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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

DRAFT REPORT ON THE SUPERANNUATION INDUSTRY

MR J.H. COSGROVE, Presiding Commissioner
MR R. FRENEY, Associate Commissioner

TRANSCRIPT OF PROCEEDINGS

AT MELBOURNE ON TUESDAY, 30 OCTOBER 2001, AT 9.00 AM

Continued from 25/10/01 in Sydney

MR COSGROVE: Good morning, ladies and gentlemen, I'd like to welcome you to the resumption of the public hearings on the Productivity Commission's inquiry into the SIS Act and certain other superannuation legislation following the release of our draft report on 19 September. My name is John Cosgrove, I'm the presiding commissioner on the inquiry and with me is my fellow commissioner, Roger Freney. The purpose of this round of hearings is to facilitate public scrutiny of the commission's work and to get comments and feedback on the draft report. After this hearing in Melbourne we will be working towards completing a final report for the government in December.

Participants in the inquiry will automatically receive a copy of the final report once it is released. That can take up to 25 parliamentary sitting days after it's delivered to the government. We like to conduct these hearings in an informal manner but you will see that we are taking a transcript of proceedings. For that reason comments from the floor cannot be taken but at the end of our proceedings I will give an opportunity to any people wishing to do so to make a brief presentation. Participants are not required to take an oath but should be truthful and accurate in their remarks and they are welcome to comment on issues raised in other submissions if they so wish.

The transcript of our hearings will be made available to participants and will also be available from the commission's web site following the hearings. Copies may also be purchased using an order form available from our staff here today. Submissions are also available. I'd like to apologise for this hammering noise that we're having to cope with. I have asked to see whether we can have it ceased but we're in the hands of others in that respect. Meanwhile I'd like to welcome our first participant which is Jacques Martin Industry Funds Administration. For the purpose of the transcript, Fiona, would you mind identifying yourself and indicating the capacity in which you're with us today.

MS GALBRAITH: I'm Fiona Galbraith, manager of compliance.

MR COSGROVE: Thank you. At the outset I'd like to extend to you and your company substantial gratitude for this very comprehensive response to the draft report. You've been able to help us considerably, I think, by identifying factual wrinkles which we didn't seem to get quite right in the draft report and of course you've also got some germane comments which we'd like to discuss with you on the essence of the report's recommendations itself. But you might like to make some opening remarks perhaps.

MS GALBRAITH: Only by way of commending the commission in the quality of the report. I was most impressed with both the comprehensiveness of the research that had gone into it and the analysis and grasp of - the appreciation and understanding of the issues that were raised. So I commend - the draft report was impressive, so congratulations on the work that was done.

MR COSGROVE: Thank you. We'll be trying to do even better of course in the final report. Well, with your agreement then we might work through this, as I say, very helpful submission which you have provided to us on the draft report. I guess I might start with a factual question which is posed - or me at least - the bottom of the first page of your submission, this statement that while not a great deal might turn on the distinction that it could be worthwhile clarifying the standard employer sponsored and public offer funds are not mutually exclusive. You go on to say that it's possible for a superannuation fund to be one or other but a number of funds are both. Could you explain how it is that they become both public offer and standard employer sponsored?

MS GALBRAITH: Right. The definition of a standard employer sponsored fund is one where the employer agrees to participate in the fund, so it's by courtesy of an arrangement between the trustee and the standard employer sponsor. As soon as you have one of those arrangements in place which effectively means that it's the employer who has selected the fund and their employees become members by virtue of that selection process, then you have a standard employer sponsored fund. A lot of corporate funds and some industry funds are standard employer sponsored funds - well, actually they are all standard employer sponsored funds. By definition that's how they operate. A public offer fund is a fund which has an approved trustee which can then accept, as the name implies, offers from the public through use of the key feature statement and a fund that does that is a public offer fund, as well it can just operate as a public offer fund and just go out and accept people off the street.

But I think probably virtually without exception, most public offer funds are standard employer sponsored funds as well. So they will one minute be handing over a key feature statement to a person who has wandered in off the footpath and the next minute they will be going in and having an employer executed participating deed or an application form to join as a standard employer sponsor and their employees becoming standard employer sponsored members. So the fund is actually both. Really the major point of distinction is the fact that you need to be an approved trustee to run the public offer fund and it's really how members arrive in the fund which is related of course to the now lapsed choice of funds legislation. Once the members have arrived in the fund there are very few differences. It wouldn't even be a half a dozen, probably two or three differences from one member to the next. Once they're in the fund you shouldn't be able to distinguish between one member and another - and this is speaking of, say, industry funds.

Obviously the other alternative is that you have a master trust arrangement. Industry funds basically generally have all members, they're all in the one universal class of membership. The other way of looking at it is that you do have some master trusts which are public offer funds, the standard employer sponsor adopts the fund but sets up an actual subplan in that master trust for their employees. There you can distinguish between the different groups of employees.

MR COSGROVE: It's essentially a choice made by the employer sponsor that they

wish to also operate on a public offer basis. Is that - - -

MS GALBRAITH: No, it's actually a choice by the trustee of the fund.

MR COSGROVE: Okay. By the trustee, yes.

MS GALBRAITH: It usually is a trustee - most public offer funds usually have unrelated members in them, be it a series of unrelated employer sponsors or even a series of unrelated members without an employer sponsor in sight. They're either public offer or they're doing their own discretionary top-up super away from their employment relationships.

MR FRENEY: In the case of an industry fund the employer can choose to use the trusteeship of the industry fund as for an employer sponsored fund and also sort of separately and what makes it a public offer fund is that the industry fund can take in individual contributing members from off the street. Is that what makes them one and the same?

MS GALBRAITH: Yes, it's the trustees' choice, and we administer about 20 funds of whom about seven or eight are now a public offer because the trustees themselves have decided to go down that path, receive approved status from APRA and make offers to the public as well as what they call their industry fund members through the standard employer sponsor. So the trustees decided to do that and they will take on self-employed or as I said people doing top-up. But our remaining - whatever the maths is - 13, 14 funds, industry funds, they have remained as purely standard employer sponsored funds, so the only way you can join those funds is if you're an employee of a participating employer. But the funds, the ones that have become public offer are still standard employer sponsored funds as well.

MR FRENEY: Thank you.

MR COSGROVE: My next question is on page 5 of your submission. Do you have anything before that, Roger?

MR FRENEY: Just a quick question, I guess, on page 3 you say it's generally not the SIS legislation which serves to deter competition but the tax legislation, and in particular the surcharge. What was it that you had in mind when you said the surcharge can deter competition?

MS GALBRAITH: Sorry, the surcharge legislation and more significantly administering it, particularly defined benefit funds. It's by far the more complex and onerous obligations administering our super funds. The legislative compliance based ones are complying with the tax legislation on the surcharge legislation. SIS on a day-to-day basis is not as onerous for us to administer the fund. There are probably some issues there for the trustees running the fund, but I suppose I was coming more from an administrative perspective. Surcharge certainly costs us over a million

dollars to amend our system to administer surcharge and we're only accumulation funds, not defined benefit funds. Defined benefit funds would have a significant component of - waiver component of as well, be it from professional actuaries through to just manually recording things and dealing with member queries and that kind of thing.

MR FRENEY: So it's anti-competitive in a sense of the complexities of the surcharge and the cost of the surcharge are deterring potentially new suppliers from coming on to the market?

MS GALBRAITH: I would say it would be a distinct barrier to entry, yes, for that very reason because it probably always has been, even before surcharge. It's just the tax legislation not so much from the contribution tax coming in - only that is an issue - or the income tax on the way through but the EPT tax is relatively complex and particularly from a systems perspective I believe there's a player out there now which actually is using American software which has adapted but there's always been the theory that software, for example, has to be home-grown because of the configuration required to basically be able to cater for the tax, and in the past, preservation, because of the various stages of preservation. It's a little more straightforward now because of the compulsory preservation going forward it's more just capturing history rather than keeping track of different dates and things to enable the history to be created.

So the degree of sophistication required in the software to administer super funds is a distinct barrier for entry because it's nowhere near as straightforward as clients perceive it to be which is the analogy of running a bank account, it's a more complex than that. Then surcharge now with its monthly payment cycle and things we're constantly having to reconcile on a monthly basis, there's surcharge assessments against what was paid the previous month, and interest adjustments. It's that whole cycle which involves some more senior financial people. It's those kind of infrastructures that you need in place that make it more complex to go into than say a normal managed investment.

MR FRENEY: Thanks very much.

MR COSGROVE: Would you make a similar judgment that it's the tax legislation, including especially the surcharge legislation, which more than the SIS Act itself might be leading employer sponsored funds to transfer members into master trust arrangements or is there anything of that type of shift amongst the existing stock of funds that you can identify and explain why it's occurring?

MS GALBRAITH: I think the consensus generally is that it is the tax legislation more than anything else. I must admit I haven't looked at the correlation of the stats but after the introduction of the surcharge there was certainly a significant number of defined benefit funds that were either at least close new entrants, if not actually moved across into master trusts or other arrangements. It is the administration that's

probably the single-most significant component in that. I suspect they probably have elements like the introduction of strict liability may have made some trustees nervous and may have found it difficult to attract member trustees. But I suspect at the end of the day that has probably led to fewer closures than - it's put an end to some nerves but not necessarily fund closures or mergers or wind-ups. I think the surcharge in particular - it would be interesting to have a look at the - if there is a correlation between that and the defined benefit funds in particular.

But also even accumulation funds, the economies of scale that are required to administer a fund effectively mean that the membership levels are creeping increasingly higher to get to the break-even point. The smaller funds, the employer was having to cross-subsidise even more heavily with the employer contribution towards the administration, be it in-house or outsourced and especially there are some administrators out there, some providers, who are effectively telling the market that - raising the barrier, the threshold, about funds that they could afford to administer and ask them to make alternate arrangements. The most obvious one of that is to go towards the master trust.

MR COSGROVE: There's an interesting suggesting at the top of that page where you say that it may be better than to apply a net tangible asset requirement across funds, particularly those of a not-for-profit kind to mandate what you call sufficient levels of suitable insurance cover to be held by the trustee. Could you explain a little more as to what you actually have in mind there? I take it you're looking at trustees taking out insurance cover against possible problems arising in the administration of their schemes. Is that the idea you've got in mind?

MS GALBRAITH: Yes, it is, either the trustees directly or I suppose it could be done by means of ensuring that if the trustee enters into an outsourcing arrangement with a service provider to administer the fund that that service provider in turn had adequate insurance cover.

MR COSGROVE: It could be either?

MS GALBRAITH: Yes, it could be either, basically to have it that the trustee could satisfy that indirectly by ensuring that as part of the admin agreement with its external service provider that that service provider in turn had adequate insurance. How the level of adequacy is established might be an interesting question. Maybe that's the kind of thing that could be mandated. These kind of figures would be more realistic as a level of insurance cover, I'm not quite sure about as actually having net tangible assets.

MR COSGROVE: Would such insurance be commonly available, do you know?

MS GALBRAITH: I don't know. I would think so. I mean, just coming from our perspective as administrators, I'm sure we do have insurance cover in place that in the event of some kind of systemic failure that we'd be able to - I'm not sure if it

would actually require - I'm not an insurance expert - there to be third party costs and damages before we could invoke it. It may be that we'd have to establish that it has caused loss to our clients and therefore - I'm not exactly sure how the mechanism would work and I'm sure someone else would be better placed to answer about the market reality of whether or not the insurance is available and if there are any constraints on it.

It's just a perspective that it's better placed as a risk being insured against - particularly with one or two notable exceptions, thankfully it hasn't happened to date, and also because there's an increasing trend towards consolidation of administration out there in the market, simply again because of this economies of scale approach. A number of funds out there do outsource; there are a few. That's been another trend away from in-house administration. It may swing back if things stabilise but the rate of change in legislation makes that unlikely in the foreseeable future. So we're talking about a sort of concentrated risk.

MR COSGROVE: The reason why you think this might be a more suitable alternative is, what, the likelihood of it being less costly than having a capital adequacy requirement placed on the trustee?

MS GALBRAITH: Yes, I think it's just something that would be more readily - the trustees would be more readily able to come up with the premiums to cover this kind of insurance cover. I imagine that the premiums would be reasonable than they would be in a position to actually have that degree of net tangible assets tied up in the administration.

MR COSGROVE: So far as our draft report was concerned we had suggested that the funds operated by non-approved trustees would not have to have, if you like, capital for reasons of substance but merely working capital. Would you still think that the cost of insurance for say a small such corporate fund might still be lower than a modest working capital requirement? I'm not sure myself but I could imagine there might be some base level of insurance premium in the marketplace which for a fund, say, with 10 members or 20 members might be higher than the actual working capital requirement along the lines suggested in our draft report. Do you have any view on that? It's difficult perhaps to make judgments on these matters if you're not actually seeking the cost of premiums.

MS GALBRAITH: True. I guess it depends on how this 10 member fund has been administered. I guess that goes back to if it's being outsourced to an external administration company then you have the economies of scale of that administration company actually being the one to be insured across its entire membership base. If it's self-administered in-house then one would have to think that it has a fairly close relationship with the employer sponsor, assuming that there are arm's length members in this fund, in which case it may have to be - the trustee may have to look at the employer sponsor, I guess, to pay for the cost of the insurance premiums.

I guess it's tricky looking at our non-approved trustees and our non-public offer funds, industry funds. As companies they are $2 shelf companies, the trustee company, and they are running not-for-profit funds and they're working on, I suppose, the dual theory: one that they're outsourcing administration so we as an organisation are the ones liable for having - picking the system up and dusting it off and getting it back on track if something happens and we have adequate insurance, but also on the basis that - I guess at the end of the day they have recourse to the assets of the fund to either effect - insurance policy or to - if they need to pay us elevated administration costs, whatever the case may be, and next time a legislative change is introduced and we have to put up our fees, it's a long cycle. Most of our contracts are five-year cycles, so it takes a while before we can do that. But that's the resource they tap into. They as an organisation have literally $2 to their name. So I guess it's as much - partly the cost and partly the vehicle as well for them to use some of the assets of the fund to pay an insurance premium. It's the kind of thing they currently do with group life and pay us to administer and pay investment managers to do the investing.

For them to actually come up with some net tangible assets in their own - working capital in their own right, would presumably mean dragging it back out of the fund into the company which will reduce returns to members, and I guess the theory is that it's there to return to members at the moment. If they need it in the future they'll just have to - in that particular period they will have to lower the returns to members if they're pulling, I suppose, one would hope, other than these negative returns, just pulling some out of the earnings out to do something and I guess they feel that they would prefer it to be down there in the fund able to fund members on an ongoing basis but still having there the pool of assets as a kind of contingency pool rather than having it sitting up with a trust company. Having said that though, insurance is probably - paying it out as insurance premiums to have insurance cover is probably the preferable option.

MR COSGROVE: You mentioned I think that you yourselves have insurance against systemic failures or failures in your systems.

MS GALBRAITH: To the best of my knowledge and belief.

MR COSGROVE: Okay. So if one of your superannuation fund clients experienced problems as a result of some difficulties in your own computer systems, that fund would not incur any expense because the costs of putting that system right would be covered by your insurance arrangement. Would that be how it works?

MS GALBRAITH: That's my understanding about it. I'm not exactly sure of the nature of the insurance policy and it may be that we need to establish liability to a third party, ie, our clients in order to invoke the policy itself and that may be the mechanism that's required. But in the event of a system failure that shouldn't prove difficult to establish because that's really what they come to us for is systems and procedures to administer their funds, so if there is a system failure then there are

going to be consequential flows and the policy would cover that.

MR FRENEY: I would like to just probe a couple of points in this area. It seems to me, whether it's an approved trustee or another trustee, under the SIS legislation they are the responsible entity for making sure that the fund runs smoothly and members' interests are safeguarded. In doing this there's all sorts of different kinds of risks, running from administrative risks through credit risks and counter-party risks, you name it. In many financial institutions there has to be explicit reserving for those different kinds of risks. So it's intriguing to me that where you've got the responsible entity that they themselves don't have to have any sort of operating capital requirements or reserving or you can have a concept of a $2 shelf company effectively bearing all these risks by an outsourcing or insurance concept. I can understand the arithmetic of it in a sense but I sometimes wonder about the practicalities of being able to retrieve problem situations where there may be culpability, negligence and you wonder (a) whether insurance policies would necessarily cover all of the risks, when you think of the costs of the insurance policies that you'd have to take out to cover all of the risks, and you also think in terms of the speed with which you might be able to realise on an insurance claim.

Often if you get computer failure you want to be able to start to rectify it very quickly. If you get error calculations in terms of contributions and entitlements you want to be able to address it very quickly. So there seems to be a bit of a basic premise of SIS of having the trustee as the responsible entity and also being able to have the wherewithal to be able to keep - sure that the show is running smoothly and effectively and to rely on a backstop of having access to members' assets. I just wonder about the practicalities of being able to grab hold of some assets or whack up an administration charge when you run into problems. I'd be interested if you had any comment on that.

MS GALBRAITH: I guess all of our funds do run considerable reserves and they do have an admin reserve and often have other reserves as well. So they do keep some of the earnings back from returning them to members so they're sitting there on a contingency basis. But having said that, even if the contingency was more than the reserves, because of the nature of super and the fact that you actually only allocate earnings on an annual basis, obviously members leaving throughout the course of the year are paid a return on their super when they leave usually on an interim crediting rate basis. But because the returns are only realised at year end - effective year end and sometime after year end - there is scope there - the earnings that come in during the course of the year, there is scope there. I mean, you can effectively go into this reserve pool. They're sitting there before they're allocated to members, if something were to occur. You could tap into that and then the crediting rate that you credit to members is reduced accordingly and possibly even negative.

I guess because of the nature of the flows and the contributions coming in and the earnings on the assets, even if you were to give a crediting rate and then have the circumstance arise immediately post-review, on the volume, particularly the industry

runs that go through, in a very short period of time you'd have the contribution flow in and the earnings, particularly the earnings on the asset base that there is that you could utilise then. It might just mean that the members - I suppose there's always an inter-generational equity issue. But I guess our funds feel that the risk is pretty low of this happening and particularly with outsourcing and the capacity for risk insurance and they would rather have the members credited with it on the way through and then if something were to occur it would be unfortunate that the members in the fund at that particular time will bear the costs of reduced earning rates for that particular period, but again it would be spread across the membership of the fund.

But with the compounding effect that is actually a better outcome than it is pulling it out either up-front or on an ongoing basis because they would have had the benefit of it up to date. So their account balances before they get there are slightly lower or maybe even slightly negative return is already significantly higher than it would have been had they been receiving say 1 per cent less a year for the previous 10 years anyway. With the compounding effect it's significantly higher. So if you then credit them maybe even 3 or 4 per cent less on a given year then they might otherwise have received they're probably still ahead.

MR FRENEY: So reserving can provide a buffer.

MS GALBRAITH: They definitely do run reserves, yes.

MR FRENEY: But it can be drawn upon is sort of one point, and then the second point is that in well structured and well run situations, like most of your clients and yourselves, you can fairly easily access reserves or debit member accounts if you have to. Given that SIS is dealing with such a wide cross-section of all sorts of different funds run to different degrees of excellence or non-excellence and many still are self-administered, I wonder whether in those cases there would be quite the same sense of security and comfort if a trustee didn't have some operating capital and was relying on the sort of reliances that you were just describing. I guess we can only speculate. But these are the sort of issues I think that SIS is trying to address and we had in mind when we were thinking about operating capital.

MS GALBRAITH: It's interesting too because the Victorian courts just recently have started to recognise the unique tripartite nature of super, and you're quite right in that the trustee is ultimately the responsible entity. But I guess one way of looking at it possibly is for the smaller funds that are self-administered which will generally be standard employer sponsored funds, I would guess there may be need for them to maybe have an arrangement in place with the employer, that the employer is looking at the employee's net tangible assets, and that the employer possibly provides the capital that might be - it is hard, that's the trouble with super, it is such a diverse, non-homogenous industry that it is very trickly.

MR FRENEY: Thank you.

MS GALBRAITH: I would think most of the smaller ones probably are outsourced and maybe it's where they're outsourced to, the administrator is the key. I think most of the ones that still have in-house administration are probably the larger corporates that are funding that kind of arrangement - that's a sweeping generalisation, but as an observation.

MR FRENEY: Thank you.

MR COSGROVE: At the bottom of page 5 you've referred to the equal representation of member representatives and employer representatives on trustee boards are something which we ourselves gave a tick to. I suppose there's still something of a question, which has been raised with us in earlier discussions, of the capacity of some of these people to, if you like, ask the right questions of investment managers or even administrators perhaps. You end up with a statement there that you feel this particular model has proven an effective mechanism. I mean, one can come to that view on the basis that there haven't been many failures of funds with such trustee structures, but is there anything more that you've become aware of in your practical experience that would lead you to the view that this is really a pretty good way to operate a superannuation fund?

MS GALBRAITH: It's probably as much just the corollary that having a professional board - for want of a better expression - is no guarantee of success, looking at some of the recent corporate failures that we've had, and the fact that you can have exactly that scenario. You can have a board running a large commercial organisation and still have not the right questions asked of the right people, internally, externally, where similarly, I guess the other analogy is the jury system where 12 peers and I guess what they both turn on is at the end of the day commonsense that people have. I suppose if one is making the assumption - for want of a better word - that the employer trustees will be more suitably qualified by education training or experience - say, like a group life policy - to ask the right questions of the investment managers and maybe the member representatives won't be. It is still a collective body, the board, and the member reps hopefully will listen and learn.

At the end of the day it still takes a two-thirds majority. If an equal rep board were to fail in asking the right questions of the investment managers then presumably the employer reps have failed as well as the member reps. Short of substituting a truly professional board in its place, people with financial investment backgrounds, having the member representatives represented directly on the board - certainly from the experience with our funds - it's a very valuable safeguard because they do - it is often the member reps who actually ask the questions that need to be asked. They actually sometimes have that wood for the trees perspective, and sometimes not being quite as familiar with it as they should be or sometimes not being frightened to speak up and say, "Look, I don't understand any of this. Can you explain it in quite basic language because I'm only a member rep, not an employer rep," there's an

element of cutting through - the emperor's new clothes sometimes happens in that the investment managers are sometimes put on the spot and actually forced to explain things at a level that if truth be known probably half the employer reps are sighing and they go, "Good, I understand, that's what that meant."

But certainly with our funds it's a very effective mechanism. It really does - it certainly gives the employee member reps much more confidence in the fund to feel that they actually have a voice at the board level as opposed to policy level committee or not at all. Considering all sorts of decisions that are made are death benefit distributions, TPD claims, there's much more justice not only being done but seen to be done. The employee members seem to accept the decisions that are made by subcommittees about things like TPD claims, death benefit distributions much better, feeling that they have their own voice at the board than if they felt it were - I suppose in a corporate fund just the employer or even in an entity fund the employer associations making those kind of decisions, because it's not just investment decisions obviously that are made, it's a whole range of them.

MR COSGROVE: Let's move on a little bit. At the top of the next page you have a statement at the end of the first paragraph that there's room for improvement with respect to the regulator's ability to adequately supervise and impose sanctions. What did you have in mind in terms of that room for improvement, what particular steps? Is it more resources for the regulator?

MS GALBRAITH: Yes, exactly that. The ability to supervise is obviously directly related to resources but I was thinking probably more in terms of the sanctions and I guess that's where my administration law is a bit rusty. I did want to brush up on it and haven't had a chance. I know there was a lot of reaction against strict liability and it may or may not be well placed, but I think there is probably some further scope yet for there to be some kind of middle ground in terms of sanctions because part of what may be perceived to render APRA still relatively toothless, more teeth than the ISC but maybe fewer teeth than maybe ideally should have or less compunction to use them when you still have to go through the hurdles of establishing the onus of proof that they have to have. You actually have to have legal proceedings and have to overcome - establish burdens of proof, means that it's a disincentive. It means that you are not so much all or nothing but it is almost that.

I know APRA is doing the right thing by saying that the approach to take is more conciliatory - not conciliatory but more a matter of working with the trustees to have them identify what their responsibilities are and to meet them rather than being punitive. There probably does still need to be a middle ground of the proverbial slap over the wrist type of things just for trustees to know that APRA means business and to take them seriously, but short of actual launching off into criminal prosecutions. I guess the best and most obvious example of that is the introduction of strict liability for filing returns, APRA returns. It's that kind of thing, that sort of level where it's a relatively straightforward admin task and the strict liability, hopefully the fines probably don't need to be too much financially. I mean, obviously they do need to

more significant if it's a much more significant breach up the scale, the kind that we would launch a criminal prosecution.

