee or financial adviser or complaints about an insurer.

No submissions advocated the elimination of the SCT, although one submission did suggest that perhaps FOS could handle all superannuation complaints as well.[38] Most submissions advocated a greater role for the SCT.

9.1 90-day time limit

The Panel does not see any reason to reduce the 90 day time period that the Complaints Act presently prescribes for the trustee to respond to the initial complaint through its internal complaints system. While the Panel would expect a trustee to be as speedy as possible in addressing member complaints, the Panel acknowledges that complaints frequently involve complex matters which require the trustee to assemble additional evidence and information and often the issue involves historic material as well as getting information from third parties.

Reducing the 90-day period could have the effect that many complaints cannot be resolved within the abbreviated period allowed, thus causing matters to be brought to the Tribunal which might otherwise be resolved without the need for escalation.

9.2 Change of name

The Panel considers that the name of the SCT should be changed to more appropriately reflect its role and suggests: 'Superannuation Appeals Tribunal'. This name would more accurately represent that the SCT does not hear initial complaints, but only complaints that have not been settled between the trustee and the member in the first instance and are on appeal.

Recommendation 10.17

The name of the SCT should be changed to reflect more appropriately its role. 'Superannuation Appeals Tribunal' is suggested.

9.3 Disablement claims

The Panel recommends a change in the time limit in the Complaints Act regarding total and permanent disablement (**TPD**) claims. The details of this recommendation are dealt with fully in chapter 5.

10 THE SIS ACT

With a view to its goal of efficiency, the Panel has considered whether the SIS Act can be improved in this regard. Undoubtedly, the SIS Act is complex, both for the SMSF sector (as discussed in chapter 8) and APRA-regulated fund trustees. Within the SIS Act, there are provisions that apply solely to one sector. There are also other provisions which, while applying to all sectors, are more likely to have an impact on one sector than another.

These complexities can lead to inefficiencies between industry participants, such as trustees, service providers and regulators. The combination of complexity and the inherent differences between the sectors can result in regulators providing different risk assessments and perspectives, leading to

inconsistent interpretation across the regulators and, in turn, to different regulatory approaches and slower regulatory responses.

Submissions to the Review's Phase Three Issues Paper — Structure (including SMSFs) expressed a desire for the removal of unnecessary and complex requirements (aimed at APRA-regulated funds) which unnecessarily added to SMSF costs.[39] Many submissions pointed to a number of confusing and complex technical issues that needed to be addressed. The Panel does not intend to address these technical issues specifically.

The majority of submissions did not support separate legislation for SMSFs and APRA-regulated funds, with CPA Australia advocating the retention of a 'level playing field'.[40] There were, however, submissions that recommended separate Acts, or separate divisions (within the SIS Act) for each of the sectors. The Panel recognises that some tension exists between the desire to remove unnecessary regulation and provide clarity of law and the concern that change might lead to one superannuation sector being unfairly favoured over another. However, the 'level playing field' argument only goes so far.

While the Panel believes that legislation should not give a material advantage to one sector over another, the fact remains that there is a distinct difference between opting to have one's superannuation looked after in a large APRA fund and deciding to take the responsibility for one's own retirement savings in the SMSF sector. The choice architecture model consciously recognises this.

Further, the Panel's recommendations in this report propose a number of changes to the SIS Act, many of which would only be applicable to specific sectors of the proposed choice architecture model.

Given the legislative distinctions that have been made in the past between the sectors and the distinctions that are recommended by the Panel, the Panel is of the view that a re-write of the SIS Act would contribute to achieving greater efficiencies in the superannuation industry.

The SIS Act could be restructured so as to set out clearly those provisions that are relevant to each sector of the industry under the choice architecture model. A re-write could address the roles of the various regulators as well as other technical issues that have been identified in submissions. This should all be done in a manner that still leaves a 'level playing field' insofar as the distinct models allow.

Recommendation 10.18

The SIS Act should be re-written and restructured to separate and to identify clearly those provisions that are common for all sectors of the superannuation industry and those provisions that are only applicable to particular sectors under the choice architecture model.

11 NEED FOR A SUPERANNUATION CONSUMER GROUP

There is currently no organisation in Australia to champion the interests of superannuation members. While shareholders have the Australian Shareholders' Association, there is no superannuation-specific consumer group.

The Review has focused much of its work at recommending member-oriented solutions; measures intended to address many concerns affecting ordinary members. These include MySuper (chapter 1), SuperStream (chapter 9), improved transparency and comparability (chapter 4) and expansion of the jurisdiction of the SCT on TPD claims (chapter 5).

Consequently, the Panel is of the view that it is premature to take the additional step of recommending the establishment of a consumer body for superannuation members before these recommendations are implemented and their effectiveness assessed.

It might well be that such an organisation is formed privately and not by government.

12 GENERAL EMPLOYEE ENTITLEMENT AND REDUNDANCY SCHEME

The General Employee Entitlement and Redundancy Scheme (**GEERS**) is a legislative scheme designed to help employees who lose their jobs as a result of the liquidation or bankruptcy of their employer and who are owed a range of employee entitlements. It is administered by the Department of Education, Employment and Workplace Relations. GEERS covers up to three months unpaid wages, as well as unpaid annual and long service leave, a maximum of five weeks unpaid pay in lieu of notice and a maximum of 16 weeks unpaid redundancy entitlement.

GEERS does not currently cover unpaid employer superannuation contributions, whether they be mandatory SG Act contributions or employer contributions above this amount. However, GEERS does cover up to three months of employee contributions, both after tax and salary sacrifice that an employer has failed to forward to an employee's superannuation fund, as the contributions are effectively regarded as unpaid salary.

Extending GEERS to cover some or all unremitted employer SG Act contributions would help protect the superannuation benefits of Australian workers. It would be of particular assistance to low income earners and casual workers since there is evidence that these groups most commonly miss out on getting their superannuation entitlements. Given that GEERS is funded from general revenue, extending the scheme would represent a cost to the Government.

The Panel did find, however, that there is a strong case for placing a limit on an extension of GEERS to cover employer superannuation contributions. Imposing a limit is consistent with the treatment of other entitlements under the scheme. Lastly, the implementation of the Panel's SuperStream recommendations should also reduce the extent of unremitted employer contributions.

Recommendation 10.19

GEERS should be extended to cover up to three months of unpaid employer SG Act contributions.

ENDNOTES

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