But there's a range in between where again justice being seen to be done as well as being done. If APRA could be perceived as being out there just slapping this one over the wrist here or just doing something there, that would certainly help the perception of the industry sort of coming into line. But to counter-balance that, I mean, APRA is fairly well regarded and the vast majority of the industry out there does have regard to their edicts on the legislation and certainly sort of an APRA audit is taken quite seriously, but it would just sort of help to have maybe some more of that middle ground.

MR FRENEY: Perhaps without taking time on that now, if you had any particular instances that you could give us later of where you thought the legislation might impose too much burden of proof on APRA - I relate to what you're saying and I think there is an issue as to whether APRA sort of can be effective enough, quickly enough in the process of investigation and I would be interested if you think there are any particular areas that the law is too demanding in terms of burden of proof on APRA. If you wouldn't mind letting me know.

MS GALBRAITH: Yes.

MR FRENEY: Thank you.

MR COSGROVE: On the next page in the context of our draft report's recommendation on capital adequacy for trusts for approved trustees, you've raised a question as to whether any such requirements would be best written in the legislation or left to the discretion of APRA. It's the second-last paragraph on that page. I wonder if you've given any detailed thought to the limits of such discretion that might be given to the regulator in this area? On the face of it, it seemed to us that if such a proposal were to be implemented it's of fairly fundamental importance requiring trustees to stump up capital which previously they had not been required to do and to put the regulator in a situation of saying, "Well, okay, for this group of trustees we'll let them operate without such a requirement but the rest of you, you'll have to meet it." I'm painting a rather colloquial picture. But have you any clear idea as to when the circumstances in which APRA might be allowed to exercise this discretion in relation to a capital adequacy requirement? I think I realise that you're not all that keen on this particular draft recommendation, but leaving that to one side.

MS GALBRAITH: I guess the preferred model - and I haven't really given it a great deal of thought - would be to do a risk analysis and identify the various factors and parameters that regard should be had to and basically build that into the legislation, maybe as either benchmarks, minimum maximum, or else establish a figure and then just allow - so the default is in the legislation and then allow a particular fund trustee to approach APRA to plead a special case so they can have regard to the circumstances of that particular entity which might lend itself more to

the benchmark type model with a sort of minimum maximum in the range - start with the default and then maybe have it that APRA can reduce it to the minimum but maybe not below.

I mean, the most obvious things to look at are, I suppose, the size of the fund, the assets of members and qualitative measures as to whether they're in-house administration or outsourced, whether there's insurance in place, maybe trading off the level of insurance against the - allowing it to do a mix. The current one is with having their approved guarantee as well as - so some kind of thing like that. But it would be preferable, I think, to have it in the regulations, either stipulated figures or in various - I mean, probably at the end of the day there wouldn't be too many permutations of scenarios or a benchmark range. The default is probably better, even administratively because that's the starting point and then it puts the onus back on the trustee to approach APRA, otherwise APRA would have to be doing it on a case-by-case basis which administratively is tricky.

MR COSGROVE: Would there be any problem there in terms of the sense of uncertainty faced by trustees of funds, not knowing what they had to do until they actually discussed their own circumstances with APRA or is it not much of a worry?

MS GALBRAITH: I suppose I was more concerned probably about transitional issues. I'm not quite sure how imposing something like this onto an industry that's already well established, even allowing a transitional period, how that would go. Yes, I mean, again the legislation would give - if it were legislated it would certainly give some certainty to the trustees out there and that is definitely preferable. I just can't imagine even the numbers that there are - there's sort of a queue lining up at APRA's door to have their own - APRA would have to resort to some kind of, not formula but some kind of methodology anyway that might as well be incorporated in the legislation as applied administratively. I guess it's something that could be reviewed once - if there's a wave of special cases which in themselves start to fall into a particular class and APRA is inclined - disposed towards reducing their requirement and that could obviously feed back into the regulations as feedback loop. But as you say at the end of the day I'm not too keen on it in the first place.

MR FRENEY: Yes. I really was just wondering, Fiona - in your pages 9 through 11 where you discuss the compliance costs concerns about contributor status and payment standards and on page 11 you give some proposed suggestions here - whether you've got any comments about the order of magnitude of compliance costs in JMIF's experience with these contribution and payment complexities of the SIS legislation. It's the costs on the one hand and then to move on, would be what sort of savings might flow from your suggestions.

MS GALBRAITH: It's probably easier to start with the benefits side first and we did supply some information - I have no head for figures in absolute terms so I can't recall them - which made their way into the draft report on the compulsory cashing aspect and that's because they are much more of a discrete sort of project base. So

every six months we do the mass write-out and wait for the responses to come in and take it from there. It's the contribution side that's going to be a little bit more difficult to quantify but I will go back to work and try to do that. The major thing is - it starts right at the beginning, I suppose, in terms of establishing procedures that have to be adhered to in training staff and all those sort of costs that come from that.

On an ongoing basis what the contribution standards mean starting from a purely administrative cost perspective is that there are various work flows that happen when a contribution may arrive, a cheque may arrive in from a member. To put it in that context, most of our money and data comes from employers. So there are contribution returns that come in monthly from employers listing all the employer contributions they're making and also if members are making voluntary or salary sacrifice contributions. So we're geared up towards bulk processing of that. That is starting to come in or has been for some time electronically, but the bulk of it is still on paper because that's what our employers prefer. I suppose it's the usual thing, we've got some large employers and there are large amounts of money and large numbers who will come in electronically because their systems are sophisticated.

But we have a series of small employers - your panel-beaters down the road with 10 employees type that still much prefer to do it on paper. That's how our processes are geared around that. So when you have a member's cheque, for example, materialise and that's just been sent in by a member, we then have to log it onto a work management system and do things like write out to the member, ask them to establish their employment status or - we have their age from their date of birth. There are issues in terms of they get resentful, they think it's intrusive. There's also follow-up and maybe a second follow-up and there's the issue about what happens when we haven't heard back from them. Do we refund it? So it becomes fairly labour intensive, monitoring it as much as doing it. These are ones that don't come in via an employer.

So first of all you're not sure that the occupational test is being met and especially it's somebody - I mean, obviously sometimes it will be somebody who we have received a contribution for within the last year so we can make - and there are a few leaps of faith that happen in this area. You can make the leap of faith if an employer contribution has come in within the last two years that they've been employed within the last two years. But it could well be somebody who has changed industries and is still employed somewhere else but wanting to still contribute to this fund, or it could be someone who actually is unemployed which is when we're not meant to accept the contribution, it's been three or four years since they have last worked for whatever reason.

Of course it gets much more complicated when you start getting into - if they're anywhere near 65 we're starting to ask questions before we even accept the contribution about their employment status, based on their age as well. There is also an exception for people who have permanently ceased due to invalidity but that's

okay because that's ceasing work due to invalidity. Once you've established that, contributions can then be accepted. There's a third one - people who have left the workforce on approved leave for up to seven years for the purposes of raising children. That one also has to be monitored as well in terms of their eligibility to make contributions under that. Of course the one that's added to that now is spouse contributions.

So it's more than just - rather than just simply processing a cheque, it involves, as I said, logging on to a work management system, writing letters, following up, sometimes ultimately refunding, handling queries. I mean, a number of times it results in the member phoning up and querying about why we've asked a question or what the rules are or whatever it might be. So it ends up taking - sometimes for quite a small sum of money - significantly more to process that one little cheque, voluntary contribution from somebody, than an entire contribution return from an employer. I suppose there are two other issues in that; one of which it impedes efficiency because to an extent it precludes the use of things like direct debit. There's an argument out there in industry to the extent to which we can throw the onus back on a member about whether or not they meet the contribution standards but the way the legislation is written, the trustee has to make reasonable efforts to establish that they do. So the onus really ultimately does fall back on the trustee.

So things like direct debit can be effectively precluded if you're taking a more conservative approach to legislation; others in the industry don't. So there are relative efficiencies and inefficiencies, depending on your legislative approach. Then the final phenomenon that happens, I guess, is that those of us who take a slightly more conservative approach and actually apply the legislation will find - and we do have this feedback just anecdotally by members - that we may reject their contribution because they haven't been employed for the last two years or they're 65 and not working 10 hours every week - well, at 70 you can't take voluntary anyway - to find that they've just gone down the road and made a contribution to a competitor fund who are quite willing to accept it. So it's building in distortions into the industry as well depending upon their approach to legislation. Some will, for example, use direct debit and some won't. So it's tricky in that respect. I guess, as I raised in the paper, from a policy perspective, introducing the concept of spouse contributions in the first place has severely weakened if not exactly broken the occupational nexus and is also a bit discriminatory against those who aren't in heterosexual relationships, because it's only heterosexual couples or ones who aren't in relationships at all and then from next year on once we're administering the new family law legislation, we'll also have accounts created for ex-spouses - ex-legal spouses - will have accounts created for them and that's another - it's a bit like a public offer of standard employer sponsored funds right at the beginning.

There are impediments to joining a fund in the first place. You may have an ex-legal spouse who has never been employed but all of a sudden now they actually do have money in a concessionally taxed environment because just by virtue of being an ex-legal spouse of an existing member. So if there's concern about - and I think

most of this is a revenue concern. It's a concern about money being in a concessionally taxed environment, well, now it's spouses and ex-legal spouses without any compunction for there being an occupational nexus. So it has been pretty weakened already. I guess that's the other thing too with the age based - both the contribution standards and the compulsory payment standards are all about not utilising the concessionally taxed environment to an estate plan and having no intention of using, particularly the assets, but even the income of that investment, just having it there and leaving it the children at the end of the day, having it stay there through to 70, 80, 90.

I guess that is a concern in terms of compulsory payment standards do need to kick in at some stage and have them paid out. But the contribution standards, there have been some developments since - these originate back in the Tax Act, things like RBLs and - reasonable benefit limits and the maximum deductible limit, an age based one for employees. I guess there's still a potential loophole, is the member undeducted, contributions which aren't measured. They're not part of the maximum deductible limit for employers because it's not employer contributions, it's member contributions. They're also to form part of the RBL measurement and I guess that may be something that Treasury could look at. If they're really worried about people priming their super that way they could look at maybe having some kind of measure there. But at the end of the day it does seem to be a bit of a sledgehammer to crack a nut mechanism for every one, high flying, high net worth individual who uses super to basically build up accounts for spouses and ex-spouses and children and whatever else.

There's one of those for every 10,000 head of population and meanwhile the rest of us are going through this administrative process to preclude them from doing that. They'll probably do it anyway through some kind of offshore unit trust whatever kind of arrangement they want to come to, other tax effective means at their disposal. But for your average PAYG or even self-employed person, it's not even - I guess it's up to Treasury to determine how much of a loophole it is but there probably could be another measure, as I said, incorporating a concept of undeducted contributions into the RBL measurement process. So look at the end of the day to see whether you consider they have had an excessive amount in there in the concessional environment, rather than worrying about it going in in the first place.

MR FRENEY: I realise it's costly for you to give us information about the costs of complying with the contribution requirements but I think it would be extremely helpful, whatever you are able to give us.

MS GALBRAITH: Certainly. It's not so much costly, I think it may not be that accurate. It's going to be more difficult - it will be an estimate but it will give you an idea at any rate.

MR FRENEY: Thank you.

MR COSGROVE: In this same area you have agreed with our recommendation 5.1, part of which raised an alternative for dealing with these compliance problems by placing responsibility on the member to provide the necessary information, indeed with appropriate penalties for noncompliance. Some other people have suggested to us that that might be a somewhat onerous task for elderly people who may not be very familiar with all of this. But do you have any views on that? Are some of these people getting around with walking-sticks are actually pretty crafty about the SIS Act?

MS GALBRAITH: Yes, this is the age based compulsory payment aspect rather than the contribution one. Yes, I mean, I suppose would prefer the onus to be placed on the members. The legislation would have to change to do that. I guess administratively that's much easier. We find most of them generally do - when we do often speak to them on the phone in this context and they do appreciate what it's about. I can understand the policy perspective that it's a bit onerous on the individual taxpayer but at the end of the day it's a relatively straightforward concept. It's really a function of how many hours you're working. So whilst super is complex that in itself as a factual question isn't too difficult. I guess you wouldn't want the penalties to be - again you're immediately looking - whether you're looking at your high net worth individual who is rorting the system to do estate planning this way or your other 99 pensioners who just got a bit befuddled and forgot to actually tell the super fund. I mean, I certainly would suspect in - - -

MR COSGROVE: Putting aside the estate planning aspect, would you say such contributors aged 65 or over are able to know what they are meant to be doing in terms of providing this information?

MS GALBRAITH: I think the theory is that they would just advise us when they have ceased working sufficient hours and therefore the onus is on them to apply for the benefit which is if you stop working at least part-time, which is 10 hours a week or more, between 65 and 70 then you must claim your benefit, and once you're 70 you actually have to be working 30 hours a week or more. I still would think that's a better model and the solution just might be in administering whether or not somebody has actually breached that. You'd have regard to things like - I think even if someone stopped working sufficient hours, particularly in the first week of July, it would be acceptable to wait until the next statement came out which would probably be a year later as a kind of reminder and we might just need to build it into member statements, "You must advise us if you cease working whatever hours and must claim your benefit," because they probably may cease work.

Having said that, ceasing work is usually a bit of a trigger to think about super. But if it's just fluctuating hours, a 70-year-old might be working 25 hours a week, still working, not really thinking about their super and with 25 hours a week they may forget to get their super, but if their reminder is there in the next annual statement and then they don't claim it within a reasonable period after that then you might want to look to enforce it. So I think so long as it's the enforcement side of it,

and that would be interesting to know how that mechanism would work. I presume it would be APRA unless you made it something that the Tax Office could look at as part of the tax assessment process, I don't know, so long as it was forced with a degree of leniency allowing for the aged and allowing for - it is a long cycle with super. A lot of funds still only send out annual statements, so there isn't that kind of reminder that there is when the bank statement turns up each month or credit cards or other equivalent.

So you would just need to have regard to that. But it probably still is - I mean, it's their stage of knowledge. We can trigger the reminder to them on things like annual statements but as opposed to writing the letters that we currently do. At the end of the day the onus is still on them to come back and say - even now when we write them letters - "Yes, I am working less and I'll apply for an application form," and send it back in. So I don't think it's too onerous.

MR FRENEY: Could I just ask a quick question while John is collecting his thoughts. A point of fact, right at the top of 13 it's talking about protection of lost member accounts and you say it can in fact be protected against investment performance, surely an unintended income. Is it a provision of SIS that leads to this?

MS GALBRAITH: Yes, it is.

MR FRENEY: Is it a provision of SIS that actually mandates that lost member accounts are protected from an investment perspective?

MS GALBRAITH: This is more the outworking of it, the way it works in practice. It's because when protection was first announced it was announced as the small accounts measure. If you look at - I think it was the assistant treasurer's announcement way back in 94, I think it was, it was to protect small accounts and to report lost ones - I mean, a lot of both but some of one or the other. They sort of became confused. By the time the legislation came out we were protecting lost members as well. What it means is, because for most funds - certainly for our funds - the break-even point at any given year is around about 7 or 8 hundred dollars. So in point of fact in a normal year, lost members who happen to be over a thousand - they're the only ones we're concerned about because if they're under a thousand they're protected anyway, they're small members. Lost members, as a practical outworking, while they're theoretically protected, someone who's lost for an entire year, in a year with a normal rate of return if they're over a thousand dollars they will be run through the protection loop in system but they won't actually need any protection because they will be self-sufficient. They will have earned more in interest than they have paid in admin fees.

But this is something I've been arguing about for a while and now the reality has struck, now we have negative returns happening at the moment. This, say, $1100 account in an environment at the moment where the returns are say, for simplicity sake, zero, means in fact they're not earning any interest, they have paid their - in our

fund's case - $52 worth of admin fees for the year's worth of admin. So they are being protected because they're paying $52 worth of admin fees and not receiving any interest just because it happens to be zero.

So you've got your twin members in the account, one of whom has moved and not told us their new address. I'm the other one, who was diligent and did, and then the two of them are sitting there starting at $1100 because the returns are zero. The one who told us the new address pays their $52 worth of fees and the one who forgot to tell us their new address but is probably still having employer contributions made and knows perfectly well where the money is, suddenly is protected - is effectively protected against the investment return. That's how it works out. So I suppose we have issues against that - - -

MR FRENEY: As you say, it's an outworking - - -

MS GALBRAITH: Yes. I suppose it comes back to the philosophy of why lost members need to be protected anyway, because the protection is against small accounts being eroded by fees and charges. If a thousand dollars - I mean, having said that, a thousand dollars - yes. If it's deemed to be the self-sufficient amount, then if you're over a thousand dollars you shouldn't need protection, irrespective of whether your address status is returned mail or not.

Of course, that's compounded by the lost member definition which also, as a second tier, has a proxy for being lost which is - even in the absence of return mail, if we haven't had a contribution in two years we actually have to positively verify their address or they're kind of deemed lost. That has an issue in itself, particularly for - yes, the fact that super is a long-term investment and that with preservation it's mandated that it's there at least until 55. So one would expect that contributions would cease at a particular point in time as somebody changes employment, or maybe is unemployed and failing the occupational nexus.

I can appreciate why there was a need for a proxy, because absence of return mail, it doesn't necessarily mean no news is good news. You will have new residents who will not bother to return mail, so you can't be sure that someone is not there. But it's particularly the two-year time frame for actually having to verify that they're still there - and it's very difficult how you actually go about verifying it, because you write to someone at that address saying, "Please confirm you're at this address," most people think you're mad. "Of course I'm at this address, you just wrote to me here." We did try that the first year and - that was before I was with JMIFA - and had precisely that kind of reaction from members saying, "Why are you wasting my money on postage, writing to me to ask me to verify I'm at an address where you've just written to me?"

So it's an issue - that whole definition thing. We think a longer time frame is more feasible. But it still leaves - that's the definitional issue - there's still the issue about why they're being protected at all. It does mean that in effect they're being

protected against rates of return being cross-subsidised by the diligent one. As I've said before to APRA, you know, there's an incentive to get lost in a period of negative return. So if you think the negative return is coming, get your member statement and send it back to your fund and have a return mail address and receive protection, so capital guaranteed by default.

MR COSGROVE: I'm going to jump ahead to page 21. In the middle of that page you make the quite valid point that, you know, while the legislation should target its basic purposes of prudent management and prudential supervision problems, you consider that to be more in the way of ensuring that the legislation achieves its intended objectives, as opposed to minimising costs. I think that's quite right. Did you have any particular thoughts about that larger issue of ensuring how it achieves its intended objectives? I mean, you go on of course to address some of the more specific simplifications that we had proposed, and I'd like to come to those in a moment, but on this bigger aspect of trying to make sure that the act does achieve its objectives - any ideas?

MS GALBRAITH: Again I think the major issue is probably just having this middle ground of sanctions. I must admit, I'm not as familiar with what APRA has been asking for recently as I should be. I haven't had a change to read it. I know that they feel that they don't necessarily have the powers that they should have.

MR COSGROVE: I see.

MS GALBRAITH: That's really the issue I guess that this is turning on. I'm not sure the extent to which it is an issue of lack of statutory based powers or whether it's actually more one of other resources or administrative function. I suppose I'm asking the question more than giving the answer.

MR COSGROVE: Yes, that's okay.

MS GALBRAITH: I guess that's what needs to be have regard to. I think it may even end up increasing costs slightly but at the end of the day, if it's meant to be a piece of legislation ensuring prudential management and supervision of the system - and that's really what it should be - that's what it should be trying to do. It's obviously very much so - the stitch in time saves nine syndrome. It's better that everybody maybe pays slightly more to have it supervised than to have the consequential flows from a failure.

So I guess from memory and from my knowledge of this is that there are some fairly - I would have thought some fairly wide-ranging powers in there that they actually have of investigation. I guess whether it's - as a practical outworking - whether collaborating with ASIC more on investigations or whether there are economies of scale that can be achieved from a regulatory perspective of utilising the powers that each of them have under their respective legislation but combining forces for intelligence and supervision and monitoring and investigation if required,

might be one way of achieving it, which is probably not - doesn't require legislative change, more of an administrative one. I think, as I said, some more just the slap over the wrist non-criminal sanctions may help just some trustees sit up and take notice that need to, that need to take it a bit more seriously.

MR COSGROVE: Of course the act, as you've pointed out to us earlier, is very complex and in some areas quite prescriptive. Are there ways in which its underlying objectives might be met adequately but without such detail and prescriptiveness? I think we've looked at one or two parts of the act which seem to have a pretty simple purpose behind them, like in requiring trustees to be cognisant of the tax file numbers of their fund members. Yet that particular part might extend to - I don't know precisely but, you know, maybe 30 or 40 pages. It seems an inordinate amount of text to have to be complied with, in order to meet a pretty simple objective. You may not now be quite sufficiently au fait with all of these parts to be able to tell us where there might be scope to bring about, you know, somewhat greater simplification than our draft report proposals actually involve. Have you got any thoughts on that type of matter?

MS GALBRAITH: I have to confess now to being a little bit of a prescription junkie, which I actually think that prescription within reason, so long as it's well targeted and sufficiently flexible up-front, actually reduces compliance costs because there's less - it's the grey area that leads to the debates internally, externally, back with the regulator. Having said that, there's certainly - I don't think it's so much prescriptiveness per se in the SIS legislation but there are certainly significant parts of it that are not well drafted and I think that's probably a related but separate issue. I think you can be prescriptive but if it's well drafted it - well, two things: if it's well targeted, which means that they're very clear about both the policy objectives but also the reality that it's going to be applied to, because it's the application that's always the killer.

So if there's consultation done prior to drafting to establish how it's going to be applied, particularly to different kinds of funds, and they're very clear about the focus of what outcome objective it's trying to achieve, then if it's well drafted prescription as per se is not an issue. But you're right and some of the TFN stuff is a perfect example of - the prescriptiveness in a written form is not too bad. It's a little repetitive and a little long and there are issues there, but at least you know what you have to put in writing. But for example, assuming that someone is going to say that same script down the phone to someone quoting TFN is unrealistic, to say the least.

What members need to know, in a nutshell, about TFNs is that it's not mandatory to quote them and that the consequences that flow if you don't - the major one being the tax ones which you can usually recoup in the tax assessment process. So to have a script as long as it is that's supposed to be quoted down the phone is unrealistic and similarly the written script is just too long probably. We do use it but it means our "TFN pages" are usually freestanding pages that go in with a corresponding letter because it's easier to do that than try incorporate the text into

another document.

So I guess that adds to inefficiencies in terms of both collating documents and extra bits of paper floating around that may not otherwise be required. That I think is more a reflection of lack of consultation and lack of appreciation of the realities. There may be too much regard to principle and a little bit - not sufficient for the practical realities and also not particularly inspired drafting. Certainly the parts of this that cause the problems are the ones that aren't well drafted, and the protection area is an example. We're actually trying to meet with APRA this week on two issues in relation to that investment period part of it which of course we're currently in - issues of interpretation, issues of application. There's one outworking outcome which we're sure wasn't intended but if you read the legislation literally it's the way it works out and it's another anomalous result between lost members and small members because of the way it was drafted. I think that's the problem.

Prescriptiveness in itself can actually in some cases be easier if it's clearer because it's then already clear about what is required. It's hard, it varies in circumstances. I know there are vast parts of SIS that I haven't looked at since it was first drafted and there was uplift, for example, huge uplift from the then Corporations Law about insider trading and some of the public offer stuff - the few differences there are of public offer, the cooling-off period on joining and whatever else - that no thought was given to the fact that it was being applied in a superannuation scenario. So some of the language is foreign and certainly the current - now current - family law regulations that have just been gazetted introduce a whole other language which makes it as difficult as anything else to interpret because they have come from a family law perspective, not a super perspective.

It's issues like that - I mean, the attorney-general again is to be commended to actually getting this legislation done and through but it is going to be a nightmare to administer. I have difficulties reading it still because it is so foreign and actually that is probably even a better example of over-prescription. It's outside your charter. Well, no, to the extent that one lot of it actually amends the SIS regulations that's back in under your terms of reference but there is a tendency from time to time to go a bit too mandatory. The TFNs was another one in terms of - all the industry wanted was to be able to collect TFNs up-front. I mean, that's more from a policy rather than a drafting perspective. We were previously only able to collect them on payment of benefits.

We wanted to collect them up-front and all of a sudden it became mandatory that we try and collect them within 28 days of joining and it became mandatory the employers gave it within - if the next contribution to return within seven days of the employee joining them they didn't have to but two-tier things, formulas for everything. That side of it, that kind of prescription is undesirable, both from a policy level and from a, "Oh, my goodness it's been eight days technically we've breached," and it really doesn't matter. It's the same sort of thing with some of the family law stuff. There is a tendency to be a bit heavy-handed and start - I think

some of it, they were trying to make life easier for the trustees but it's actually made it more difficult.

So they were stipulating, for example, time periods. The trustees could only accept instructions from members about splitting benefits within 28 days. So they don't appreciate it if someone turns up on day 29, having to actually talk to them, why they've missed the boat. It's actually more difficult than having no time period. In the end one of the things they recommended and they've changed it is basically 28 days or such longer period as the trustee allows. Now, our trustees will allow members to come up at any time. They might have divorced three years ago or whatever. They can come and split the benefit now, fine. It's stuff like that, when it's prescriptive at that level, that degree of prescription is - I suppose I was thinking of that as a different kind of prescriptiveness when it's just dot the i's and cross the t's.

Particularly I think I was thinking more disclosure, and prescribed disclosure in some ways is actually easier and leads to more homogeneity and comparability within the industry and that means marketing people can't actually take concepts and manipulate them into being misleading. So from a disclosure perspective, prescriptiveness certainly helps.

MR FRENEY: I seem to keep asking Fiona for more stuff but would it be useful to have a list of topics where, while we might think the objectives of the legislation are fine - we understand what the objectives are - but the actual terms of the legislation don't fulfil the objectives very well. What we're looking into is to see if we can get more effective legislation in terms of the content of the legislation and the wording of the legislation achieving its objectives. So I've made a note of the tax file numbers and family law, but if there are other things that come to you in the wee small hours of the morning it might be useful for us to have a list.

MS GALBRAITH: I can certainly - yes, I'll give that some thought. I mean, there are entire sections of SIS that I have nothing to do with.

MR FRENEY: Just whatever you can.

MS GALBRAITH: Yes, some of the insolvency stuff and whatever else, yes.

MR FRENEY: Thank you.

MR COSGROVE: Then under option 7.1 at the bottom of page 21, Fiona, you've listed in response to our request what you see as the most beneficial recommendations to be given priority. Should we regard that list as being ranked in order of importance or is it random from that point of view?

MS GALBRAITH: Actually it was intended to be ranked in order of importance and I was going to stipulate that but haven't now I've read it. Now I look at it I'm

changing my mind anyway. The lost member and member benefit protection provision, certainly from our funds, would actually probably rank above - I'd be tempted to move that up to one and shuffle everything back down the list. But they're all significant. At the end of the day it's a bit arbitrary, a concept of - I think the list was slightly longer and I pulled out the major four that have more significant impact, I guess.

MR COSGROVE: Okay. You get into some interesting discussion on the next page about the second option relating to the licensing proposal. You've drawn an analogy with various aspects of road rules and licensing of drivers. You're right to say that once you have a licence until you reach apparently 80, you just keep driving whatever your performance is. But in the superannuation industry at present we have a situation where at age 17 or 18 to draw that parallel you don't even need a licence, unless you're an approved trustee. You've got to pass the disqualified persons test but otherwise you're pretty much up and running as a super fund trustee. I guess it was from that perspective that we formulated this idea of requiring somewhat stronger qualifications or what have you to be shown to the regulator before we would be allowed out in the paddock to manage superannuation funds. Do you still feel though that we've somehow exaggerated the nature of the potential problem here?

MS GALBRAITH: I guess it does hark back to the earlier conversation about equal representation and things like that. I certainly feel there's a place for licensing when it comes to individuals and certainly professions, for example, the self-regulated professions like medicine, law and accounting. Licensing an individual and revoking an individual's licence to act in an area that requires professional qualifications certainly makes a lot of sense. I guess it's just more the issue of licensing a corporate entity where the decision-making process is not that straightforward, it's a lot more complex. I suppose, first of all, I think it's a barrier to entry to people who might otherwise be perfectly competent and experienced in what they're doing. I mean, the trustees in particular, it is analogous to trustees generally who have never owned a trust or been required to have any kind of professional qualification or experience.

They are not only entitled to but are expected to rely on professionals. They're meant to be there as the kind of guiding hand of again commonsense, objectivity, that kind of thing, and rely on professionals. They're not meant to know the nature of derivative synthetic products. They're meant to be asking the investment manager some sensible questions about it. I just have a feeling that with corporations there's potential for all sorts of things, apart from things like the key directors and officers of boards and decision-makers turning over - licensed one day, half the people can leave the next. There's also the potential to use - for want of a better expression - figurehead people. You can always trot somebody in who has qualifications or experience or training who may never be used as part of the decision-making process, who may be for whatever reason structurally or maybe overridden by others on the board who don't have that kind of experience.

So to me it's a less useful concept, I suspect, and particularly there was talk about - yes, if a licensed entity wants certain, specific conditions satisfied by the trustee - I just think by the time you're balancing the competing interest of not having too high a barrier to entry, not having impediments, so there's a sense where the standards keep coming down and down to at the end of the day once you have one person with an economics degree or one person with a - I mean, there might even be enough incoming people who are professional, qualified people who could almost float around and be nominally on the board, on half a dozen boards of half a dozen corporate trustees, because they bring the paper qualifications with them and that's enough to get the licence.

But they may not attend board meetings. They may not have an input or a say. Meanwhile it could be run by the people who would not otherwise have met the conditions that entitle that entity to have a licence and it's that perspective I suppose that worries me, that licensing is sometimes seen to be more of a safeguard than it possibly can be, given the dynamics of boards and management decisions and how they are taken, and the processes that are gone through and the amount of consultation or non-width of board. It's just there's potential for a licence entity to not really be, at the end of the day, involving the individuals with the training and experience in the decision-making process, in which case I'm not sure how much it helps to know that they're there on a piece of paper but not necessarily involved.

MR COSGROVE: I think we had in mind obviously that this seems to be the only part of the financial services sector where, you know, some sort of licensing to run a business is not required, leaving the approved trustee component to one side. There is a problem, as you mentioned, with individuals coming and going and that may be a reason why you could think about licensing them. But at the same time it might be a more significant problem if a financial entity, in this case a superannuation fund, was to fail as an entity. I mean, Mr X somehow or other fails to meet his responsibilities in terms of a licence then, you know, he's in trouble, at least for a while. But if the entity of which he had been a trustee fails to meet its obligations under the act - and that seems to be a larger issue because more people, potentially at least, are affected and the fund itself might well go into demise.

So they were some of the considerations I think we had in mind in advancing this proposal. It didn't seem to us either that the requirements were terribly onerous. We've discussed already, and I don't want to go back over that ground, the operating capital element. The other conditions of a licence would essentially be only that the trustees show that they've got some capacity to manage the fund and that, you know, they've got some sort of investment strategy that APRA is content with: they use an independent auditor and disputes resolution schemes and so on. So I guess there's still a question in my mind at least as to whether this is something that's unwarranted really.

MS GALBRAITH: I guess I feel that if the conditions aren't too onerous then

they're almost not worth having in terms of - and yet I wouldn't advocate onerous conditions. I think that would be far too high a barrier to entry. I also don't want to be flippant, but an example to raise is HIH which as an insurance company, in theory, was definitely licensed and the parent organisation, and in theory was much more closely prudentially supervised as a life company and has far-reaching ramifications in the same way that a super fund failure potentially would have. Yet it still managed to fail despite being licensed in, one would presume, a more rigorous regime than the super one could possibly be.

I suppose that's the analogy I drew with - I must admit, this is 2 o'clock in the morning. The analogy I drew with driving licences is that while obviously there is a threshold that you must overcome to actually be licensed, the key from that point on is making sure that the road rules are right and introducing various things, and it sounds heavy-handed but it is detection and enforcement that is the key to the whole thing. You could have people who have paper qualifications or even the MBA or some experience behind them, but at the end of the day my perspective of the key to prudential regulation is having a framework of rules and regulations that work, that have defined policy objectives and are able to be applied and clearly meet those objectives, and then basically, for want of a better word, auditing and reviewing against those standards and that means utilising the auditing bodies and the actuaries, the professionals, as much as the regulator itself doing its own, and whistle blowing and member complaints, all sorts of sources of information and intelligence and basically, at the end of the day, being resourced.

I think the resourcing that's spent on the licensing process, from my perspective, would be better spent in the investigation and enforcement process, maybe having the kind of analysis that might go into looking at whether or not particular entities, the current composition of directors and officers, are sufficient to be licensed could be spent maybe in doing risk assessments based on looking at designing, for example, APRA returns that disclose more information that could be fed into a risk analysis program, approaching that side of it in a better way, because I just feel that that's the key to it.

MR COSGROVE: I think we'd agree with you on all of that. The fundamental question that we're still trying to grapple with is an entry standard issue. I mean, once somebody has been established as a trustee of a superannuation fund they should certainly adhere to the legislator requirements and, you know, the regulator should enforce those requirements. But it would seem to us, in our draft report, that there was still something to be said for trying to make those tasks easier ie not to put the regulator, and indeed more importantly fund members themselves, in a situation of potential risk of diminution of their financial benefits as a result of somebody having got in and, at least for a period of time, under pretty minimal entry requirement having the capacity to do some damage. That's, I guess, where we're trying to focus the spotlight really. Are the entry standards adequate?

MS GALBRAITH: I guess one thing I would advocate might be like a reverse

engineering process, where it might be interesting to go back and look at the few failures there have been to date, look at the parties involved and see whether they would have been granted a licence in the first place, and I suspect most of them would have been. There have often been accountants and others involved and I just think that if you looked at them on paper, the people where these failures happened, I'm speculating that they probably, in most cases, would have been granted a licence. So the only alternative then, as I said, is to raise the barrier so high that - and it's almost like the gap between theory and practice as well.

Virtually anybody can - you know, it's talking the talk and walking the walk. Virtually anybody can trot out somebody who has a degree from, say, 10 years ago that they've never used or can pay lip service and might have an understanding as to knowing what needs to be done, but just may not have the capabilities of putting it into practice, and unfortunately that's only tested in the field when they're actually trying to run the particular fund and they're dropping the ball here or there are various issues there, and that unfortunately is detected at the post-licence stage, at the actual operational stage. I mean, I don't know. It would be an interesting exercise for APRA to do, to go back and have a look and see whether they would have given these people licences and I suspect they probably would have done.

MR FRENEY: I perhaps make the observation, if you want to react, that coming back to the analogy of professionals of tradespeople or other financial service providers, I think the objective of having a licence is to see that they have the capacity and the capability of doing what they undertake to do and, yes, then you get into the regime of regulating and supervising and that they have to maintain their standards and their capacity and their capability through time. Some of them don't, so either they fall by the wayside or they need to be dealt with. But I think what we were getting towards, isn't it better to have a system that has some requirements about capacity and capability to do the job initially and in an ongoing sense than a system that basically doesn't have that?

There is a requirement for people to meet the law and the SIS Act sets out all of the obligations on people. But it doesn't require anything with respect to their capacity or capability to do it, so that to come back to your initial analogy about professionals or tradespeople or whatever, I personally feel more comfortable with a system where those people initially have some kind of system that sees whether they have a capacity and a capability to do what they undertake to do, than not to have a system that requires that.

MS GALBRAITH: Yes, I suppose the only difference with individuals is that it makes sense that they're assessed - especially through some kind of accredited body - that they receive their degree, do their post-degree things that they require before they're let loose as individuals. I guess I just still feel that corporations - it's hard to assess the capacity of a corporation, because a corporation at the end of the day is its individuals.

MR FRENEY: No, but it has responsibilities as an incorporated entity to do certain things, by virtue of its articles of association and memorandum and all that. So as for licensing individuals, it likewise seems to me that if it's a corporate entity they should demonstrate some capacity of being able to do what it purports to do.

MS GALBRAITH: Yes, I suppose I'm just concerned that there is scope to demonstrate a capacity that then is not realised because of the - - -

MR FRENEY: That might be a failing of the licence system itself. It might be to say that the entry requirements are not high enough or they can't subsequently be supervised or adhered to well enough.

MS GALBRAITH: I suppose that's what worries me; is that once you have a licensing regime introduced - and I guess that's why I drew the analogy that I did - there's the temptation to then attribute a failure to the failure of the licence assessor, not to a failure of ongoing supervision or enforcement. As I said, I think there have been accountants involved in a number of these sort of smaller failures. I guess that is my concern; that there's undue emphasis placed on it and resources diverted to it and that the barriers are raised and yet, as I said, we still have an HIH where the insurance company licensing was - I would hope - at a higher standard than at least it proposed initially for super funds, and it happened and it's an unfortunate reality of life. So I don't know, I just think that there's kind of false comfort drawn by a licensing regime that - - -

MR FRENEY: Yes, licensing won't prevent failure, sure.

MS GALBRAITH: No.

MR FRENEY: But the issue is, is it warranted in terms of setting generally sufficiently high standards to give a greater prudential protection than without it.

MS GALBRAITH: Yes, and maybe in a more immature market too there might have been more place for it. I guess the feeling now is that the market is a more mature market and therefore there isn't quite the same degree of attraction of ready money to new players out there on - I mean, they will always be out there if you can perceive a niche and think that they can make a particular market. But this is a more mature market now - I don't know.

MR FRENEY: Thank you very much.

MR COSGROVE: I need to move along because we're a little behind time, I'm afraid. On page 25, where you are addressing the duplication of compliance in respect of life insurance companies and the SIS Act, you have some reservations about that, based apparently on the view that there might be a lesser standard applied under the life companies' operating requirements as compared with those in the SIS Act itself. But do you really think they are lesser?

I don't know whether you're very familiar with the Life Insurance Act but it seemed to us that they were probably on the whole rather tougher requirements that a life company - certainly it has to have quite substantial capital backing in order to obtain its licence. It was on that ground in part that we were effectively suggesting that there might be scope here for removal of some unnecessary duplicated compliance. Do you have anything further to say on that?

MS GALBRAITH: I guess my major reservations are in the nature of the relationship between the superannuant and the entity that they're dealing with. While things like the existence of the statutory fund deals with one aspect, like keeping trust moneys separate, and deals with some of the - as you say, in the capital adequacy aspects of it. There are a number of other trust duties and obligations that exist on trustees that govern the nature of the relationship they have with that person and the way in which they make decisions about the super fund that would be absent in the absence of a trustee structure. I mean, the most obvious one is to act in the best interests of members and not to be subject to direction, to be unfettered in the exercise of discretion. That can range through all sorts of decisions that are made in relation to the superannuation fund, not just - if it were to go on a contractual basis, not just the terms and conditions of the contract that's entered into.

The example was life officers in the past, with their punitive early termination penalties and things like that, but also all sorts of aspects about quantitative and qualitative about the investment aspect of things, the nature of any like insurance that might be in place, even making decisions like death benefits and TPD. There's so much more potential for qualitative interest without the trustee structure interposed, apart from the fact that there are obligations owned to shareholders and other stakeholders, particularly with things like life companies, that they are providing the investment management service as well, and providing the group life insurance there. It's a conflict of interest minefield in there and the trust law - it still exists today. I guess those of us who have descended from the English common law origins - it's a bit like equal rep. It's something that's often remarked on by civil law countries; that the benefit that we have by having trust law and equity and the flexibility and the strength of it I guess.

MR COSGROVE: Okay, I see where your argument lies. The next area that I was interested in is the Superannuation Complaints Tribunal area. Here again I guess we're talking about, if you like, fundamental principles perhaps. But you say on page 28, in the middle of the page there:

> Given that superannuation constitutes a unique form of investment in that contributions are mandated by the SCG legislation, a statutorily independent body is warranted.

Well, I can see the argument there, but there are other mandatory forms of expenditure that people must incur that are not subject to a statutory independent

body in terms of complaints in respect of that. I think in third party motor vehicle insurance, for example, you must have it. But I imagine if you've got a complaint you go to an industry established body, rather than a parliamentary established one. So is that uniqueness so unique that it requires the statutory body, do you think?

MS GALBRAITH: I suppose third party motor insurance is mandatory. I guess owning a car isn't necessarily mandatory but I guess that makes it effectively practically mandatory because most people do own a car.

MR COSGROVE: Yes.

MS GALBRAITH: So I take your point that - - -

MR COSGROVE: But it's a shade of difference.

MS GALBRAITH: It is only a shade, you're quite right. I guess that this is quite significant because it really has been accepted now by the courts and generally by policy-makers that superannuation is by way of deferred salary and wages earned by members and that the government is basically compelling them to forsake what could be income and could make a difference for people on the margins - to their day-to-day living now, that impedes their ability to pay the mortgage or whatever it might be - and that the government has come in and mandated that it's going to be 9 per cent next year actually is diverted into a super fund. That's two of the three planks of their retirement income policy. The government is actually doing it as a measure now, to save on - because of the decreasing age dependency ratio - to save on the age pension down the track.

When you have nearly 10 per cent of your - and in some members' cases obviously it is more, through fund design or employment arrangements. When you have 10 per cent of your current salary and wage diverted into a mandatory system I think that again it's a - I think it's the third time I've used the cliche - justice not only being done but being seen to be done. I think for members, employees out there - or the public at large - to have faith and confidence in their superannuation system I think is certainly influenced by the existence of the SCT as an independent statutory body. The fact that we say that in our literature, it's part of disclosing about the existence of the SCT, is saying that. I think a lot of people draw comfort by that fact. There will be perception, if not a reality, that industry based bodies are a creature of the industry and they will be serving the interests of the industry and not of the superannuants.

MR COSGROVE: Yes, but those which have been approved by ASIC must satisfy a quite extensive range of requirements, including independence so that there seems to be some possible implication in this discussion, in this debate, that those ASIC approved dispute resolution schemes are somehow inadequate to dispense independent and well-reached decisions on complaints in relation to superannuation. Do you think that's really the situation, that they are in some fundamental sense

inadequate to deal with this issue?

MS GALBRAITH: I think it's really a twofold thing. It's not so much the reality, it's more the perception, and at the end of the day public confidence in super perception is a significant factor. I think the other issue too also is there's a suggestion in the paper that by allowing ASIC-approved industry based bodies, that that will allow a number of them to be created and to basically compete and I guess - I'm not sure that - I suppose my initial perspective is that there's some benefit to be gained by a centralised body that not only learns from its own experience, from the number of cases in front of it, but also even more importantly, be it reality or perception, consistency.

I would hate to see an outcome where there was arbitrage by different industry based bodies. Either there's going to be one in which case it's substituting one for the existing SCT anyway. If the theory is there may be two or more, to make them competitive and thereby efficient and effective, I'm not sure - I just wouldn't have thought that dispute resolution was a matter of - competitiveness and efficiency were not really a major concern and I think it would almost be inevitable before there was at least again a perception if not a reality that if you have a particular kind of complaint against a particular kind of body you're better off - and I know that the trustees would select but one is for example more in favour of trustees than the other. That was obviously the analysis that was done by the SCT when it first came out. Still the first thing that's done is to look at how many go in favour of the trustee and how many go against. If you have more than one body then you'll have the trustee selecting them on sometimes spurious grounds. So I don't know.

MR COSGROVE: Just quickly on a couple of other points in this area, you've mentioned on page 31 that these types of other bodies that are in this area at the moment wouldn't be well-suited to superannuation because of the significantly larger number of superannuation funds involved as compared with the other industries which the bodies are covering but might you not think that it's the type of complaint as distinct from the number of funds that matters and there does seem to be some similarity at least between the types of complaints dealt with for example by FICS and the type of complaints dealt with by the SCT and many of them relate to permanent disability disputes or death benefits for example. I'm not sure which is the more important criterion but I was inclined to think that if you're comparing the SCT's work with that of an industry-operated scheme then there's a fair bit of similarity I think in terms of the type of complaint.

MS GALBRAITH: I guess there is, yes. I suppose it's just that there is often another overlay with super, the variety of benefit designs out there - the different fund-governing rules and the SCT I suppose has built up a body of expertise in dealing with the variety that there is out there and admittedly I guess that would come over time with an industry based body as well but it is - as a matter of fact in the short term it might actually be almost not so much a backward step but it would almost be - they would have to almost unlearn some of the things, some of the

preconceptions or conceptions they have for the non-super industry and then learn how super is not only different, I mean there are some things that are super-specific, but also just so varied and that is part of the issue.

MR COSGROVE: My final question, and I'll let Roger see if he has some others, concerns a statement at the bottom of page 32, Fiona, where you say in this very context of selection of a complaints scheme by the trustee that:

> Allowing agencies to compete for business could produce outcomes which were less favourable to members of the superannuation funds with the trustee itself in the driving seat.

You've earlier espoused, as we have, the value of the equal representation nature of many trust boards so wouldn't in that situation the employee members be able to exert their influence if they felt that the trustee was doing something which was against the interests of fund members?

MS GALBRAITH: As with the employer reps?

MR COSGROVE: Yes.

MS GALBRAITH: I guess so. I suppose it's just a feeling that at the point where a trustee decision is being scrutinised there probably is a tendency then towards being collective and that's even a tendency that happens on boards even now. It's partly encouraged by the two-thirds majority rule but it's also - not all boards divide evenly along employer member rep lines at the best times anyway but I suspect that once it comes to their decisions being scrutinised it will be not so much united against the common foe but it will be much more of a collective decision. They as a whole will choose - they will select the dispute resolution mechanism that they feel I guess at the end of the day will uphold more of their decisions than not because obviously they've believed in the decisions in the first place.

That's the basis on which they made them and they don't want to have them overturned for a whole variety of again, perception reasons. They don't want their members seeing decisions overturned and they also don't want the expenses associated with that, depending on the nature of the decision. Sometimes some consequences flow. So their guiding force is going to be to choose the one that's believed to be the one that is more likely to uphold their decisions. I'm speculating. That's one time when the division may actually dispute.

MR COSGROVE: Thanks very much, Fiona.

MS GALBRAITH: You're welcome.

MR COSGROVE: That's been a very useful discussion. There may be some additional matters that we might, with your indulgence, deal with separately in the

next week or so but we'll try not to trouble you a great deal more. You've already put in a mighty effort on this inquiry. Thank you very much.

MS GALBRAITH: Thank you.

MR COSGROVE: I apologise for slipping behind time. Our next participant is Maurice Blackburn Cashman. For the purposes of our transcript would you please identify yourself and the capacity in which you're appearing today?

MR BERRILL: My name is John Berrill, I'm a partner at Maurice Blackburn Cashman solicitors.

MR COSGROVE: Thank you, and thank you for the submission that you've provided to us. Would you like to make any remarks about it.

MR BERRILL: Chairman, I'm only addressing one of the issues raised in the draft paper and that's the Resolution of Complaints Act proposal.

MR COSGROVE: Yes, I understand.

MR BERRILL: Just by way of introduction, it's my view that the major problem here in identifying whether the appropriate structure for the SCT is a statutory scheme or an industry based scheme - non-statutory industry based scheme - involves a bit of a look at what ADRs - alternative dispute resolution schemes - are designed to achieve and the role of superannuation, because the key point in the draft report is, well, what makes superannuation so special that it should get statutory treatment, if you like, as opposed to industry schemes and dealing with other financial services products.

In my view it actually comes back down to the powers of the court of review of decisions in that superannuation is unique in that sense in that the courts have over the centuries set the bar much higher for review of decisions of superannuation trustees than they have for other - for insurance companies, for instance, for banks, for any financial services provider, financial planners et cetera. So because of that, any final dispute resolution mechanism has to be of the nature that it gives consumers faith and a proper dispute resolution mechanism. The place of ADRs in the dispute resolution landscape in Australia has developed over the last 10 years really. I mean, they have popped up everywhere in financial services. It's in general insurance to the ISC, financial planning, life insurance, managed investments through FICS. They have all amalgamated now - banking ombudsman, telecommunications industry ombudsman. There's a whole raft of them out there.

Their role is that they sit below the courts. As the name suggests they're an alternative to the courts and they're designed to be quicker, cheaper, more user-friendly, more informal and more flexible than the courts. They're not designed to be second-best as such but designed to offer people access to justice to have disputes resolved in a more user-friendly, less adversarial forum. They're more inquisitorial than adversarial which is what the courts are. The courts are by nature more inflexible, more adversarial. They have got rules of evidence developed over centuries and it's a bit of straitjacket in which they operate. So ADRs are designed to break that down, if you like. The other main problem with courts is that they're so

expensive and therefore it denies a lot of people access to them.

The way ADRs operate as a general rule is that they don't have court hearings, they don't have formal hearings, everything is done on the papers. They have a sort of an involvement process where most of them have case managers who assist people to flesh out the issues involved in the case and try and resolve matters, although the resolution rate is not that flash, and that's across all ADRs. If they can't be resolved then it goes to a panel of people, an independent panel, who then makes decisions on complaints. This is one of the key points: the decisions are binding on the member company but they're not binding on the consumer. So the consumer has the alternative of then saying, "I'm not happy with that and I'm going to take my case top court."

The reality is that most people either don't have the resources to take their cases to court or they're happy that they have had their dispute properly aired and they're happy enough with the outcome. They might not be happy with the ultimate outcome but they're happy enough not to take it to the next step which is to court where you've got all these formal rules et cetera and you've got the adverse costs potential in claims et cetera. But a key element of them is that you do have this alternative of taking your case to court. A court has full powers of review of decisions of life insurance companies on a death benefit claim against financial planners who have given poor advice against stockbrokers for misplacing investments et cetera.

But this is where the key difference is with superannuation, that if you're unhappy with a decision of the SCT or an ADR scheme, the courts don't have full powers of review - not the decision of the ADR scheme, but don't have full powers of review of the decision of the trustee. Their powers are limited. The court's powers of review are that unless there's a finding that there's been an exercise of bad faith, improper purpose, not a real and genuine consideration of the matter raised or if they give reasons - and many do not - the adequacy of those reasons, or following a decision of the Victorian Court of Appeal last year, if no reasonable trustee would have made or could have made the decision that was made, it's only in those circumstances that a civil court will overturn or send back to the trustee for reconsideration a decision.

That contrasts with the Superannuation Complaints Tribunal which has got more broader powers of review in that the threshold is if the decision is unfair or unreasonable then they can overturn the decision. That's a similar power that industry ADR schemes have got. But, as I say, unlike other financial services products where if you take your case to court, if the court thinks the decision is wrong they can overturn the decision, in superannuation the court can't do that. The bar is set a lot higher and the reality is because you don't have the full power of review or to take your case to the ultimate arbiter I think it elevates the importance of the role of the ADR scheme in superannuation to being something like replacing the role that the court fulfils in other financial services products.

MR FRENEY: Can I ask a question? Do you mind if I interrupt?

MR BERRILL: Yes, go for it.

MR FRENEY: Why is the court's powers with respect to superannuation limited like this? Is it a making of the courts themselves, that it's a standard or a practice that they themselves have got into or is it something that is set by a higher authority? I'm not a lawyer, so I don't know whether it's the constitution or not, but is there some legal impediment to the courts considering superannuation?

MR BERRILL: It arises from medieval England times. If you watch that series that's just started on SBS about the history of Britain it will probably cover a bit of that sort of stuff in it. It arose out of treatment of court reviews of charitable trusts from medieval England. What has developed is that the courts are reluctant to interfere in the discretions of trustees in charitable trustees.

MR COSGROVE: On the basis that the trustee is meant to be looking after the interests of - - -

MR BERRILL: Designed to look after the interests. Also in most cases they were volunteers and therefore you don't want to put them off by scrutinising them and whacking them over the ears when they get the decision wrong. So over the centuries the courts have developed, the common law has developed so that the courts have only in limited circumstances reviewed decisions of trustees. The argument that has been run - and I think it's a compelling one - is that it's not a proper fit in a compulsory employment based superannuation and it's really about time someone grabbed the bull by the horns in the civil courts and overturned this anachronistic treatment of superannuation funds.

But in one sense what the Resolution of Complaints Act did was that it overcame the problem in a lot of ways by setting up this statutory body that had the powers of review, on the basis that a decision was unfair or unreasonable. So, as I say, that's in contrast to the civil courts, of an appeal or a complaint against the decision of a financial planner.

MR COSGROVE: But not in contrast to what an industry operated scheme could do.

MR BERRILL: Yes, the industry operated scheme has the same powers as the SCT. But, as I say, the whole philosophy behind ADRs is that they sit below the level of the courts to provide this alternative, not second best but sort of second tier level of dispute resolution with the ultimate sanction being that consumers know that they can take their case to court and have it dealt with in this sort of formal setting where there's, in most cases, no query about independence, no query about influence, no query about the relationship between the various parties involved and in particular

industry's relationship to the scheme, no query about influence, interference, that sort of stuff.

So I think superannuation does sit in a unique position in that sense and that therefore the role of the SCT is, if you like, the de facto role that the court should be able to fulfil but can't because of the constrictions of these feudal underpinnings. So I think the SCT works very well and it's, if you like, the best of both worlds because it is this more user-friendly inquisitorial system and I don't know what the commission's experience of courts is, but a lot of cases tend to be drawn out. The interlocutory proceedings and the procedural rules are very complex, they're costly, and depending on how the parties deal with them, it can take a long time and it becomes a very expensive exercise and it's an adversarial atmosphere and when you run your case in court a lot of consumers have a lot of difficulty doing that because of the very nature of the court system and they're turned off when people like me suggest to them, "Well, if you're not happy with this decision you can take your case to court," and they go, "Oh, no, I don't want to do that."

So the SCT provides a realistic option, in the same way ADRs do, but the difference is, with ADRs if you're not happy you can take your case to court. With the SCT you can, but they've got much more limited powers of review. So it does sit in a unique position. There are a couple of other points on that, that I think are relevant and the other I think is the size of the SCT and the number of members it has, or not members but superannuation funds that are answerable to it, as opposed to industry schemes where they've got a fairly small, discrete membership. The IEC for instance, the general insurance complaints scheme, has about 100 members. The Financial Industry Complaints Service used to have about 130-odd members I think.

It has actually gone through the roof now because they've amalgamated with the Financial Planners Scheme and they've brought in the stockbroking disputes and they've now got about 1500 members. So that has now become a much larger scheme and how effective that will be, will be - well, it's a bit of a wait and see situation at the moment. The SCT covers a much larger - because of the advent of occupational superannuation in the late 80s and compulsory superannuation from 92. The number of schemes out there, there are a huge number and a much larger group of companies can be taken to the SCT. The significance of that I think is that the very nature of industry ADRs is, there is involvement and it's perfectly proper that there's involvement in the companies, in the way the schemes are run.

The companies have involvement on the boards through membership of the overseeing boards. They have members on the panels of the schemes or they appoint members to the panels. They're not answerable to them directly. They're involved in things like rules committees, promotion of the schemes, whether the terms of reference should be altered, how the scheme can be improved. It's an inclusive role that the industry has, not so, and it's not as inclusive with a statutory scheme because you have the statutory underpinnings. Everything is answerable ultimately to parliament. You're not answerable to a board in which industry has involvement.

So the necessary involvement of industry is, I think, undermined as the scheme gets bigger. It's virtually impossible for anything other than the big players to be actively involved in how the scheme is run and how the scheme performs and how the scheme is promoted if you're dealing with an industry-based scheme. With the Superannuation Complaints Tribunal the SCT is a discrete entity and it has a life of its own. It's not answerable to a board, it's answerable to parliament. Its promotion of the scheme is done internally through the chairperson and he does a fantastic job, and through, in one sense I suppose, the minister responsible.

MR COSGROVE: The industry schemes are answerable to a statutory body, it's - - -

MR BERRILL: They are through ASIC, yes.

MR COSGROVE: Yes.

MR BERRILL: It's more of an indirect role and their review, if you like, comes up every three years when their licence is up for renewal.

MR COSGROVE: Yes, right.

MR BERRILL: There's much more of a direct correlation between answerability of the SCT to parliament. They have to report annually. I know industry groups do too, to their board, and a copy goes to ASIC. But ASIC in most situations can't do anything about the ongoing performance of it until the three-year review ticks around. The SCT is answerable to parliament at any point of time and they can have their rules - they can have the statutory underpinning changed at any time. So it's much more of a direct relationship I think.

But the point about the size is, because you've got a much larger pool of participants in superannuation and the involvement, which I think is a requirement, a necessary requirement of industry schemes and perfectly proper, it becomes much more difficult and it would be confined to the peak body or the larger players, not so much the smaller bodies who might only have the odd complaint go to the SCT. So I think that makes it more difficult. I know it has been talked about: the compulsory nature of superannuation makes it a peculiar beast, requiring of a special treatment, if you like. I do agree with that to some extent, in the sense that the ultimate sanction, if you're not happy with a dispute resolution scheme, which is part of the package you get when you buy the financial services product, is that you can abandon the product.

You can say, "I'm not going to buy your life insurance policy because I don't trust life insurance companies and your dispute scheme is rubbish, it's beholden to you, so I'm out of here." You can't do that with superannuation. So the compulsory nature of it does create a special feature, so the ultimate sanction isn't there. You've

got to stick with the scheme, whether it's an ADR or whether it's a statutory scheme. You talked before about compulsory third-party insurance. Well, in Victoria, New South Wales and Queensland which I'm familiar with, there are specific dispute resolution bodies you can go to. They're all statutory bodies.

In Victoria for instance, if the compulsory third-party insurance is handled under the Transport Accidents Act, dispute resolution is through the state, Victorian Civil and Administrative Tribunal, or through the civil courts. There is no industry-based ADR which you're answerable to. So I think the compulsory nature of it does create a bit of a factor there. I suppose the other thing is, are the other schemes operating a comparative success? How are the schemes operating? Are they all operating successfully? I'm not bagging industry schemes. I was involved in one. I still am involved in one now. I think they're a fantastic idea. They're the future of dispute resolution in Australia.

I think the courts, in financial services at least, are rapidly becoming a relic of the past in most cases and industry-based schemes perform an essential role in dispute resolution. But I think the SCT has performed - its place is really special in that I think it's a really good model. I don't know that I would think that the other industry-based schemes should become statutory as well, probably not because of this sanction that you can actually take your case to court, whereas with superannuation you can't. But the SCT has got advantages over the industry schemes in that it's independent. It is independent of the stakeholders because it's statutory and particularly industry, and there has been - I know it has been talked about, perceptions.

There is a perception out there, I see it all the time, from people who when you suggest to them, "Well, you can take your case to FICS" - you have to tell them what it is first - "or the IEC," and they quiz you on it a bit and say, "What's that?" and then you tell them and they say, "Oh, well, they're just one of them. They're just part of the insurance industry so I'm not taking my complaint there." I don't agree with that. I think they are worthwhile schemes and they are independent. But there have been queries raised in the past. Their involvement in things like the amendments to terms of reference, industry has a role, a sort of a direct role in that, through their board members that they appoint and in most of the schemes - and I know you could always alter the terms of reference to change this. But in most of the schemes any amendments to the terms of reference must be approved by the industry body first, unlike a statutory scheme where it doesn't have to be approved by anybody except parliament.

Industry schemes have from time to time struggled - it's an evolutionary thing I think - struggled with issues like procedural fairness and natural justice, which are sort of legal concepts that courts are familiar with but it doesn't mean having formal Rules of Evidence. It means basically giving everybody a fair go, having the opportunity to see what the other party is putting before the complaint body and giving them a right to be heard, which is all motherhood/fatherhood principles. But

industry bodies have struggled with that from time to time. They are getting a lot better at it, I've got to say, but it's an evolutionary thing.

The SCT jumped into that straightaway and from day 1 there was a full exchange of information. An example is things like video surveillance in disability claims for instance. The industry schemes have really struggled with the notion that the insurer should give up - the complainant should have access to a copy of the videotape. The argument that was put was, "Well, because this person can take their case to court if they're not happy here, and we want the element of surprise if you like, or not allowing them to sort of prepare themselves for what's coming before them if they're going to take their case to court." That has been overcome to some extent through the industry schemes, but the SCT just said from day 1, "Forget it, you've got to give it over. If you want to rely on it, if you want us to look at it, you've got to give it over. So they have been better at issues around procedural fairness and natural justice.

Accountability - I said before I think there's a greater level of accountability in statutory schemes through to parliament. Parliament is not the be all end all of course but I think it's a better construct. The success rate of complaints is actually higher in the SCT than it is in most dispute schemes, although it is starting to come down a bit. Those sorts of issues I think say to me that the SCT is pretty much the best of all worlds, best of both worlds, and it does provide a greater level of certainty than industry schemes I think. But I think industry schemes are - they're getting better at it and they perform a very, very important role.

So my view is that the SCT should be retained in its current form. It doesn't mean there aren't improvements, and the paper talked about some of the things that I think do need to be improved. One of the issues I think, which wasn't actually covered much, is the right of appeal against SCT decisions to the Federal Court or whether the SCT's decision should be binding. There is a right of appeal on a question of law to the Federal Court, not on a question of fact. But the reality is that it's usually the superannuation fund/insurers who have the bulk of the appeals.

Most complainants are in no position to appeal. In fact one of the rules is that if the respondent is not happy with a decision, they do appeal. If the consumer responds to the appeal and defends the appeal and they lose, then they're stuck with a monstrous adverse costs order against them in the Federal Court. The only exception to that is if you don't respond to the appeal and just lie down there and just let the court do what it wants to do, well, then there's no adverse costs order. But it creates a ridiculous situation where there's only one party turning up and arguing the case. The court is in a position where they have got to act as advocate, if you like, for a party who's not there, which is just a ridiculous situation.

MR COSGROVE: Okay, thanks very much. We had sent to you a day or so ago some three questions in fact that we were interested in.

MR BERRILL: Yes.

MR COSGROVE: I think you have pretty much responded to the first of those, although there's one angle I might come back to on that. The second question was what might be the practical consequences for complainants of the absence of monetary limits on complaints to the SCT. Could you tell us a little on that one?

MR BERRILL: Well, you've got to look at how industry schemes have adapted to their monetary limits. Those limits are as a general rule rising in most of the industry schemes. The IEC for instance, the general insurance scheme, its jurisdictional limit now is $120,000 - it has binding determinations, gone up to $290,000 in recommendations. The FICS has a $250,000 threshold for lump sum claims in life insurance products and $500,000 per month threshold for income protection or income stream risk products and $100,000 for financial planning products, stockbroking disputes et cetera.

There are issues around whether someone is inside or outside jurisdiction. I know we have at least half a dozen complaints a year where we get involved in this toing and froing with them over whether it's in or outside the monetary limits or not. It's a frustrating exercise and it's frustrating for the complainant because it wastes time, it wastes resources. At the funds end it's an administrative expense to have this sort of argy-bargy about whether what's in dispute is more or less than the threshold limit. I mean, I just don't think there's any good reason why the amount of money involved makes any difference to whether the dispute is capable of being dealt with or not. There's no philosophical reason for it.

Why is a complaint worth a million dollars any more complex and requiring of action and someone to take their case to court than is a complaint worth $10,000? What's the difference? In most cases there's none. If you have a rule in these schemes that says that - and they do, they all have them - if a matter is particularly complex and is a matter not appropriate for the scheme to be dealt with, well, then it can be excluded. But that said, most complaints are within jurisdiction.

You did ask are there any figures. I don't have any figures about the number of complaints that are outside jurisdiction at FICS or the IEC. I'm actually waiting on the answer to that from FICS at the moment. I can tell you that the $5000 per month income stream threshold at FICS is up for discussion at the moment, and from industry we got figures that 14 per cent of income protection products have monetary amounts over the $5000 per month threshold. So presumably 14 per cent of complaints or thereabouts that would arise from those can't take their case to the dispute scheme. They have no alternative but to take their case to court if they have got a complaint.

The SCT thankfully doesn't have those sorts of issues. It's a bit demoralising for complainants I suppose if they lodge a complaint, because it wastes time. It takes two or three months before you get the outcome often. I think the SCT works well in

that way. I mean, the SCT has got a particular problem in the number of complaints that are outside jurisdiction. It has been a perennial problem they have had, and the figures are something like 50 per cent. But that's primarily a function of - if you look at the figures, at least 25 per cent of complaints - and 50 per cent of those are outside jurisdiction - are where the complainant hasn't been through the IDR process, the section 101 complaint process.

There's liaison group that the SCT set up. Well, we've discussed a number of options there. One more extreme option is - at the moment it is compulsory for a fund, in making a decision, to notify the complainant of the existence of the right to lodge an internal complaint to go to the SCT. One way of doing that would be to remove the compulsion to notify the existence of the SCT when a first decision has been made, so that less people will just jump straight again to the SCT. But it's otherwise an education mechanism. Some of the letters notifying of the right to complain are pretty complex and I think there's a role for the SCT in having model standard letters that can be used. I know ASFA has been involved in setting up some model complaint letters and some of the - particularly the industry funds - have got really good complaint notification forms. But the figures are still far too high and it's just a huge waste at the moment.

MR COSGROVE: Yes, we noted that in the draft report. The third question related to a statement - - -

MR BERRILL: The dramatic sea change?

MR COSGROVE: Yes, the sea change. It's on the third page of your submission to us. I was wondering, you know, what was the nature of the evidence that - - -

MR BERRILL: Well, it's more our experience - and I don't have any figures as such. But our experience was in the early days of compulsory superannuation was that claims were dealt with in a much more - and claims were essentially disability claims. Death claims were dealt with in a much more, not forthcoming way by the superannuation funds. This goes back to this courts limited powers of review. Because the courts have had this limited powers of review there wasn't the scrutiny - there wasn't the accountability, there wasn't the scrutiny of decisions that there is now. The advent of the SCT have played the most important role in that. I'm sure most funds will tell you that's a good thing. It's no bad thing that they have to have been made more accountable and it's no bad thing that they have, for instance, had to set up claims review committees to deal with section 101 complaints, the internal dispute resolution complaints in a much more formalised way and in a much more serious way than used to be the case.

The correspondence to members and notifying them of rights to complain is a lot better than it was, and the way the interpretation of issues like, what is total and permanent disablement, what is total disablement, there has been a dramatic change in that over the years. I mean, at our level the success rate we've had on claims for

disability benefits has gone up dramatically. It was a very low rate in the early days of compulsory superannuation or from the start of the 90s but now it's much higher and I think the SCT's role has been important in that. Various players in industry have from time to time said the SCT has taken it too far and they have put interpretations on things like what total and permanent disablement means that were never intended.

I've got to say I don't really agree with that. I think the SCT is actually tough enough. We've had many decisions go against us that I thought were pretty unfair, but nevertheless you cop them. Well, it's the complainants that cop them at the end of the day. So I think they have certainly played and important role by simply being there. This accountability and answerability that just was not there before - - -

MR COSGROVE: It's still the case, from some statistics that we've seen, the number of complaints proceeding to the tribunal continues to rise.

MR BERRILL: Yes, it does.

MR COSGROVE: There are more and more superannuation fund members obviously from year to year. But you don't really get an impression that the tribunal's indirect influence on the seriousness with which funds - trustees themselves address members' complaints - is being revealed in an increased proportion of complaints being dealt with before they have to go to the SCT, is it?

MR BERRILL: I see. Look, I think if you look at it across all the ADR schemes their complaint numbers are steadily rising. FICS is probably the one exception to that in certain areas, such as in life insurance products. Their complaint numbers have dropped. It's probably more a function of the disclosure requirements that came into being in 96. They have flowed through the old - FICS used to have a significant percentage of complaints about mis-selling at the point of sale but they have basically disappeared with the advent of the life insurance code of practice which introduced stringent requirements on agents selling products.

But most of the dispute schemes the complaint numbers are on the rise. The banking ombudsman just released his report yesterday in which there was a 15 per cent rise in complaints. The telecommunications industry ombudsman's report came out about a month ago in which they're on the raise. Is it the blame and claim society we live in, well, maybe. I think it's probably more a product of people's awareness of their rights and entitlements, an awareness that they can complain. Probably a better indicator is the percentage of complaints that have been upheld, is a better indication of whether industry is doing better at it. That's at least what IEC and FICS will tell you is the reason why they have been effective is because the success rate of complaints has dropped.

IEC's success rate of complaints I think is around about 25 per cent that go to review, and FICS in life insurance products is about 33 per cent and in other

financial services products is currently running at about 40 per cent I think. The SCT is a little higher but it is dropping, and that's no bad thing. I think that's a better indicator that industry is getting it right. It doesn't mean people won't complain because that's probably the nature of the beast but they're getting better at it - industry, I mean - in dealing with matters.

MR COSGROVE: Okay.

MR FRENEY: If I could just go back to some of John's early comments in that the courts are restricted in considering superannuation complaints. If that's the case I can understand therefore why you need to have a good level below the complaints for getting good outcomes on superannuation complaints. But I don't really understand why that necessitates a statutory body and an SRC Act that sets out the operations of that body. It seems to me that the - what are the key features that you're looking for in terms of getting good results in a sub-court level, a complaints resolution system, and what would be the distinguishing feature of a statutory body as opposed to industry based ADRs. In your submission you say that one of them is independence and you talked a little bit about independence and that's fine, I understand that. Perhaps some of the qualities that you looked for would be things like very well informed and well researched appraisal processes and decision-making processes for knowledgeable and well informed complaints determination mechanisms. You'd probably look for impartiality and you'd probably look for things like quality of decision-making and consistency of decision-making and those sort of characteristics to get a good complaints decision-maker.

I was thinking that they're more characteristics of the tribunal itself, whatever it may be, or the ADR itself, rather than the fact that it's a statutory body per se and the operations of which are determined by an act of parliament and the appointments to that tribunal are made by a minister. So I was just wondering in your view what are the essential characteristics of a statutory body as opposed to a non-statutory body or an industry based ADR in that area of qualities that would answer the question that we have to answer is why is this act necessary?

MR BERRILL: Well, one of the things is independence, as I said before. The ability or the inability, if you like, of the stakeholders to change the rules which they can do in industry schemes, as opposed to parliament - the sanction of parliament having to change the rules. All the ADR schemes, the boards have the powers to alter the rules of those schemes. Just about all the ADR schemes have in their rules that ASIC has a role in reviewing those changes. But ASIC does not have the sanction of saying, "No, you can't change the rules." Their only sanction is when it comes to relicense the scheme after three years, after their review, they can cause them some grief at that point.

The statutory sanction and the statutory underpinning means that the scheme cannot be changed without sort of the ultimate sanction and the ultimate accountability, which is to parliament. If you believe in parliamentary democracy I

suppose that's an important role.

MR COSGROVE: I'm just looking at the relevant policy statement of ASIC's.

MR BERRILL: Yes, 139.

MR COSGROVE: In terms of changes to the terms of reference, it does say that the scheme should consult with ASIC about all proposed changes to the terms of reference.

MR BERRILL: Yes, and that is for instance in the rules of FICS, that they must consult.

MR COSGROVE: Right, yes.

MR BERRILL: But they don't have a right of veto, and the process is fairly drawn out in any event. Part of the approval process for any change is it has got to be approved by the industry.

MR COSGROVE: Presumably though, if a change in some way breached the principles in ASIC's policy statement, then ASIC would no longer approve the scheme.

MR BERRILL: Yes, well, there's a lot of flexibility within the policy statement. It's a very good document and it has been used as a stick to beat - to get changes in things like procedural fairness, exchange of documents et cetera, out of the way the industry schemes have operated. It's a really good document. But there is a lot of flexibility within it. The statutory underpinning means that nothing can be changed without parliament saying yes or not, and if you believe that the parliament has a role in that and it's an important sanction, well, I think that's important, as opposed to an industry scheme where there is that role for the stakeholders in review. I'm not saying they use it for evil, not good, and in fact as a general rule they do not. Most of the amendments to the rules have been positive in industry schemes. But I think it's an inferior product, as opposed to a statutory scheme.

So I take your point that a lot of the features you enunciated before are in the SCT now and are common with industry schemes. That's why I say I think the SCT has got the best of both worlds. It has got the statutory underpinning. It has got independent chairperson panel members, and at the end of the day they're the key players in the independence game, if you like, as the decision-makers. It has got an independent source of funding. It's not directly funded by industry.

The way industry schemes all work is that they pay a membership fee and they pay a per-complaint fee, an initial filing fee on a complaint and then a further fee if the matter goes to determination. The SCT doesn't operate that way. Again I'm not saying it's a bad thing that industry schemes operate that way. I think it's a good

thing. But it's much more of a perception that the funding is direct from industry, whereas the SCT - it's funded from a levy which is paid by industry ultimately anyway but it's a guaranteed thing.

I suppose the sanction against companies if they don't comply with - in a statutory scheme you can compel the trustees to comply with decisions. With the industry schemes it's a contractual arrangement. So it's not a breach of the law as such for a company to say, "We ain't going to pay," if a decision is made by the complaints body that they pay. They can be sued for breach of contract, and again I have not seen it happen but you know, there has been lots of argy-bargy behind the scenes about unhappiness with decisions that have gone on. That just doesn't happen at the SCT, and I think it's a superior product. Again, with the idea that it's fulfilling the role - in one sense, as I say, I think it fulfils the role that the courts should be fulfilling but isn't, because of these restrictive rules they have got.

MR COSGROVE: Yes.

MR BERRILL: Yea Old England rules.

MR COSGROVE: I think all of those points you have been making are helpful to us, John. There's still one angle that I would like to ask you about and that is the situation which now prevails in terms of the ASIC approved schemes. You have mentioned at the top of page 6 of your submission that industry based schemes from time to time struggle with a public perception of being too close to industry and not completely independent, and you have expanded on that a little earlier in our discussion.

I don't know whether - well, my question directly is, would you still say that that is the case in terms of those schemes? I think there may be no more than three of them which have been approved by ASIC. But leaving the perception issue to one side - I think that's a fair point. You know, people do form perceptions, whatever the reality is, from time to time. But do you feel that schemes which have been approved by ASIC are not operating in a genuinely independent manner, or that the industry bodies which are involved with them are too dominant in some way?

MR BERRILL: There are two levels you have got to look at it at. The first level, which is the most important level, is at the panel level, which is the dispute fact-finder. They ultimately make the decisions. I have not seen any evidence - I was on the panel of FICS for six years and I know you're going to hear this from them anyway - but I never saw any attempts to influence us in what we did by any industry body member. We would have completely ignored it anyway. I have not heard of any such similar thing with the IEC, and my firm deals a lot with the ISC as well.

We've got lots of complaints with the IEC. We've got a lot of confidence in the way they operate. I mean, one of the things we've got confidence in all these ADR

schemes - we encourage people to take complaints there, rather than channel them to the courts. It's a criticism of some lawyers that they're not interested in these ADR schemes. They don't know anything about them, a lot of them, and others that do are not interested in them or would much rather funnel their clients towards court. Well, we don't operate that way. I have forgotten by train of thought now. What was your question again?

MR COSGROVE: Well, the extent to which ASIC approved schemes are in some way less than truly independent.

MR BERRILL: I'm sorry, yes. At the decision-making level, no, I don't think there's any query about the independence that I have seen. But at the board level I think it's a different ball game. At the administration level I would say again no, but at the board level I think it's different, because of necessity industry has a role to play. They appoint have the board members. Any amendments to the rules have to be approved by the industry. A lot of the case managers et cetera come from industry. They're involved in the schemes. That's part of the nature of these schemes, that there is a role to play for the players, the stakeholders in the game.

Consumers have much less of a role because they're not organised as such. The consumer groups tend to be fairly disparate. I mean, there's a couple of key consumer peak bodies. There's the Australian Consumers Association and Consumers Federal of Australia. I'm involved in those organisations and we do meet with the schemes periodically. If we've got any queries we can put them up, or if we've got any complaints or problems we can put them up, and they will be listened to, that's fine.

But the direct involvement of consumers at the board level is not at the same level as it is for industry, and indeed there have been queries raised and there's a bit of controversy about appointments that have been made in the name of consumers to some of the boards of these schemes, and indeed in some cases to the panels. So yes, I think there's a question mark on the independence of the schemes at that level. It is getting better but I think it's still there. But you just don't have that problem with the SCT.

MR COSGROVE: Your reservations are essentially about appointments to scheme memberships, and perhaps in some cases panels, appointed by those members, and the capacity of the board to change the terms of reference of the scheme.

MR BERRILL: And also the direct funding of the schemes - the independencies that there is. So I think there is a question mark on that. You just don't have that problem with the SCT because there is no board. There's no board that the secretariat is answerable to or the panel is answerable to. There's none of that. They're answerable to parliament.

MR FRENEY: As members of the tribunal itself that are appointed by the minister,

are there not?

MR BERRILL: Yes.

MR FRENEY: Right.

MR BERRILL: They're all appointed by the government.

MR FRENEY: Yes, so that again we come back to the membership and composition of the tribunal.

MR BERRILL: Yes. I'm not quite with you.

MR FRENEY: Well, with respect to the balance of the membership of the tribunal and the kind of people who are members of the tribunal.

MR BERRILL: Yes. Well, the appointments to panels is always - it's a bit of a vexed question. Appointment of judges is done by government. Do we want a voting system like America? I don't know.

MR FRENEY: Yes.

MR BERRILL: I think ultimately you have got to have, in a statutory scheme - the responsibility I suppose has to fall on government to appoint them or whether you should have some formalised role under which the chairperson should have a role in it - I mean, they do have a role at the moment but it's not a formalised role. But when you've got a system where industry itself appoints half of the board members of half minus one of the board members and they've got powers of veto over certain things being done, the perception is real: is it done for evil and not good? Well, no, it's not as a general rule.

But where you need this independence, where it has got to be water-tight, which it is with the courts pretty much, and where you've got to have a sort of a higher level of that, which I think you do when you get a step above the ADR level, then I think it has got to be statutory and the SCT, because it fills the void that the courts don't have, fills the void that the courts have vacated in dispute resolution in superannuation, I think it therefore should be statutory. That's my humble opinion.

MR FRENEY: Perhaps just one last quick question, if I could. In terms of the quality of outcome of the decision-making of ADRs versus, say, the SCT, if at the end of the day it's the quality of the judgments - you're a consumer or you act on behalf of consumers - would you have any comments about the respective qualities of judgments?

MR BERRILL: I don't have a problem with any of them. We wouldn't recommend the clients to take their complaints to these dispute schemes if we did. The very

nature of ADRs is that you don't have a full airing, a full and complete airing of the matters in dispute, because people aren't cross-examined on what they say, that sort of thing, which the courts do have and that has got its good points and its bad points. But the way complaints are dealt with I think is pretty fair. But I just think the SCT - it's a bit of a no-nonsense outfit. They just don't take any nonsense from players saying, "I don't want to give over that material. I don't want to give over that."

They say, "Well, just give it all over. We're going to see the whole lot, whether you like it or not," and Graham McDonald as chairperson hasn't stood for any nonsense and maybe that's personality driven in one sense, but I think it is a bit of a function. There's more of a respect I think afforded to that scheme because it's statutory than to the industry scheme. But look, I don't have a problem with the outcomes. I have a problem with some of the individual decisions because we don't win and some of them, you just think, "Oh, that was an outrageous decision." But as a general rule, no, I don't and that applies across the board. The SCT, IEC and FICS.

MR COSGROVE: John, there are just a couple of other matters - again I don't want to detain you very much longer - which you might be able to help us on. One is a point you made on page 4. It's just down below halfway. You're talking here about the SCT goal to be quick and the bad effect that the challenge to its jurisdiction had. You then go on to say, "The time delays have been reduced in the last 12 months although the continuing delays of up to 20 weeks or more in written decisions being published following review meetings are still of concern."

MR BERRILL: Yes.

MR COSGROVE: That, I take it, is still the case at present, pretty well.

MR BERRILL: Yes.

MR COSGROVE: How would the industry-based schemes compare in that respect? Are they also slow or seemingly slow?

MR BERRILL: It varies. The IEC prides itself on being a lot quicker than the others. That's more a function of the product involved I think and the dispute involved.

MR COSGROVE: Yes.

MR BERRILL: But the IEC says that it gets through complaints within six months. It prides itself on, you know, 99 per cent turnaround within six months. FICS is a bit slower and is getting slower because the sort of disputes that are coming to the panel at FICS now are much more complex than they used to be. A lot of, you know, the old disputes when I first started there in 95, a lot of the standard complaint was who said what to who at the point of sale and it was not overly complex. I mean, the products underlying them are often extremely complex. But the disputes

weren't and they used to be banged through a lot quicker than they are now.

I suppose the other thing that's - because the IDR, the internal dispute resolution mechanism, is working better, and that's across the board, it's only more your hard-edged cases that are getting to the panel stage. So the time lines are blowing out a bit. The SCT's problems, it had the unique problem with the Breckler case and the challenge to jurisdiction. Graham McDonald assures us that the backlog is - they're into the year 2001 now I think, the start of the year 2001, or about 12 months behind or less than that. But my major bugbear is this, that, you know, a review meeting is held and you don't get a decision for anything up to 20 weeks. We're constantly telling clients, "Well, I don't know. It's coming, it's coming."

MR COSGROVE: Do the industry schemes have a similar operation?

MR BERRILL: No, they don't tend to - - -

MR COSGROVE: Of publishing reasons after - - -

MR BERRILL: Yes, they all publish reasons, yes.

MR COSGROVE: But they too are slower than you would like in that area?

MR BERRILL: No, they're pretty quick in publishing the reasons. FICS for instance would publish reasons - my personal experience when I was on the panel until recently, we would publish reasons within two to three weeks of hearing the matter. It's a resourcing problem at the SCT and I think that's pretty understandable because, as I understand it, their funding levels are now just back to the levels they were before they lost the jurisdiction and this is despite the fact that the complaint numbers have continued to rise and they've been dealing with this backlog. So I mean, that just doesn't make sense to me. I mean, all the other schemes, their funding, as the cost of the schemes have progressed they've risen.

I saw the figures the other day for the IEC and their costs of administering the scheme has gone up, minuscule compared to what it costs to administer the courts I might add, and the same with the SCT. You know, it's the other factor the government will have to keep in mind, is that if all of these complaints were going to the courts it would cost the government a much greater amount of money than it does, having them dealt with through these mechanisms. But I mean, I'm assured that the 20-week figure will be coming down and, touch wood, it will.

MR COSGROVE: Let me see. On page 10 of your submission - - -

MR BERRILL: Conciliation?

MR COSGROVE: Yes.

MR BERRILL: Yes, the strike rate is pretty poor.

MR COSGROVE: "Only the tribunal" - at the very bottom - "with the power to order compulsory conciliation would overcome the strike rate problem," yes.

MR BERRILL: Did I say "overcome"? I don't think it would overcome the - - -

MR COSGROVE: Sorry, "ameliorate" you've said.

MR BERRILL: Yes. I know there is a suggestion now that there is going to be an amendment to the act to make conciliation compulsory. Where it worked fantastically well was in the civil courts down here in the early 90s, in the middle-level court, the County Court. They introduced compulsory mediation. Whether you liked it or not, you turned up to a directions hearing and the judge sent you off to a mediation. You could talk till you were blue in the face about there was no chance of settling this. He'd say, "I don't care. You're going off to mediation whether you like it or not," and lo and behold, the settlement rate was very high and remains very high through the civil courts.

MR COSGROVE: Compulsory conciliation I guess simply means that, you know, you have to go through that step initially but you still have the opportunity to go to arbitration.

MR BERRILL: Yes.

MR COSGROVE: I guess my question in this area is whether such a change might - well, how effective it would be. You've partly answered it by saying, in this case you were just referring to, that it resulted in an increased resolution.

MR BERRILL: A lot of the time people don't settle cases because they don't turn their minds to it and they don't sit in the same room together. My experience is, it works very well. There is a problem with the SCT of course. It's a national scheme and unlike the civil courts down here, where everybody is in the same place, with the SCT you can have someone who's up in Boulder or somewhere and someone who's down the bottom end of Tasmania. So getting people in the one place is going to be very difficult.

MR COSGROVE: Yes.

MR BERRILL: So videoconferencing, they use telephone conferencing a lot. Face to face I always find is a lot better but it doesn't mean that the other mechanisms aren't good. They tell me that the strike rate is improving a lot and our experience is that it is, but it's not at the level that it is through the civil courts by any means but it is improving. It's not only a problem with the SCT, all dispute schemes have this problem. It's a function of the stick that everybody is beaten over the head with in court is the ultimate, scary prospect of running a case to judgment and then copping a

whopping big legal bill at the end of it if you lose.

MR COSGROVE: My final question related to your final section on Naming Parties which was one of the proposals in our draft report. You've agreed with it. Not many other people have. Some people are saying, apart from the name/blame aspect of it all that it could be unfair in the sense that a lot of disputes are dealt with before they have to go to the Superannuation Complaint Tribunal and naming trustee board X for having had, let's say, two complaints taken to the tribunal yet having dealt with a hundred of them internally might seem a little unfair.

MR BERRILL: Well, I don't know, why would it be out of perspective though. If they have got two complaints at the tribunal and the tribunal is dealing with hundreds of complaints, is that going to be out of proportion?

MR COSGROVE: I see what you mean.

MR BERRILL: The reality is, it's only people who work in the industry that look at these things. It's not as if suddenly tabloid TV shows are going to be interested in it; they're not.

MR COSGROVE: You could have some of the industry magazines and newspapers, I suppose, following it and saying, "Beware of this group of trustees, they've got a terrible record in terms of dealing with complaints."

MR BERRILL: That happens in the courts now. What's the difference? If you don't see the courts as being the be all and end all, which I don't, I don't see that people should be treated differently from one to the other. It doesn't mean just because you've had a complaint against you that what you've done is evil by any means. It can be disagreement that's resolved by a third party, the SCT. It doesn't mean you're going to be pilloried for it in the press. But if you've done something pilloriable - if there is such a word - then so be it.

MR COSGROVE: Okay.

MR BERRILL: In saying that, you've always got to have the sanction that is in every court that if it's appropriate that the names be suppressed, well, then they be suppressed. That should be the power in the tribunal to do that. All the ADR schemes have got the same thing, none of them publish names. I don't quite know why that happened. In all these things - with industry schemes anyway- industries have to be sort, not dragged along but they accept these schemes in the first place as in one sense a marketing tool, "Look, part of what we offer you is, if we're not happy with us you can go to a third party," and then once that was set up it sort of became a bit of a beast with a head of its own and they have been sort of trying to rein it in a bit by not letting it get out of control. These sorts of issues are progressive. I assume eventually it will come to industry schemes too where names will be published, but it's not there now.

MR COSGROVE: Okay. I think that's all we have in the way of questions. Thanks very much for coming along.

MR BERRILL: Thanks for having me.

MR COSGROVE: Thanks for providing us with a submission. I think we'll just take a very short break for a few moments.

MR COSGROVE: Our next participant is the industry funds forum. Ian, could you identify yourself for the transcript and indicate the capacity in which you're appearing today please.

MR SILK: Yes. My name is Ian Silk. I'm the convener of the Industry Funds Forum and am representing Industry Funds Forum today.

MR COSGROVE: Thank you. Thanks for another submission, we've had a chance to read. I don't know whether you would like to make any opening remarks?

MR SILK: I would like to make some opening remarks, and firstly to thank the commission for allowing us the opportunity to appear before you today. As you know, we provided a written submission in response to the initial issues paper, and we appeared before the first hearings that the Productivity Commission conducted on this matter, and of course we have provided a written submission in relation to the draft report. So our views are reasonably well-known to you and we don't propose to go over any of the issues that we've provided to date, although of course we're happy to answer any questions you may have.

The purpose in appearing before you today is firstly to note the observations and recommendations in the report - or the key ones at least - with which we agree, and secondly and probably more importantly, to bring to your attention our concerns with a couple of the recommendations which we believe would have a detrimental impact on the superannuation system and in particular have a detrimental impact on the members of superannuation funds.

Firstly if I could just briefly nominate some of the key observations in the commission's report with which we strongly agree. Firstly, at page 17 to 18 of the overview there was a comment:

> The restrictions on competition contained in the SIS legislation are not extensive and competition in most segments of the industry appears to be relatively strong.

Secondly, at page 84 of the report:

> The trust basis of the legislation is effective in facilitating prudent management of superannuation entities.

Thirdly and finally in this context, at page 87 of the report is the quote:

> The equal representation rules for trustee boards of standard employer-sponsored funds provide balanced representation of employer and employee interests. They are conducive to active member interest and the prudent management of these funds.

For the record, we would strongly endorse each of those comments.

MR COSGROVE: Yes.

MR SILK: However, as I indicated at the outset, there are a couple of themes running through the report which manifest themselves in some of the comments and recommendations which do trouble us, and we would like to raise those today. The first relates to capital requirements. Draft recommendation 4.1 reads:

> The net tangible asset requirements for approved trustees should be strengthened through legislative amendment. All approved trustees should be required to have a specified minimum amount of net tangible assets (or approved guarantee or combination thereof) regardless of their custodial arrangement. Approved trustees who use custodians should not be required to have more than the specified minimum amount.

Draft recommendation 4.2 reads:

> The operating capital requirements for all approved trustees should be revised through legislative amendment so that they represent a specified proportion of an approved trustee's operating costs.

The Industry Funds Forum believes that if these recommendations were implemented, in particular draft recommendation 4.1, they could have a profound impact on the structure of the Australian superannuation industry.

The very essence of not for profit superannuation funds - which is a characteristic of course of all members of the Industry Funds Forum, as well as various other superannuation funds, like most corporate funds - is to provide all operating profits to members. Our interpretation of draft recommendation 4.1 is that it would strike at the heart of this philosophy and this approach. Not for profit superannuation funds, including members of the Industry Funds Forum, may have substantial difficulty in meeting the requirements set out in these recommendations.

Given that this would appear to be a real possibility if these recommendations were implemented, the Industry Funds Forum believes the Productivity Commission should, as part of any final report in which such recommendations appear, state precisely how not for profit funds could meet these requirements, or articulate in more detail the net benefit it sees flowing to superannuation fund members in the event that some funds are unable to meet the requirements.

The potential benefit to competitors of not for profit funds of these recommendations being implemented are reasonably clear, but we can't detect the net potential benefits to members. On this subject the Industry Funds Forum is in agreement with the commission's own words at page 43 of the draft report:

> Compared to some of the other entry requirements, for example the custody requirements, liquidity requirements, contingency plan, insurance requirements and disqualified person test, a NTA requirement may not address as directly the characteristics or skills which make a "good" trustee.

We regard those comments as being a very eloquent, simple and persuasive case for not extending the capital and NTA requirements as proposed elsewhere in the draft report. The second major issue that Industry Funds Forum would like to address is that of licensing. Draft recommendation 7.1 reads:

> The SIS legislation should be amended to require that superannuation entities be licensed by the Australian Prudential and Regulation Authority, subject to specific conditions pertaining to such matters as trustee capacity, operating capital and the provision of an investment strategy. The government and the Australian Prudential and Regulation Authority should consult widely on the details of such a licensing arrangement.

We're not able to adopt a definitive position on this licensing issue because the paper quite reasonably doesn't spell out with precision what the licensing criteria should be. Indeed, it would make it difficult, we would suggest, for any party to come to a definitive position in the absence of any criteria. Therefore the criteria that is used, if licensing as proposed does become a reality, is the critical issue.

The draft report indicates support for licensing on the basis of concerns expressed by various parties that appeared before the commission, and in particular on the basis of some reported cases of mismanagement in some funds. These cases appear to mainly involve mismanagement of investments by some small employer sponsored funds. The Industry Funds Forum believes that it is important to note that in these cases it would appear that the trustee did not have a genuinely equal representation structure in place.

It appears that all directors in these cases were effectively appointed by the employer or the trustee. There appears to have been a lack of scrutiny and rigour in the examination of the investment proposals before these trustees, based on the particular commonality of interests of most or all of the directors. So we would submit that it is very important to differentiate these cases, rather than to seek to use them as justification, as some people in the industry have done, from the assertion that trustees are generally insufficiently educated or qualified.

There is of course an obligation on individual trustee directors to be professional, to be diligent and to continue to develop their skills and experience as trustees, but most of the examples of failure referred to in this debate reflect more on the absence of a genuinely equal representation trustee structure than they do on the overall quality of trustee directors.

Given the timing of the recently released APRA issues paper on the safety of superannuation and the reference in that paper to some of these issues the Industry Funds Forum believes that it is important to rebut the colourful but, with respect, ignorant comments made on the release of the report by the minister for financial services, the Honourable Joe Hockey. The minister chose to ignore empirical data and attack the quality of governance of industry funds, when neither the APRA paper nor the Productivity Commission's papers had identified any inappropriate behaviour or mismanagement on the part of industry superannuation fund trustees, or their individual directors.

Now, all of that said, the Industry Fund Forum believes that the licensing of corporate trustees does have the potential, subject to the detail of the licensing criteria, to assist in ensuring that superannuation funds operate on an efficient and professional basis. We would emphasise that the detail of such criteria would be critical because a licensing regime does have the potential to add a layer of costs and complexity which may have a net negative effect on members' interests. That concludes all of the formal submission that I was proposing to make. You did ask me to answer some questions yesterday and I've obtained some information in that respect. Would you like me to deal with that now?

MR COSGROVE: Yes. Please go ahead, Ian, thanks.

MR SILK: I only got these questions yesterday so I regret that I - - -

MR COSGROVE: Yes, I'm sorry.

MR SILK: That's okay. That's more by explanation, the fact that I haven't got answers from all members of the forum. But I have had responses from nine superannuation funds that are members of the forum and they're by and large substantial funds which in agregrate have a combined membership of around 2.8 million members. The first question was: which of the funds members conducts its administration in-house or with a closely related party. Eight of the nine respondents advise that they do not conduct their administration in-house nor with a closely related party. The ninth doesn't conduct their administration in-house, does have its administration conducted through JMIFA in which they are a minority shareholder. So I'm not sure whether that constitutes a closely related party, but they're to be distinguished from the other eight organisations.

The second question was: which of the funds members have custody of assets or are held by a closely related party? The answer to that is that none of the nine have their assets held by themselves or a closely related party. The final question was: which of the funds conduct both their own administration and have custody? So the answer to that is none. I can, if you wish, pursue the laggards and get their responses if that's of interest to the commission.

MR COSGROVE: How many laggards are there?

MR SILK: There's about 15.

MR COSGROVE: In addition to the nine?

MR SILK: In addition to the nine.

MR COSGROVE: Well, we would have some interest I think, if you could in the next week or so.

MR SILK: Sure, yes.

MR COSGROVE: We don't wish you to do it by this time tomorrow but - - -

MR SILK: No, that's fine.

MR FRENEY: Yes. The background to asking those questions, Ian, was thinking about the operating capital requirement and I had a recollection that some industry funds used to conduct their own administration and I suspect some might have had custody of their assets some years back. But I didn't have a very good feeling for the current general practice and I was interested in the practice now so that I could help to get my mind around this question of the applicability of operating capital for industry funds themselves.

MR SILK: I think APRA's last data, as reported in your draft report, indicated there were about 160 industry funds. I don't know the situation with respect to all of them but I do know - there's at least one industry fund that I know that does conduct its administration in-house. But I certainly only know of one. Some of the IFF members have previously done so, but as the industry has evolved they have moved to outsourcing that function.

MR COSGROVE: A related question that I had was whether you could tell us how many of your member funds actually use approved trustees, because they're offering public offer products. I gather it's a growing tendency but I don't know - - -

MR SILK: Yes. It's a growing but nascent trend, if I might use that term. I don't know the answer with precision but I would estimate of the 24 member funds, I would suggest approximately half. It might be a fraction less than half but it would be this order - and I should say these are not the 24 largest funds of the 160-odd but certainly most of the large funds are members of this forum and the tendency to go down the approved trustee route has largely been followed by the larger funds rather than the smaller funds. So there's a disproportionate percentage of IFF members who have pursued that path than the remaining industry funds.

MR COSGROVE: So roughly half of your members would be affected by

recommendation 4.1 because they have approved trustees.

MR SILK: Yes.

MR COSGROVE: And all of them would be affected by 4.2 on the operating capital arrangement.

MR SILK: Yes.

MR COSGROVE: A related question in connection with recommendation 4.1 is whether you could tell us how many of those funds with approved trustees hold capital in their own right, or whether they rely on the custodial arrangement.

MR SILK: I'm not aware of any funds that hold capital in their own right. I can't give a guarantee that that's the case but I'm certainly aware of most of them and most of them use the custody arrangements to satisfy that requirement.

MR COSGROVE: Moving away from the approved trustee group, in respect of the others, you know, it appears to be the case that they can be established with what I think everyone would agree are pretty low entry requirements, essentially the disqualified persons test, not a lot more than that - got to get an instrument of approval from APRA, or do you? No, that's only approved trustees. So I think that was the stimulation really for this recommendation which we put forward in the draft report, Ian, that while the act itself contains, you know, a vast number of obligations for those trustees and others, that people can set up shop without necessarily in all cases having established that they're really competent and honest players in the superannuation funds scheme.

Now, you know, we realise that at a minimum, in addition to meeting some conditions of a licence - some other conditions of a licence I should say, as we broadly outlined, they would be required to have some operating capital. What is the problem that you see with the operating capital requirement? Is it that, as you've just told us, virtually all of the fund members that you've heard from in response to our questions are using outside administrators and custodians so why should the trustee itself have to have operating capital? I guess in that context our question is, why should they not? There's a risk that something could go amiss with those outsourced arrangements, in which case some element of financing would be required to put things back on track. Do you have any views on that?

MR SILK: I do. Can I initially answer that by asking a question of you and if you don't want to answer it then I'll respond to your initial question.

MR COSGROVE: Yes.

MR SILK: Can I inquire how you envisage that operating for not-for-profit funds that don't retain money in the way that a normal commercial operation might?

MR COSGROVE: It could happen, I guess, in a couple of ways. They could draw the designated amount of capital according to the precise details of such an arrangement from the members' contributions and that would be one option. They could go into the marketplace and seek to acquire funds, either directly or by way of some guarantee. But that again presumably would be a burden on the members. But underlying those additional financing arrangements is our question as to why shouldn't the membership have some element of security, if you like, against the risks of certain failures, be they purely operational or larger ones.

MR SILK: Okay. There are a few dimensions to it. The mechanisms you spoke about are ones that we had considered. Both of those - and there are a couple of others that are along similar lines - involve an either direct or indirect reduction in members' accounts and therefore their financial interest in the superannuation fund. Leaving aside for the moment the benefit that that produces by way of some degree of comfort that if things go awry there's a reserve to compensate for them, that disadvantages members from their current position, and the rationale for that is what. The rationale appears to be that there are some funds that have to date got themselves into trouble and presumably there will be some funds in the future that do so.

Those funds that have got themselves into trouble have if not exclusively then certainly by and large been governed in a less than optimum way by virtue of the equal representation rules not being implemented properly there. We would say that that's where the focus should be and not to penalise - if I can use that term - the members of all superannuation funds because of the errant behaviour of a small minority which should be identified by the regulators and the position redressed there. So we're talking about instituting a rule or draft recommendation 4.1 contemplates introducing a new practice that would adversely impact on all superannuation fund members, including those in the vast majority of well managed funds to address the misdeeds of a very small minority - and a very small minority misdeeds which should be addressed, in terms of the regulator, identifying and correcting the trustee's own errors or own shortcomings, more accurately.

MR COSGROVE: That's a fair comment, I think, but in response - and if you used the equal representation arrangement as your security blanket, if you like, against risk of problems, then in a situation in which a trust board composed on that basis made use of other specialist people, like administrators and custodians and so on to actually look after the members' financial interest, you still wouldn't necessarily be addressing the possible risk of problems, would you, because the equally represented board might well select a very fine administrator and custodian but there would still be a risk, even in the best of companies, sometimes computers break down or someone misplaces document records or allocates them incorrectly. It was again against that kind of situation that we were suggesting that the working capital for the funds that you've been recently referring to would have some benefit.

Now, I certainly agree with you, there's obviously a direct cost for the

membership and you have to be able to identify some potentially significant benefit associated with that cost, but I'm not sure that a requirement, say, that you just have a board made up of equal numbers of employer and employee reps fully addresses that situation. It could go some way towards doing so, I agree.

MR SILK: I have to agree that it of itself is not a guarantee against losses being incurred but we can only go on our experience to date and the costs involved in the proposal seem to us at least to far exceed or seem to outweigh the basis on the other hand of the problems that have been identified. The problems that have been identified have been very narrowly focused and we're looking at introducing a "solution" that would be all pervasive. So to take up your issue of the cost benefits, we see substantial costs and very marginal benefits.

The other point I would make is that - and I guess it's related to 4.2 - if a fund does run into substantial difficulties and it's a large fund, then for this reserve to be of practical effect it itself has to be of some substantial size.

MR COSGROVE: Yes, although in the case of the operating capital I was just looking back to the wording of our recommendation on it. You've got it in your document.

MR SILK: I'm not sure that you mention a percentage.

MR COSGROVE: Specified proportion, yes. I imagine if you take the case of a large fund or many members - although I see it's not spelt out in the recommendation at present you would clearly have some cap. I mean, you wouldn't have X per cent of all - well, no, it was based on expenses, that's right. So it's a proportion of expenses. Yes, I overlooked that point.

MR SILK: Just on that point, in the absence of a figure in the recommendation we're unsure as to the magnitude that might have been contemplated there. But if I can foreshadow that if you might maintain draft recommendation 4.2 in your final report then we would (a) oppose it but (b) have a fall-back position of urging that there be a cap on it or that there be some realisation that particularly for not-for-profit funds the only recourse we have to obtain such money is directly out of members' accounts.

MR FRENEY: I guess I'd just like to ask Ian two questions in this area. If you don't have an operating capital reserve, in the current situation if something happened to go wrong in a fund, what would be the practical way of responding to it? Say you had a change in computer software, an administrator had a change in computer software that really didn't suit the circumstances of a fund and it started to churn out some wrong calculations with respect to member balances and all of a sudden there was a cry that significant costs are going to be incurred in terms of correcting this problem and we need to put some new software in and all this is going to cost X million dollars to achieve, and the trustee is responsible ultimately for it, what

would happen now, and I suppose the other question is, are there any other sensible alternatives to having - if you thought there was some merit in having a kind of reserving requirement or an insurance or some sort of buffer to provide for contingencies of operational problems, would there be some alternative to having an operating capital reserve?

MR SILK: Industry superannuation funds essentially have two sources of income aside from employer contributions and member contributions directly into the account. One is a deduction from those contributions of an administration fee and, secondly, of course there's investment income. In the event that the situation as you've described occurred, funds would draw on one of those two sources; that is to say, administration fees are deducted from members' accounts and typically put into an administration reserve from which various expenses are met. They're typically reflected in accounts as assets - member assets not yet allocated to member accounts. So there may be money in that reserve that would be allocated. In the event there was not money allocated in that reserve, the likely situation would be that a trustee would shave their crediting rate and take it off investment income in the hopeful event that there was a positive crediting rate.

MR COSGROVE: So that's a very similar mechanism to the one that you and I were discussing a little while earlier.

MR SILK: Yes.

MR COSGROVE: I guess the difference of opinion on this between us may boil down to the fact that you would rather deal with those situations as they arise rather than having to, in advance, provide for them on a permanent basis.

MR SILK: Yes, that is so, on the basis that those funds that operate well, that is the overwhelming majority of those funds, are unlikely to find themselves in this position. I take your point, there's no guarantee to that effect. But history dictates that that is the case to date at least. It's a very pivotal issue. It's not an esoteric debating point. The single core identifying feature of not-for-profit funds is that all assets of the fund belong to the members and they're either allocated directly to members' accounts - and that is the case with almost all of the assets but the minority are not yet allocated to members' accounts but ultimately at some point would be. So given that, we don't see that a case has been made out to pursue those two draft recommendations.

MR FRENEY: With respect to the administration reserve that you mentioned, Ian, what would be the essential difference between that and an operating capital reserve? Is it the point you just mentioned that ultimately the administration reserve becomes credited to members' accounts, whereas an operating capital reserve wouldn't?

MR SILK: Yes, that's right, the administration reserve, and it has different titles in different funds and slightly different uses, but it is used for a variety of

administration based purposes. So it meets the direct expenses of the fund in many cases and if the fund was to be wound up at any time that money would go direct to members on a proportionate basis.

MR FRENEY: Would it contain what you might call contingency reserves for disaster recovery type situations?

MR SILK: In my experience there wouldn't be an explicit line, nor would there be in my experience express provision anywhere for such an eventuality.

MR FRENEY: Could I just briefly ask, Ian, again the second part of my thinking, is there a viable alternative to - we had an early discussion with JMIF about insurance and we asked a few questions there about whether these sort of risks are insurable and what would the premiums and the cost be, and one sort of area of thinking and another area of thinking was, how quickly might you get insurance money anyway in the event of some unforeseen contingency, particularly if there was some culpability somewhere. So we had a bit of a discussion along those lines, but I was just wondering whether you had considered any alternative.

MR COSGROVE: This incidentally was a proposal that the trustees of funds would take out insurance against the risk breakdown of some of their support services.

MR SILK: Yes. I have to say we haven't given that any consideration. Can I just address one issue that wasn't covered in our submission but was dealt with in your discussion with the last speaker.

MR COSGROVE: Yes.

MR SILK: That is the issue of naming of funds. We would not support the naming of funds largely because many of our members are very large funds and simply by virtue of their size we would expect them to be appearing before the Superannuation Complaints Tribunal on a more frequent basis than smaller funds. But I think the notion of naming and shaming in principle is a sound one and we would support the comments that I think were made by the chairman of the SCT to you when he said he essentially reserves the right to name funds that appear before him on a disproportionate basis or having committed some dastardly deeds, I think that is entirely appropriate.

But simply naming organisations on the basis of a number of times they have appeared before the SCT doesn't illuminate any public debate, doesn't give any practical or useful guidance to members of superannuation funds or any other interested parties if it simply reflects the size of a fund. Therefore, we would say such identification has the very great potential to mislead people rather than to display a transparency.

MR COSGROVE: Yes, I understand that point.

MR FRENEY: I just want to pose more of a philosophical question about capital requirements which are very widespread among all sorts of financial institutions in terms of prudential supervision and prudent management philosophies and standards around the world, I guess. In a way I can understand your comments that they're not compatible with the basic philosophy of not-for-profit superannuation funds, but on another level, I find it a bit difficult to understand why you would exempt a manager, a trustee and manager of very large volumes of money, huge assets, when virtually all other kinds of financial intermediaries and financial institutions for prudent purposes are required to have some sort of capital. There are different reasons for having the capital. So I struggle really a little to understand why for those sort of reasons - that I think we would be able to agree among ourselves are needed - that we wouldn't have some sort of capital requirement for approved trustees, rather than reliance on the capital requirements for custodianship. Do you have a comment on that? We haven't really touched on that topic just yet.

MR SILK: Sure. I would gather that the only concern you would have with the alternative that currently exists through the custodian approach is that something might go amiss with the custodian, therefore leaving the trustee exposed. Is that - - -

MR FRENEY: Well, I can understand the logic of having net tangible assets requirement for custodians for the sort of risks that go with custodianship, but I can't help getting my mind away from the Life Insurance Act, for example, and the reserving requirements that there are on the statutory funds of life companies and all of the various sort of risks that are explicitly reserved for there, whether a huge amount - $180 billion worth of assets in those statutory funds - and yet for some approved trustees, which used to rely on custodians, there's no sort of reserving requirements or capital requirement at all. It just strikes me as a little anomalous, so that there's many other risks other than risks attaching to custodianship that you could advance for having some kind of capital holding by an approved trustee entity.

MR SILK: Most of the organisations that you refer to that have capital requirements similar to those proposed here are commercial entities which, aside from normal operational risk, don't have the governance structure that most superannuation funds have, certainly the superannuation funds that are members of the Industry Funds Forum. So we don't just say that the costs of implementing this proposal could potentially be significant on individual members of funds.

We overlay that point with the observation that the overwhelming majority of superannuation funds have proven governance structures and those proven governance structures have led to a situation where none of the funds that I'm referring to have run into the sort of difficulties that are sought to be protected against by this recommendation. Therefore, notwithstanding what might apply in other areas, we can't see that a case has been made out to transport arrangements in some sectors into the superannuation sector.

MR COSGROVE: This may be outside the purview of your membership, Ian. It probably is, I suspect. But I was recalling your earlier statement that those instances of fund failures were often cases where equal employer-employee representation on the boards was not present There have been a couple of recent problems with super funds. One I came across just this week. This is the appointment of an acting trustee to Hart Staff Superannuation Pty Ltd. Do you know anything about that case? My impression is that that may well be a trustee with equal representation.

MR SILK: No.

MR COSGROVE: You're not sure, no.

MR SILK: I'm not aware of that case and the point I was making, or seeking to make, before was that some funds purport to have equal representation but the reality is somewhat different and that people who are ostensibly member representatives are in fact quasi-employer representatives.

MR COSGROVE: I see.

MR SILK: And that in the absence of member election or union appointed trustees, it sometimes bears a bit closer scrutiny to determine whether member elected trustees are as they seek to represent themselves, or as others might seek to represent them.

MR COSGROVE: This is because they can be appointed by employer members of the board. Is that what happened, rather than elected by the members?

MR SILK: They can be essentially appointed by the employer and certainly in some of the cases that have been exposed this year, some of the investment decisions that have been made have been back into the company and you don't have to take a great leap in imagination to see that they would have been pretty close to unanimous decisions, but not necessarily having been exposed to great scrutiny.

MR COSGROVE: There's also a fund, I can't recall its precise name but it's - as they say these days - a correctional officers' fund. Do you know anything about the composition of that board?

MR SILK: Yes, I do. I know a little bit about that case and the comments I was just making are quite relevant in relation to that case. That fund invested approximately half its assets in a building that was used by the employer. The company lost two key contracts with the Queensland government, was forced to sell the building at short notice and realise a substantial loss, and therefore the members who were paid out themselves realised a substantial loss.

MR COSGROVE: I suppose you could say both of those cases, on what you've told us, are examples of a failure of the equal representation or rules to be properly

applied. Now, that's not to say there's any sort of systemic failure here. But are you able to say - it may be difficult - more generally whether or not such instances are rare or more common than you would like them to be?

MR SILK: I think they're both. They're both rare and even if one occurs it's more frequent than certainly the individuals and those of us who have an interest in there being considerable public confidence in the wider superannuation system would like.

MR COSGROVE: Yes.

MR SILK: But most of these cases, as has been identified by APRA, are typically in small corporate funds. So I think it's important that when we're all casting around for solutions to the problems that exist in this industry that we come back to where the problems are and then identify solutions that directly address those problems, rather than necessarily casting a much wider net.

MR COSGROVE: I have a couple of questions related to your written submission to us. One is the statement of support that you made on the second half of the second page in connection with draft recommendation 5.1, "Employment requirements on contributor status and cashing out of benefits." You say you support the thrust of the commission's recommendation and I'm glad to hear that. But I wondered whether the word "thrust" might have implied that you had in mind going any further than our recommendation did or any broader point.

MR SILK: No, you shouldn't read too much into "thrust".

MR COSGROVE: No, okay, fine. Then at the very bottom of the page, again you're supporting recommendation 5.2. But there's a question there of how to actually implement this. Again we've been rather general because we realise we're not steeped in the experience of application of this legislation. I've forgotten whether our text did mention a particular limit, a small limit, that is. Do you have any ideas there at all on implementation aspects of such an approach?

MR SILK: Not in terms of limit, but this has been a problem of some long standing and a lot of superannuation funds would, I think, be very thankful if that recommendation was implemented. It's a needless and basically pointless provision. It's of no particular benefit to the individual member. It certainly imposes costs on the fund which are borne by the rest of the membership and the recommendation that you've made there is one that I think would have, I would guess, reasonably close to universal support through the industry.

MR COSGROVE: Yes. I think we've discussed most of the rest that I had on my list. The licensing proposal you're not attracted by, as I recall.

MR SILK: If I could just clarify that.

MR COSGROVE: Yes.

MR SILK: We're not opposed in principle to licensing provisions. But we suspect for industry funds the devil may well be in the detail. So we're very conscious of that.

MR COSGROVE: I guess it was that aspect of the matter that I was going to ask you about. I think we have listened carefully to what you have had to say about the working capital issue. But apart from that, essentially what is involved is the trustees establishing their capacity to manage the fund and provision of an investment strategy to the regulator, use of independent auditors and use of an approved dispute resolution body which of course at present can be the SCT. Do you have any views on those in terms of whether they are too onerous a detail of the licence?

MR SILK: No, at page 20 of the overview, two criteria are mentioned; that is management capacity of the trustee and provision of an investment strategy. In the draft recommendation itself those two are extended to three with the inclusion of the operating capital criteria. So my comments on the operating capital criteria would still hold. But that aside, the criteria that you just enunciated we think are reasonable expectations to hold of a superannuation trustee **.**

MR COSGROVE: Okay, thank you. I don't think I have anything else.

MR FRENEY: No, although I would be interested in Ian's comment as to the Superannuation (Resolution of Complaints) Act. You say you strongly reject our recommendation on that. What would you see, Ian, as the essential need to have a statutory complaints tribunal as opposed to the more standard format of ADRs that have since seem to have proven themselves in more recent years?

MR SILK: I thought it was interesting to hear what John Merrill had to say immediately prior to me speaking with you, because his firm is actively involved in representing claimants against trustees and certainly his firm is actively involved in pursuing claims of our members against decisions of our trustee. But notwithstanding that the position of often being opposed to one another - that is, our fund and many industry funds, on the one hand, and John's organisation on the other - I couldn't but agree with much of what he said. I thought he put a pretty persuasive case, coming from the legal side of things, before.

The issue from the Industry Funds' point of view is that now that the constitutional issues of the Superannuation Complaints Tribunal have been resolved, since that time our experience has been similar to that which occurred prior to those issues first being raised, and that is that the SCT has proven to be an effective mechanism for resolving disputes in the industry.

We still have our complaints with the tribunal from time to time. In particular, they appear to have extended the definition of total and permanent disablement

beyond that which we think is appropriate, but that is an issue that we hope we can work through with them, but I understand you are talking more broadly than that. It is a mechanism that enjoys, if not total, then a large amount of confidence on the part of funds - certainly members of the Industry Funds Forum, on the one hand - and increasingly members and their representatives on the other.

I'm aware of the approach the Productivity Commission takes - an approach of not starting with the status quo but starting with ground zero, for want of a better term. But it would be a disappointment I think for most stakeholders in the industry if a body that is operating well, enjoys the confidence of all parties, were to be replaced by a body which probably couldn't aspire to more than meeting the services that are currently dispensed by the SCT.

One of the characteristics that it has that has led to parties feeling that degree of confidence in it, is its clear independence, the fact that it doesn't have an industry board involved in this operation and that it does report to parliament. I think that particular characteristic obviously wouldn't be shared by an alternative disputes resolution mechanism and whilst I understand they operate quite effectively in their industries, we currently have a mechanism that is operating particularly well and is manifestly independent and is respected for that.

MR COSGROVE: Thanks again, Ian. We don't have anything further to ask you. If you have got any other points you want to make to us - - -

MR SILK: No, that concludes my submissions.

MR COSGROVE: Thank you for coming along again and giving us some useful feedback on where we have got to date.

MR SILK: Thank you very much.

MR COSGROVE: Our next participant is William M. Mercer. I would like each of you please, if you wouldn't mind, to indicate your names and the capacity in which you're with us today.

MR WARD: My name is John Ward. I'm a principal of Mercer and also manager of the research and information department.

MR STEVENS: I'm Ray Stevens. I'm also a principal of Mercer and technical manager in the financial planning side of the business.

MS ARMSTRONG: I'm Stephanie Armstrong, also a principal at Mercer, and I'm a research and information consultant.

MR COSGROVE: Thank you very much. Would you wish to make any remarks on the basis of your most recent submission to us, which I think is now the third, and we have been glad to have each of them.

MR WARD: I have been designated to make a few opening remarks.

MR COSGROVE: That's fine, John.

MR WARD: Thanks, John. Firstly I would like to thank the commission for the work they have done so far and for the opportunity they have given us to make these submissions. The general comments - we certainly agree with many of the recommendations that are in the draft report. I think this morning I would prefer to concentrate on those issues where we do have some concerns with the draft recommendation.

If I could start with the capital requirements and licensing requirements, I think we have just listened to a very eloquent set of remarks by Mr Silk and we would agree with almost all of what Ian had to say in those areas. In regard to the net asset requirements, I think one point that we would like to raise is what those net asset requirements would actually achieve. It's not clear to us how the members would benefit from those net assets if the approved trustee - if we're looking at an approved trustee - went bad. How would the members have recourse to those assets? I think there needs to be some further work done in that area, before we start considering whether the net asset requirements are great enough at the moment or whether they need to be increased.

I should also preface our remarks by saying that Mercer has a number of hats. We act as advisers and administrators to a significant number of corporate funds. We act as advisers to a fairly small number of industry funds. We operate our own approved trustee and we also operate our own master trust. Again we're the approved trustee of that master trust. So we're trying to look at these issues from a number of different angles.

If I could start with corporate funds or perhaps the not for profit sector in general, the major issues that we see are where any of these net assets or capital requirements are going to come from. For those funds it effectively has to come from the members themselves, the members' accounts. If something goes wrong, obviously those assets may be available to provide some protection to the members.

However, if those funds have come from the members in the first place, I would argue that the members are no better off by having those capital requirements in place. We've taken that money from the members' accounts, put it aside into another box. If something goes wrong, well, that money in the box is there perhaps to claim on, but those current members can't be any better off because there's no more money in the box than what they have put there themselves. So from the point of view of current members, they're foregoing their superannuation benefits on the off chance that maybe they will need it, but more likely it will never be used, or perhaps eventually given back to some future generation of members. We don't believe that that is the most efficient means of adding additional protection to that not for profit sector of the industry.

MR COSGROVE: Our proposal doesn't require not for profit funds to have a minimum amount of NTA. They have to have, under our proposal - - -

MR WARD: The capital.

MR COSGROVE: - - - a certain amount of working capital, yes.

MR WARD: Working capital requirements, yes. In many ways I see the two as linked. Both are going to need financing from members' existing accounts. So our view at present would be that there is no need for such requirements, particularly for not for profit funds. If something goes wrong, how are the problems then financed and fixed? Most trustees these days have trustee indemnity insurance, which will cover some but not necessarily all.

MR COSGROVE: Most trustees, including those of not for profit corporate funds - - -

MR WARD: Most corporate funds - certainly the larger funds - would have such trustee indemnity insurance. A large proportion of those not for profit funds would not be administering the fund in-house. They would be outsourcing to a superannuation fund administration company. Those companies themselves are likely to have some form of insurance or other net assets or et cetera. In many cases, if it is the administrator that has caused a problem, the administrator themselves will fix the problem of their own volition. If they're going to remain in the industry they can't afford to get a bad name because, due to their computer collapsing or whatever, they haven't been able to properly put their clients' funds back in order.

MR COSGROVE: Are you saying that the cost of such repairs would be a

deduction from the profit of the administrator, as distinct from a charge to the client?

MR WARD: I think that would normally be the case; it was the administrators that were at fault. Now, obviously if the administrator has gone belly up, there won't necessarily be that protection.

MR FRENEY: Do you mind if I ask you a question as you go, John?

MR WARD: Yes.

MR FRENEY: I was wondering if circumstances where it might be an internally administered - say we're talking about an approved trustee and our idea that all approved trustees ought to have some little bit of capital, regardless of the custodial arrangements. So if it's a self-administered approved trustee, or even if it's outsourced but to a small administrator, say, I think I've had a little bit of experience that one of the relatively important things with operational failure is to get onto it pretty quickly and to have the wherewithal to fix it quickly, otherwise you can get compoundingly bad situations of miscalculation building upon miscalculation, for example, and that would seem to me to be one virtue of having some money in a box and could be drawn upon quickly.

MR WARD: I think if we're looking at the approved trustee area of the business, I think there needs to be some level of entry that stops just anybody putting up their shingle. Whether capital requirements are the best way of doing that, I'm not convinced. You can have a capital rich organisation with no experience or ability on the one hand, and on the other hand you can have a capital poor organisation with highly competent people who could do a much better job. Nevertheless I think there does need to be some level or barrier to entry in the approved trustee end of the market. If the approved trustee is doing the administration in-house I suppose you've got a concentration of the problem in the one area.

Needless to say, the approved trustee would likely still wish to remain in business and from a business point of view is going to do everything it possibly can to make things right.

MR FRENEY: Sure, up to a point, and within its capacity to do so. But I am aware of circumstances in the past - I can't recall, frankly, whether it's technically an approved trustee or an entity like an approved trustee - that very significant problems have arisen because there was not an immediate wherewithal to address operational failure. They just seem to compound. So one of the thoughts that's been in the back of my mind in this whole discussion in putting this idea forward has been the importance of having some readily available wherewithal to deal with problems as they arise.

MR WARD: If we're looking at problems of funds, I think we need to look at them in two parts. Firstly, there are the problems on poor investment choice and then

we've got the operational issues. The net asset requirements may be of little use in a case of poor investment choice. If we look at, say, the commercial nominees example in the last 12 months, an approved trustee, then I think the losses on the investment side in that case would have far outweighed the 5 million or 10 million or whatever capital requirements could have been in place. I'm not sure in that particular case whether they were using the custodian option to justify the net assets or not. But however they had done it, the net asset requirements would not have been sufficient to cover the problem.

In the case of the operational risk, in having those net assets there may have enabled some finance to be available to get onto those operational problems and fix them. I'm not quite sure what happens then if you've spent that money; are you then out of business as an approved trustee because you've just spent your - - -

MR FRENEY: I'd say better than having it in round 1 than not have it in round 1 though.

MR WARD: But I think that sort of issue raises a question that I think we need to look further than just setting up the net asset requirements. We need to look very carefully at how those assets can be used, how they should be used, what requirements are going to be placed on them et cetera.

MR FRENEY: I think in the case of the approved trustee capital requirement proposal, we essentially had in mind an approximate indicator of substance that this was - now, you've made some fair points about whether or not that's a good indicator of capacity to manage or to make sound investment choices. But we didn't I think envisage that that minimum amount of up-front capital would be there with a specific purpose of helping to contribute to the costs of a failed investment, for example, although it could be used in that way. But there is at least one other mechanism in place which deals with problems which are a function of fraud or theft, otherwise I'm afraid that superannuation fund contributors need to realise that it's not a risk-free environment; that they are placing money in, or having money placed on their behalf. So I make that remark simply by explanation.

MR WARD: I'm not sure that the difference between what I would call mutual funds and commercially operated funds is as big as we think. We're really talking about whether you establish reserves in case some of these things happen in advance, or whether - as was mentioned in the previous discussion - you wait till a fraud or a fire or something has actually occurred and then really you look at how do you actually recover the money. If a fund is outsourcing its tasks, if it's a fraud, for example, committed by somebody on the staff of an external administrator, then the first place you look for recovery is of course to that administrator. But if it's had the result of sending the administrator out of business then ultimately it will come back to the members of the fund having to bear that loss. What we're really talking about, I think, is when these things are sheeted home and the only resource is the assets of the fund, do you have some reserves specifically set aside in the past to draw on, or

do you simply wait until they're needed. I see risks either way.

I started my working career with a crowd called the AMP which was then a mutual life office and was very much indoctrinated into the thing that we were very holy and Colonial Mutual and National Mutual and so on were all very holy organisations compared with bad corporates who operated for profit like MLC and City Mutual. I notice my former employers seem to have changed their views and I guess I too as I got out into the wider world and realised it was sort of bigger than this, but a lot of the problems were much the same. But what I think places like AMP did was they probably had a certain amount of luck in their very early years but then they tended to build up reserves against these things and probably went too far in that course and then later on finished up with money that really was provided by early policy-holders who should have got bigger benefits. Then it was distributed to a different generation.

I think with large industry funds in particular we're going through a similar sort of development mechanism. But I see a difference more between if you have a so-called not-for-profit fund which is virtually outsourcing all its things; in other words, the trustees are more acting as an overseeing board of directors, certainly taking heavier responsibilities, but not much. A lot of the financial risk is actually delegated out to the outsourcing, or if you have a large industry fund which does all its administration in-house, self-insures and all the rest of it, then it's running quite different risks and it's probably in that circumstance where there's less outsourcing that I'd be more concerned to see some reserves being set up within the fund, one way or another, whatever the mechanism is, towards potential losses; whereas if they outsource, in effect they are using the resources of the people that they outsource their work to.

I think all funds, even commercial funds, face some of the same issues that, whatever way you have tried to provide for these risks, when an event actually happens you have either got ample money, resources to cover it, or the event that's happened is just too traumatic for the reserves or whatever you have set up to handle it.

MR FRENEY: It's one of the challenges for the legislation in a sense, Ray, that there is such a disparate industry with so many different relationships and practices going on, that at the smaller and lower end of the industry I imagine that there are still some relatively smaller and lower end of the industry I imagine that there are still some relatively small approved trustees that might be using relatively small accounting firms, computing systems as an outsourced administrator, and in theory you can say that relatively small outsourced administration is an independent thing; that the trustee ultimately has to take responsibility for it.

It's interesting to think that we might still have those sort of situations around that this legislation is having to accommodate and provide for and protect against the risks in those sort of environments, as opposed to the kind of risks that Mr Silk was

discussing with us earlier on. So you have got to in a way be looking at some relatively low denominators as well as the higher practices.

MR STEVENS: I think this is where supervision by the regulator becomes, well, extremely important - that an approved trustee, we're really saying these are typically people who are operating at arm's length from the funds and to some extent we need to protect trustees from appointing people who just don't really have the substance and ability to do the job. But at the other extreme, yes, we allow very small funds to use well meaning service providers but who just aren't really significantly enough involved in the business and they are the ones that are, to my mind, more likely to go wrong.

About all you could say is that, "Well, if it's a small fund, I guess the loss in the end is smaller," but it's very large to the small number of members in those funds and it is a real problem in this industry - always has been - is the diversity of the size and at the other extreme we have got people we are allowing to run their own funds and some of those, the standard of administration horrifies me. All you can say is, well, if they muck things up and they lose money because of it, then, you know, it's their own money that they have lost, but that's not good either.

MR WARD: I think we have probably been lucky that we have seen so few failures of superannuation funds. I would like to make the point though that the failures that have occurred have not been restricted to one particular area of the market. We have seen an approved trustee go down. We have seen some smaller corporate funds go down. We have seen some industry funds - a hairdressers fund in Queensland I think - they have all had problems. In the main those problems have been investment related, inappropriate investments. That problem is not restricted to corporate funds. We have been very supportive of the equal representation system. We think it does provide some sort of mechanism to protect the funds. At least the trustees are generally - and at least in corporate funds - members of the fund. So they are dealing with their own superannuation benefits as well as those of their workmates.

I think a number of the cases where such corporate funds or even industry funds made bad investment decisions, often those investment decisions were made many years ago. In some cases they would have been made before the introduction of employer or equal representation requirements. They were made before the legislation tightening the in-house asset rules. It's not always easy for a trustee to change the current investment mix when they come on board. Needless to say, I still think that bad investment decisions are the biggest risk that funds are going to face and one of the issues in regard to the regulator is the regulator's ability to monitor the investments of particular funds. I think at the moment the monitoring of that is not up to standard. I think it could be improved considerably.

This ties in with the need for funds to provide risk management statements and so on. I think it's time that the regulators and the industry sat down together again and worked out - "Well, risk management statements, they are not working out as

effectively as had initially been hoped. How do we restructure those statements to perhaps put less emphasis on derivatives where they are very concentrated on at the moment, even though many funds might not even invest in derivatives, but have a much wider focus." So potential problems on the investment side can be picked up far earlier. In many cases it's fairly obvious when looking at the asset mix that there is a huge concentration into one asset or one asset type.

MR COSGROVE: Would you think, John, that you could even go one stage earlier and include in the legislation some guidelines at least, if not prescriptive instructions, as to the composition of an asset portfolio? When raising that question I don't have in mind anything of a very specific or detailed nature. You certainly wouldn't want too much in the way of detail on investment choices - but, you know, for example, some sort of general rule that said no fund should have more than, let's say, a third or thereabouts of its investments in a single asset.

This is a practice which is used in some other organisations with which I'm familiar - one very large one, namely the World Bank - which constrains the management from, you know, allocating the portfolio beyond certain designated levels according to particular regional areas or country components of its portfolio.

MR WARD: Yes, I'd be concerned, depending on the level of detail in the legislation. I mean, we've already got legislation that effectively prohibits in-house assets to more than 5 per cent. If we go back 20 years - - -

MR COSGROVE: But at present the relevant part of the act is very general, isn't it. It, as I recall, simply talks about diversification of the portfolio without any clear purpose beyond that.

MR WARD: I mean, personally I would find it inappropriate if a fund were investing, say, more than a third of its assets in one investment. We need to be a little bit careful about how we define an investment, because many funds would invest in pooled superannuation trusts.

MR COSGROVE: Yes.

MR WARD: That pooled superannuation trust might be very widely spread but it might represent, say, 60 per cent of that fund's investment - so I think as long as we could exclude that sort of thing.

MR COSGROVE: Yes, that would obviously make sense.

MR WARD: Starting to put restrictions on how much can be invested in any one country or whatever is perhaps going a little bit too far. We certainly need to acknowledge that members more and more are requiring greater choice of how their superannuation benefits are invested. It may be inappropriate to start putting too many limitations on that choice.

MR COSGROVE: Yes.

MR WARD: But I'm sure there could be some general guidelines built into the legislation that does certainly put some sort of general limits on sort of at least the extremes of concentrating investments in small areas. You then start to - as soon as you start getting investment requirements, then you start to worry about will the next requirement be "you must" invest so much in venture capital for example.

MR COSGROVE: No, you wouldn't want that.

MR WARD: Which has been promulgated by at least one political party of late.

MR COSGROVE: I know.

MR FRENEY: All government securities have to go back to the 30-20 rule.

MR WARD: Yes, so you end up in trustees being forced to make investment decisions that they believe are inappropriate.

MR STEVENS: Ideally you want a regulator who is able to almost sit down with trustees and talk about their investment strategy and say, "Look, I think this is much too skewed in a particular direction." The problem is as a community we like to put fences around our regulators and restrict the extent to which they can virtually act as advisers, and then on the other hand if they can give advice but there's no teeth to it then the trustees can just say, "Well, we feel quite comfortable at 99 per cent of our assets invested in this beautiful property, you know, you can tell us all you like but there's nothing you can do about it," whereas really what it wants is some almost paternal advice where strategies are wrong, but the community probably just won't wear that.

MR WARD: But I would think that we're going to achieve far more in protecting members' superannuation if we concentrate more on those investment-type requirements than we will achieve by most of the licensing and capital adequacy requirements. I'm not saying there's not a place for some sort of net asset requirement for approved trustees. Certainly I wouldn't go trying to push that into the not for profit sector.

MR COSGROVE: Okay. We've probably interrupted your line of presentation quite a bit but - - -

MR WARD: I think, John, we've probably covered most of the introductory remarks.

MR COSGROVE: Okay.

MR WARD: We've made a number of other comments in our submission, following your draft report. We're certainly happy to take any questions on that. I know you have given us a couple of questions on notice.

MR COSGROVE: Yes, and we've had a reply to one of them. In the interim, you don't feel that it's possible for you to help us on the quantification of the compliance costs?

MR WARD: I think administering a superannuation fund has so many facets that it's not possible to sort of get people to code their time down to how much time they spend on each of the myriad of requirements.

MR COSGROVE: Yes.

MR WARD: So we just don't have a feel for it, other than in regard to chasing up people over 65 it's a pain in the neck. You can write to them. They don't respond. What do you do then? You follow them up. They don't understand. It's just an extremely difficult and in our view unnecessary requirement. Ray, I might ask if you would like to make some comments on the second question, which is if there are any tax or social security implications on enabling a greater flexibility in contributions after age 65.

MR COSGROVE: Yes. You might have noticed our own recommendation was rather cautiously worded, for that very reason. We're not of course, on our terms of reference, allowed to delve into taxation matters, but it just seemed to us that there might be some risk of tax concessions being exploited, one might say, if there were big changes.

MR STEVENS: I think the first one, which was easier to tackle, was the social security effect. I think that for example to free up the ability of people to use superannuation, particularly between ages 65 and 70, would have some effect on social security costs but probably not all that large in that if you want to use pensions, for example, to get exemptions from the assets test, then if you can't contribute to superannuation you can still buy a complying annuity from a life office and achieve the same effect.

It may well be that the life office can't offer quite as favourable terms to non-superannuation investors as others, but in other words the only thing that a superannuation fund can do that can't be done outside of superannuation is the provision of allocated pensions. Allocated pensions and annuities are restricted to superannuation, whereas other types of annuities are available for either non-superannuation money or not. With the allocated pension, while it can be used attractively, eventually with that people get caught by the assets test, so that if they're really trying to use these things to exploit social security availability and the main thing they want is exemption from the assets test, they can achieve that, whether it's through a superannuation fund or whether it's outside.

On the tax side there is certainly the ability to defer tax by using superannuation, but I make the point there that while that is obviously attractive, it is in most cases deferral of tax, rather than complete avoidance of tax. You can delay when you're actually paying it. If you don't free it up between 65 and 70, people moving non-superannuation assets into superannuation around the time of their retirement - what happens now of course is they're encouraged to sort that out before they actually reach 65. It's the people who have reached 65 and haven't organised their affairs that are the people who miss out, and freeing it up would of course allow those people greater scope to use the provisions.

So there would be some cost to tax revenue but I couldn't put a figure on it. As much as anything, I see it as not so much a cost to revenue issue as an equity issue - that we are more and more as a community trying to say that people over 65 are not really on the scrap heap, that we're trying to encourage them to participate. Age 65 has been the sort of dividing line for many, many years and expectation of life has changed dramatically. Therefore to at least move those provisions up to age 70 would relieve funds of a lot of administrative work, would make the work of advising people certainly a lot easier.

I see it as much as anything that issue and don't believe that - while I couldn't quantify it - that the effect on tax revenue would be an astronomical issue. Certainly there would be some impact, and obviously if it were opened up - working in the financial planning area, as I do - then we would of course be encouraging people to take advantage of is then available to them. But I see that as being in line with community policy anyway.

MR WARD: Ray, could I add that at present somebody with appropriate advice could achieve all of that social security and tax deferral advantages by arranging their affairs appropriately before age 65 or by arranging to work 10 hours in one week at the age of, say, 67 and contributing during that week. They have to go through a few hoops to achieve it.

MR STEVENS: Or in many cases you find that with a couple, one partner is still under 65 and through the spouse contribution mechanism you can use that. So the person who is excluded, if they really want to make use of the social security or tax provisions, you know, can generally get around them. It's just a bit more effort and what one asks is why do we put these barriers in their way, which just means it takes me a bit longer to sort out exactly how to achieve the objective, but I still achieve the objective in the long run.

MR COSGROVE: Before I go on, you've also suggested to us in your submission on page 2 that the contribution rules shouldn't be linked to employment status. That's something that we are attracted to as an idea ourselves, I remember, although I think we only raised it as a question rather than recommending it in the draft report. Are there any risks associated with such a move, of the kind you've just been discussing?

MR STEVENS: There are certainly risks if you're talking about by opening superannuation to a wider group of people. But again I think part of the issue is the situation we've got into. I just mentioned spouse contributions. I've always maintained since that was first mooted that that is one of the most discriminatory provisions that we've ever introduced, that we have a situation that if you have a partner - and that can be a de facto partner as long as it's not a same-sex partner - then you can make use of superannuation. But if you're a single person and you're out of the workforce then you can't put money into superannuation and that seems to me to be - I mean, I think the only reason it's there is because government wants to perhaps gradually widen the availability of superannuation.

We've had disabled people for example who may not be able to contribute, depending on their circumstances, or they may have the money to contribute, perhaps through an inheritance, but because they've never been in the workforce and can't get into the workforce they're not able to use superannuation and there is just as much need for those people to have a mechanism to put some of their money aside for retirement as there is for other people. So again I sort of see the employment nexus as being almost an accident of history, that that's the way it first came about. It was employers seeing the need to provide for their employees and it's about time we sort of moved and said superannuation is really a mechanism to set aside income from earlier years, however one defines that, to provide for income in one's later years.

MR COSGROVE: The similar area, again on the tax revenue side that I was coming to was the next point in your submission, the non-resident members' benefits where you've suggested we shouldn't use a limit that's too low, in fact a minimum of $20,000 and maybe as much as $100,000. On the face of it, you know, we thought that somebody could come into a tax advantage in the Australian superannuation environment, clock up - if they were, you know, a reasonably senior person in a company - some pretty substantial contributions either directly from their employer or from their own income and walk away with it. It would seem to be opening a bit of a door to exploitation of the taxation benefits associated with superannuation contributions. Do you not agree?

MR WARD: Can I just comment on the tax advantages there? I'm assuming we're talking about a fairly highly paid individual. Any contributions made to that fund by the employer would be subject to 15 per cent contribution tax. In addition to that, it's likely that there would be a 15 per cent surcharge. So we've already paid 30 per cent tax on the contributions on the way in. If that person were to take the money out of the fund, say on returning to their home country, assuming the person was under 55 at that point of time which would be the norm, again there's another 21 and a half per cent tax on the benefit, assuming he hasn't gone over the reasonable benefit limit, in which case it would be, say, 48 and a half per cent. There's really not much of a tax advantage left.

MR COSGROVE: Could be a bit of tax deferral, as Ray was mentioning earlier in

another context, I guess.

MR STEVENS: Yes, but I think your question assumes that payment of taxation in Australia is relatively more attractive than in other countries, that it would be enough to encourage people living in the United Kingdom for example to invest in Australian funds rather than invest elsewhere.

MR COSGROVE: Yes.

MR STEVENS: A few years ago, in another context, I wrote a sort of paper which was not tongue-in-cheek but it was really saying we were trying to encourage countries to set up their regional headquarters in Australia and one of the things that I found some of those companies would like to do is to be able to set up a superannuation fund in the same places where they have their headquarters and superannuate the people that they've got working for them in South-East Asia in particular and that our current rules basically discouraged that.

So we're on the one hand telling people yes, we'd love them to come here and set up their headquarters here, "But we don't want your superannuation," and was making the case that I really feel that we get enough tax out of their superannuation that we should actually be quite happy to have people with no other connection with Australia having their money put into an Australian superannuation fund, taking out 15 per cent of it, at least up-front, in tax and having it invested in Australia, getting some tax on that investment income and then getting some benefit tax when they take it out at the other end and that instead of that, in many ways we discourage the use of the Australian funds.

So I would go to the other extreme and say we ought to, as a matter of policy, be encouraging the use of Australian funds by non-residents. I mean, I was particularly talking about companies which set up their headquarters here and we have seen cases where the ability to operate their superannuation out of Australia has been one of the factors that has influenced them not to set up their regional headquarters here, but to go to places like Singapore which are much more free in some of these financial areas, so that I, from another angle, don't like the idea of restricting the use of our funds by non-residence and taking it out, as John has mentioned, to some extent is already discouraged, prior to age 55, by the tax system. But that's a slightly different problem. I would see some cases where people ought to be able to take it out and transfer it to a fund in another regime, but certainly not advocating they should be able to put money in and cash it out when they're 35 on some favourable basis.

MR WARD: Just expanding on the tax issue too, there are many overseas countries or a number of overseas countries that would actually charge or apply tax to the growth in the benefit in the Australian fund, so that the member may find himself paying tax, not only in Australia but also in, say, the US, which makes it particularly disadvantageous and if we're thinking that there are people who are non-residents of

Australia who would be wanting to invest in an Australian superannuation fund for tax advantages, I don't think that's likely to occur. They're much more likely to be going and investing in a fund in the Bahamas or some other tax haven where there will be no tax.

MR COSGROVE: Yes, although the superannuation guarantee contributions would need to be made.

MR WARD: For an Australian resident at least.

MR COSGROVE: Not for a non-resident? I thought they were applied to non-residents.

MR WARD: No, there are some fairly complex rules. It depends on whether the employer is a resident or a non-resident of Australia and it depends on whether the employee is a resident or a non-resident of Australia. In the main for work performed in Australia, the SG will always apply, even for a non-resident. But where there's work performed out of Australia it will depend on whether the employer is a resident or non-resident, and I think from memory whether - I've forgotten the exact details.

MR COSGROVE: It sounds complicated, yes.

MR WARD: But again what we're saying is we don't believe there should be any restriction at least if the money is - not paid in cash but transferred to an appropriate superannuation or retirement plan overseas.

MR COSGROVE: You pose some issues to be considered in terms of simplifying the risk management statement requirements. Is there any aspect of those matters that we should take some tutoring on - the content, for example, anything in particular that you would draw to our attention that could be simplified?

MR WARD: I don't think any of us at this table were experts in that particular - - -

MR COSGROVE: I'm not sure it's an area of such great detail that we ourselves will need to delve into.

MR WARD: But we would certainly agree that it needs some sort of revision and probably the best approach is for APRA and the industry to sit down together and work through it.

MR COSGROVE: Okay.

MR WARD: I guess on licensing, again depending on how and what licensing means, it could have drastic implications for those funds where equal representation currently applies. Who is going to be licensed? Is it the trustee? Is it the individual?

How will it all work?

MR COSGROVE: We had in mind licensing of the entity.

MR STEVENS: Rather than the individual?

MR COSGROVE: Yes. Although a condition of the licence would be that the trustees met certain requirements, like demonstrating their capacity to manage the funds, having an investment strategy. There's also the working capital element included in that, using independent auditors, those sorts of things.

MR WARD: John, how would you see that working an equal representation environment where the trustee is relying on members of the fund sticking up their hands and saying, "Yes, I'm prepared to nominate for election"?

MR COSGROVE: Well, I don't - you mean would there be any deterrence to them doing that? You've got an entity, whether it's industry fund - - -

MR WARD: Corporate fund - take a corporate fund.

MR COSGROVE: - - - B plus, what have you. A corporate fund? Well, my understanding is it's generally the practice that the constitution of the fund will be separate from the constitution or the balance sheet, if you like, of the employer. So you've got a superannuation entity there, that entity is licensed and the members of its trustee board - presumably on the basis of equal representation of employers and employees - as I say, are required to meet those broad and not comprehensive proposals that were in our option 7.2. They're spelled out at the bottom of page 119, top of page 120 of the draft report.

Keeping an eye on the clock, if you would like to have a look at those at your leisure and get back to us if you see any practical problems with this approach then we would be grateful for that.

MR STEVENS: I guess my concern, without having studied it in full, is the requirements I think that are envisaged for the individuals are related to more what I'd call their financial competence. I see it as very similar. I've always likened the trustees to a jury, and I think we would all say that we don't want to see a situation where to be on a jury you have to be a lawyer. In fact, ironically I think the law actually operates the other way that if you were a lawyer you could get exemption from serving as a juror. But, you know, for good reasons we're saying we're looking for a reasonable representative group of people and you're not going to get that by requiring them to all have legal competence. I think the danger I see in this is that we're concentrating on the financial competence, whereas a corporate trustee which has three elected from the shop floor, so to speak, can get some of their very best people in other areas, like handling disability claims and some of the other issues that come before a trustee meeting, by having people - - -

MR COSGROVE: I'm just looking at them, Ray. I mean, the first one, you would want people either by dint of their experience or their ordinary commonsense to be able to represent the interests of the members who have put them on the board. That's pretty much what the first one is saying. The second one, well, that's of some controversy, as we've discussed earlier. The third one, provide an investment strategy, I don't think that means that they themselves have to draft such a strategy but they would be required to have hired you guys or someone else in the financial sector who could advise them on a suitable strategy which they then would lay before APRA. The last two - in that last dot point - are, I would have thought, uncontroversial and not requiring the trustees to have any financial expertise there.

MR STEVENS: But as far as any requirement placed on the individual, the basic problem I see is at what point do you apply that, that with equal representation in many areas the member representatives are appointed by election and you invite nominations from throughout the eligible employee group. Does somebody virtually vet the people who nominate to say, "Look, you're obviously not up to this so you won't be allowed to stand"? That obviously has employee relations implications as well. In other words, I can't see when you do it or do you, worse still, wait until the person is elected and then say that you don't really think this person is competent. I mean, I've seen situations where it's amazing, the intuition of members that you've seen somebody with, what you might have thought was, strong backing and the members themselves in a secret ballot just don't support a person who has been put up for perhaps the wrong reasons.

MR COSGROVE: Well, I guess as a practical matter that would be something that would be done by APRA, presumably each and every time the representative positions on the board changed hands. But we had some evidence early in the day which suggested that might be no bad thing. Mr Silk, I think it was, was suggesting to us that there are some seemingly employee representatives who are not quite that, that they have been appointed to some extent by the employer. So the purpose, in other words, of the equal representation rules is being circumvented. This type of arrangement while it might imply a fairly engagement by the regulator would, one would hope, have some effect in terms of avoiding that kind of circumvention.

MR STEVENS: But I would have thought one way of trying to avoid that sort of thing is to ensure there is a genuine election, and then to sort of say that some employees and members of the fund are eligible to stand and others aren't, I just see a very big practical difficulty. Ironically I'm not sure that this is a problem that's faced so much by the funds that Ian was representing because my understanding with a lot of the large industry funds is that they're a membership-wide election with 2 million members or something is just also not a practicality, so that the member representatives there tend to be chosen by the relevant unions and that has brought forward some very fine people, but it has the same risks to my mind as appointment by the employer. It works well where those appointments are made in good faith but if they're made for other reasons it's not so good.

MR FRENEY: One solution could be that you could have still the same kind of election processes that we've got now, or nomination processes and choice processes and trusteeship could be a requirement - individual trusteeship could be of attending an industry accredited and APRA approved course in the first 12 months of trusteeship of so many hours of general tutoring of the responsibilities of being a trustee and the provisions of the act and the standards of care that are required and that sort of thing. So you mightn't necessarily exclude people at the initial stage but you would look for them to have some basic understandings and some expertise in the area as quickly as they could possibly get it. I mean, it's probably an imperfect solution but it's the kind of thing that could have - - -

MR COSGROVE: Yes, you would have to have some sort of mechanism like that where they may well be able to operate until they reach the stage where they have to sit that test or pass that test.

MR FRENEY: I wasn't even necessarily thinking in terms of passing tests, but some demonstration of attendance and competence to a certain level.

MR WARD: The other issue on licensing is, how many licences does a trustee need - because with the FSR legislation many trustees are going to need a licence under that. Do we need them to have another licence under APRA?

MR COSGROVE: That's obviously a matter that we'll have to give further consideration to.

MR FRENEY: That's with respect to certain activities I think, is it not, with respect to the - - -

MR WARD: Yes, not every trustee would need - - -

MR FRENEY: - - - marketing of certain products, which is one function. Then there is maybe a rather different function in terms of being a trustee of a superannuation fund. So as John says, we would certainly need to look at the interconnections between the two.

MR COSGROVE: I take it that what we've just been discussing provides the background to a sentence near the top of page 5, where you note that licensing and equal representation may be almost mutually exclusive? Is that more or less what we've been talking about?

MR WARD: I think that was the general context. I mean, we weren't quite sure - - -

MR COSGROVE: I wasn't, yes.

MR WARD: - - - how far your licensing proposals were intended to go.

MR COSGROVE: Yes.

MR WARD: Who they were licensing et cetera.

MR COSGROVE: Well, there are some other matters that we might raise, but I'm conscious of the fact that it's already 2 pm and we're due to be back here in 30 minutes. We and others will need a bite to eat. The lodgment of annual returns issue is one that we have discussed quite a bit already with some other people, although not so much here today. This suggestion you have put forward of choosing a date other than 30 June as to the sort of annual reporting date in principle looks okay, but we understand it's not one that attracts the pleasure of the Taxation Office. They seem to have some serious reservations about that.

MR WARD: They are very loath to approve alternative dates.

MR COSGROVE: Yes, bit of a blockage there.

MR FRENEY: Do you know why that is, John?

MR WARD: I don't know, Roger.

MR STEVENS: I thought it originally started with a desire to ensure that you lined up the time when you could claim a deduction for the employer contribution to the time when it went into the superannuation fund. But since most funds pay the contributions on a continuous sort of basis these days, I really can't understand their objection.

MR FRENEY: After quite extensive discussion with the Institute of Chartered Accountants in Sydney last week, greater use of substituted accounting periods seemed to be a favoured solution, if you will, rather than extending the lodgment period. But we did note that that would require the agreement of the Australian Taxation Office, clearly because of the links back into the Tax Act.

MR STEVENS: We need to sort of smooth the load.

MR FRENEY: Right.

MR COSGROVE: Yes, no doubt about that.

MR FRENEY: That seemed to be one of the key concerns of industry, to smooth the load, to reduce costs and improve standards of accounting and auditing and diligence and just giving people more time to get it right.

MR COSGROVE: I think we might have to call it stumps at this stage. Would

you mind though, John, if in respect of a couple of areas of your submission, we got back to you separately from the hearings and see if - - -

MR WARD: Yes, sure.

MR COSGROVE: I'm not sure we'll need to, but there might be a couple of questions for example on the trustee representation section. I think that's probably the only one, but I think it would be best for all of us now if we take a break. Thanks very much for all the written material that you have provided to us and for this interesting discussion today as well. I'm grateful to you.

MR WARD: Thanks for the opportunity.

MR COSGROVE: We're aiming to resume at 2.30.

(Luncheon adjournment)

MR COSGROVE: We will resume now. Our next participant is PricewaterhouseCoopers. Would each of you, for our transcript, identify yourselves and the capacity in which you're here today please.

MR COOGAN: David Coogan, partner PricewaterhouseCoopers.

MS KEATING: Claire Keating, director PricewaterhouseCoopers.

MR COSGROVE: Thank you. Thanks for another input to our inquiry. I expect you'd like to make some opening remarks.

MR COOGAN: Yes, sure. I guess in principle, in overall terms we're comfortable with the majority of the issues raised in the draft report, from a totality point of view. It seemed to cover a lot of the broader issues and certainly from a PricewaterhouseCoopers point of view in working with our clients it picked up on a number of the issues and concerns I guess that were raised by our clients. So we've very appreciative of that. We think today that two areas that we thought we'd like to spend a little bit more time on are really the whole issue of licensing and capital requirements, and also the issue of lodgment dates for annual returns and in particular SAFS. Would you like us to expand on it?

MR COSGROVE: Yes, go ahead, yes.

MR COOGAN: In terms of the issue of, I guess, licensing and capital requirements from a licensing point of view we would like to see that and the capital requirements looked at as part of really a more comprehensive review. From a licensing point of view I guess we were pleased to see that equal representation was supported within the Productivity Commission report. From a licensing point of view we feel that from an equal representation point of view the current trustee system - we would be concerned, I guess, if the current trustee system was changed. We feel that from a competition point of view that the trustee system does a good job and it isn't anti-competitive. Whether you're a bank, a life company, a fund manager, a not-for-profit corporate fund, industry fund, public sector fund, you can basically operate a superannuation fund.

From a licensing point of view I guess the reality is, there are a number of trustees out there that do not have a lot of qualifications from a degree, whatever, point of view. But they do carry a lot of practical hands-on knowledge which helps keep the system honest and has proved the test of time, I guess. On the issue of capital we think the real issue there is one of distinguishing between capital and operating reserves and I guess sitting back and considering, or putting into context, the whole structure of SIS as to how it was constructed and the thought process put into place behind that, from a capital and operating risk point of view.

To elaborate a little bit further on that, most not for profit funds use outside experts, professional administrators, accounting firms, fund managers, custodians

and so on, and all of those organisations have various capital and operating risk requirements. So if there is a problem, if something does go wrong in a particular fund and there is generally recourse to the various service providers that are providing services to the fund, then we think that's where the focus from a capital point of view needs to be. We recognise that yes, in the current environment there has been a lot of change, rationalisation, concentration I guess in the number of providers in the industry for a number of reasons: (1) because it has become increasingly complex and that in itself carries all sorts of capital requirements.

Those organisations at the moment are required under Corps Law to have various capital requirements to make sure that they are operating, from a solvency point of view, all those different Corporation Law requirements. So at the end of the day we think that that's probably an area that the commission should focus a bit of time on, in terms of what are the capital requirements of all the different service providers that are providing services to the industry? Are those capital requirements adequate, given the level of operational risk that a number of those organisations take on. From a trustee that sort of leads you to the issue of: do trustees need capital? Under SIS, provided the trustees follow due process they have the protection under SIS if something does go wrong to, I guess, use the members' money to correct situations if things do go wrong. Assuming that trustees don't follow due process then they are personally at risk, from a potential liability point of view, and would potentially have - - -

MR COSGROVE: Do you mean in terms of a court case?

MR COOGAN: Yes, or could have recourse on trustee indemnity insurance. So I guess that's the current structure. That sort of does lead into the issue of whether superannuation funds themselves - whether they're not-for-profit funds or for-profit funds for that matter - need to have some form of operational risk reserves, operational reserves, and certainly a number of the not-for-profit funds do have administration reserves, for example insurance reserves, investment reserves for that matter, although in this environment where we've got member investment choice most funds have distributed or used up a lot of their investment reserves as such, but still have administration or operational reserves in place.

So we think that there needs to be a clear distinction between operational reserves and capital and, you know, there needs to be a more comprehensive review process, consultation with the industry, not for profit and the approved trustees and the likes, because I think the approved trustees are also affected by this. A lot of the approved trustees can simply have $100,000 worth of capital effectively plus all sorts of other different things under the SIS requirements. But that does beg the issue of whether that is enough, given some of the funds that they are responsible for. So I think there's a fair bit of debate still to occur in that area.

The other key issue there I guess is the whole issue of the underlying quality of different organisations and superannuation funds, from a risk management point of

point. What sort of processes do they have in place, from a risk management point of view and from a control point of view in terms of how they manage their fund, their different service providers, what sort of reporting is done, the whole corporate governance structure the organisations are operating in the industry. So for example those organisations that do have very strong fund and corporate governance processes in place, strong internal audit functions, risk management functions and so on, compliance processes, monitoring on different service providers, those sorts of organisations that have those tight controls, perhaps they don't need as much capital or operational risk as some of the others possibly.

So that's a very quick summary of some of the issues that we thought that we wanted to expand on a little bit in terms of what we originally put into the Productivity Commission and also the follow-up submission. Claire, I think, will cover the issue of lodgment dates.

MS KEATING: One of the issues is obviously the time frame in which to lodge annual returns which is now four months for APRA funds. Due to the concentration of service providers in the industry this is a quite difficult time frame to meet and we actually question the benefit of that time frame, considering that APRA could obtain information which is unaudited on a more timely basis and members currently are able to receive unaudited information. So the time frame of four months for audited accounts does not actually impact on the information that's provided to members.

So those are, I guess, the two main reasons why we think the four-month deadline does not serve any real purpose. In particular for SAFS, members have access to the information. They typically receive monthly or quarterly reports on a quite timely basis, and from an audit perspective there is actually little opportunity to spread audit work throughout the year because a number of SAFS would receive contributions 30 June or quite close to the end of June and it will have no new members and no benefit payments during the year. So there is very little opportunity to actually spread audit work throughout the year. So from that perspective the requirement to both prepare accounts and have them audited within four months, we believe is a very tight time frame which serves little purpose.

MR COSGROVE: I was interested in - if we might start on these - the issue of lodgment of returns in your suggestion that APRA accept unaudited information in the June quarter as it does in the other quarters with six months for the audited returns. Have you raised that possibility with APRA?

MS KEATING: We've raised a number of possibilities with APRA but not this one specifically. No, we haven't raised it with them.

MR COOGAN: I think it has been raised previously in terms of the lodgment fees as being a way of quickening the process in terms of collecting lodgement fees, and that was through the Institute of Chartered Accountants, I think.

MR COSGROVE: On the face of it it seems to have some merit but I suppose the question for the regulator would again be, is it prepared to wait an additional two months to get the audit information. I don't know.

MR COOGAN: There are a couple of issues in there. One, I guess, is the reality of the situation really is that investment managers - superannuation funds rely on two things from an annual accounts point of view really, two key things: one is they're a professional administrator or, if they're running the administration in-house, to run what they call the vested benefit reports and run the annual review, and before that, they need to know how much they can credit. The other key issue is one of working out what the investment returns and the tax position of the fund is or firming up in a more precise manner, because most funds have interim crediting rates or unit pricing in place which is - you know, they're fairly comfortable that they've got it reasonably right throughout the year but there is sort of a one-off correction generally at the end of the year for most funds. Some funds will do it on a quarterly basis and correct to refine the tax and different things.

But at the end of the day most of the fund managers aren't providing final signed audit accounts until generally late September, so that really only gives trustees a month - and their different service providers - to firm things up. Now, they're obviously working with unaudited numbers but given a lot of funds have, you know, quite a number of different fund managers, not only just local fund managers but also international fund managers, and a lot of funds are now diversifying into other forms of investments, development capital investments, infrastructure projects and different things like that, and there are a lot of valuation issues involved in valuing those types of investments - so all of those things take time. You know, it's not to say that funds in isolation can't meet the four-month deadline but I think the issue is more one of the volume of funds and the concentration amongst a number of service providers to keep up with all that and also the risk of cutting corners and making mistakes if you do push the deadline and concentrate the deadlines too fine.

MR COSGROVE: Is there in your experience a lot of difference between an unaudited set of accounts and an audited set? I mean, obviously in individual cases there will be but, by and large, is there any observation you can make about that?

MR COOGAN: By and large, there isn't. Most funds will have - a lot of funds will have a sort of half per cent sort of operational reserve or investment reserve that allows for, I guess, swings and roundabouts in tax numbers and valuations and different things. So whilst from an audit point of view the auditing profession does pick up a lot of different adjustments, our experience has been that they generally net out and there aren't too many cases where - you know, it might be 1 per cent of cases where you might find that there is a significant adjustment which would have an impact and annual reviews need to be re-run and things like that. But it is isolated.

MS KEATING: Yes, and I guess the other thing we find is that the base numbers may stay the same but the disclosure of those numbers may change which does not

impact on the amount that's credited to the member. So the disclosure, there's definitely often changes in those.

MR FRENEY: From APRA's point of view, if they were getting unaudited accounts within, say, four months, they might be glad to have those in the one sense, that if they could see problems in particular funds from those unaudited statements, then it would allow them to get on with the job of looking into that fund and they'd also know, I suppose, that the members have the information - if it was a SAFS, say. But on the other hand, from the point of view of APRA processing, it may be a bit duplicate for them in that they'd have to ask themselves a question, "To what extent do we rely on a first submission of unaudited accounts and then we're waiting on a second sort of submission of audited accounts within six months." It might be a bit difficult for them to know to what extent do they rely on the first round submission or - so just thinking out loud, I could see that it might be a little bit awkward for APRA to know quite exactly what to do with the first round of accounts perhaps, other than chase the ones that have got some clearly significant deteriorations in them or whatever, or problems in the set of accounts.

MR COOGAN: I would have thought on that that as part of the final APRA return process, you could make it a requirement that there is a reconciliation between the unaudited accounts and the final accounts so that APRA can see exactly what the changes are.

MS KEATING: I guess the other thing is that APRA accept unaudited information, as I understand it, from other bodies that they regulate, so why would they regard superannuation funds as different?

MR FRENEY: Maybe just numbers.

MS KEATING: Yes.

MR FRENEY: And their probably closer relationship to many of the other financial institutions that they audit. We were actually told - sorry, John - we were told in Sydney by the Institute of Chartered Accountants that in some ways the market is beginning to work and that some funds managers are now reacting to market pressures to get the taxation and unit pricing information distributed earlier, although apparently this year there's some signs of laggards again causing problems. But the Institute of Chartered Accountants representative told us that there are some signs of superannuation funds and other investors being a little bit more selective in terms of the service that the funds managers can give in this respect, and so there's a bit of pressure emerging for less delay in the delivery of taxation and investment return data. Are you seeing that as well?

MR COOGAN: Yes, we are. We certainly spend a lot of time with our trustee clients in planning before the end of the year and saying, "We need to collectively get on to our different fund managers and custodians to make sure that we are getting

the information in time and bringing forward valuations," and things like that. A number of funds, I guess, are making it a prerequisite before they appoint or reappoint particular fund managers, that they can provide accurate and timely tax information, valuations within, you know, X number of days at the end of the month. It's moving in the right direction.

MR FRENEY: We had quite an extensive discussion with the Institute of Chartered Accountants in Sydney about this and towards the end of the discussion the consensus sort of seemed to be that there is merit in trying to have as short a submission time as possible and I think came to the view that if you can possibly achieve at four months it is desirable. But having regard to the practical difficulties, a suggestion was made that greater use of substituted accounting periods with respect to the Income Tax Act in preparation of tax returns which are so intimately linked with the preparation of, would be a really good outcome. That was the preferred outcome that if you could get - I think you say the same thing that if you could get more - a substituted accounting period, do you have a feel for - I understand there might be some resistance to this from the Australian Taxation Office which hasn't looked kindly on it. Do you know why and what room there may be for trying to make some progress in this area, what the issues are?

MS KEATING: I think there is an issue on the ATO's perspective that they don't like to grant substituted accounting periods. But I also suspect within the industry that there will be some resistance from funds who are being compared against other funds that are June year ends. You often find that December year end funds when they quote their returns they're not being compared on the same basis as the June year end. So there is actually some resistance in the industry, even though it would be helpful from a lodgment perspective that from a marketing or a providing information to members perspective that there is some reluctance to move to a substituted accounting period.

MR FRENEY: You can't have it both ways.

MS KEATING: Yes, that's right.

MR COOGAN: But it would help if the Tax Office would recognise the situation there. From a revenue point of view the institute and others I think have been arguing with the Tax Office that now we're on quarterly instalments and different things that from a revenue point of view it shouldn't have an impact, or a significant impact from a revenue point of view, by having different tax return dates or reporting dates for tax purposes. But the Tax Office hasn't been receptive to that point.

MR FRENEY: To what extent is this problem a result of the structure of certain approved trustees having very many SAFS? I mean, is it a problem that would be there in any case and where is the main resource pressure, is it on auditors? In other words, how much of this is a making of the structure of some of these approved trustees anyway?

MR COOGAN: Well, I'm involved in one approved trustee that audits thousands of SAFS and the biggest issue is - it depends how standardised the investment options are. If you have an approved trustee that's offering SAFS out there in the market and people can choose just about any type of investment they wish to put into their own personal superannuation fund, then that does generate a lot of complexity from a reporting point of view in terms of collecting information from all sorts of different organisations. So a lot of the approved trustees would literally have hundreds of different fund managers and investment options that people can select from.

So when it's the normal sort of investment managers that a lot of us can relate to out in the market it's not an issue. But once you get into other investment options that's where the problem arises. The other issue, I guess, is the other complexities on the tax side in terms of getting accurate tax numbers, particularly with the unlisted investments, as distinct from a lot of the listed investment managers that are providing the right sort of distribution reports and different things. So that does take a lot of time and effort to manage all of that. A lot of that information you can't plan for ahead of time, you've got to do it after 30 June, so to speak, so it very much is a volume issue. From an audit point of view we work around all of that. The reality is as a profession we have to bring in to the extent that we can people that's worked part-time and different things to handle that peak period between mainly August and September. So I guess from a costs point of view if that was spread further out there would be some potential savings there to the industry.

MR FRENEY: I have a sense that to some extent this problem is partly a creation of structures and desires that certain areas of the industry or certain SAFS are almost a creation of their own making. It's not to say, I suppose, that you should limit their investment choices to fit in with a reporting time frame. But in terms of dealing with the problem there can be some solution to it from that end as well as the regulatory end, it seems to me.

MR COOGAN: No, that's right, but I guess with that comes additional investment, additional capital, to potentially do a lot of those things which would have an impact on costs. So it sort of does beg the question that you do have these SAFS that we're talking about a four-month reporting deadline, but for the Tax Office SMFS you've still got nine months there and really that's linked to a tax return. The reality is, it doesn't matter which camp you're in, you're getting the same information reporting from a member point of view, so why does it have to be four months if it really doesn't matter that much from a total cost benefit point of view.

MR FRENEY: Because you can have arm's length members in SAFS who may not know what's going on in the fund as compared to SMFS where everybody does have an opportunity of knowing what's going on in the funds.

MR COOGAN: But provided they're getting the quarterly, monthly information

which I guess if that's the issue of those members getting the information, then let's make sure that they do get information on a regular basis. That would be a lot easier of going to all the expense and trouble of condensing the annual returns into four months.

MS KEATING: I guess there are a number of SAFS where I guess we could say arm's length members, if we're saying arm's length from the trustee - because you've got an approved trustee therefore by definition you are arm's length - as opposed to, say, a husband and wife in a fund; exactly the same structure with the SMFS in those situations. But no distinction is made between a SAF that has truly arm's length members and SAFS that have just, say, for example, a husband and wife in the fund. There's no distinction made.

MR COSGROVE: I guess the information provision to members is on the part of the issue though, isn't it? APRA wants to get its hands on information as well and that's the nub of the problem it seems.

MR COOGAN: Yes, I guess on that there are different ways of doing that. Like, as you mentioned earlier, if there is a fair bit of concentration in the market through some of these approved trustees in this area, there's nothing stopping APRA from reviewing approved trustees or if the legislation doesn't necessarily allow it, to change the legislation in such a way that APRA could have access to the processes and controls of an approved trustee. That way you can see what's actually going on in a broader context rather than just narrowing it down into individual funds. I think with a lot of these SAFS out there in the market with a number of approved trustees, from a risk point of view the risk is in a small concentration of some of those funds and the effort needs to go into those ones where there are higher risk-type investments - investments in different unit trusts and all sorts of different things. So let's focus on identifying where those funds are and what the risk is and handle it that way. I think that's probably a separate issue to - yes.

MR COSGROVE: Let me go back to the start of your later submission to us, in which you agree with our option 1. We did ask people, to the extent that they can, to try to indicate priorities amongst a number of those proposals encompassed in option 1. Have you given any thought to that - you know, the age contribution and cashing out rules, the small account balances, lost members, non-resident accounts - I have forgotten what else. Are you able to help us there, in terms of an indication as to which you think are most troublesome for people complying with the legislation?

MS KEATING: I think one of the - definitely the age requirements would be one that we would put on top of the list as being unduly complex and relatively easy to simplify.

MR COOGAN: The overseas non-resident - we wouldn't worry about a dollar limit. We would make sure that money is being transferred into another fund offshore - and provided it's going to an offshore pension-type fund.

MR COSGROVE: We had a discussion before lunch - I think it was with William Mercer - about possible tax revenue risks associated with such an approach. Their view was basically that it's not a very big risk because there are some seemingly substantive taxes levied on contributions which are withdrawn I think before age 55. Is that lying behind what you were just saying in terms of don't really need a limit?

MR COOGAN: Yes.

MR COSGROVE: Okay. Licensing and - well, capital requirements first. You have given us a bit of an account of your views there, in your opening remarks. Yes, I can see it makes sense to address the question in a broader way than in a sense we did. I think there's some structural tidying up of our report which we'll undertake in the final report which will bring together the notion of, if you like, substance capital, the NTA requirement if I can use that phrase, and the working capital arrangements. We had confined the substance capital to approved trustees, so that anyone operating on another basis would only have to have working capital.

Now, I think you've told us a little bit about how you see the working capital operating, with reliance in some cases on capital held by service providers of one kind or another. That might work, but the trustees themselves have ultimate responsibility so they would need to be pretty confident that whatever operating capital the administrators and custodians and so on had was likely to be sufficient to meet any system failures. It may still be a question, in other words, as to whether or not the trustees themselves mightn't have some operating capital or another proposal, which was also raised with us this morning - was a notion of insurance cover held by trustees. If you have any thoughts on the insurance arrangement I would be interested.

But then so far as the approved trustee's substance capital is concerned - I mean, it seems to us there's a situation of that type in place at present. We were really questioning, as an entry barrier issue - or an entry requirement issue I should say - whether an approved trustee should be able to operate without any substance capital of its own; ie, rely on the custodian arrangement. Do you think that's adequate for the purposes of approved trustees?

MR COOGAN: No. I guess in our experience, from an accounting audit point of view with a lot of funds, the reality is there is a lot of operational risk out there in administrating funds. Things can go wrong in benefit payments. They can go wrong in processing of contributions, in allocating investments in a timely manner based on the choices of different members - from the membership - under an investment choice arrangement. So there are things that can go wrong. Our firm view is that organisations that are responsible for those services need to have adequate capital in case something does go wrong.

MR COSGROVE: Sorry, I'm not quite sure I'm with you. You seem to be talking

again about the people who provide services to trustees, rather than the trustees themselves.

MR COOGAN: Rather than the trustees themselves, yes.

MR COSGROVE: So you don't really see a need for an approved trustee - - -

MR COOGAN: Trustees?

MR COSGROVE: - - - or any trustee to have capital in its own right?

MR COOGAN: Well, in terms of approved - I guess, yes, okay, in terms of trustees it really depends whether those trustees are providing some of those services themselves and really engaging in taking on operational risks themselves, as distinct from outsourcing. I guess it really gets down to that issue of what sort of due diligence process, initially and ongoing, is in place in terms of those service provider arrangements; what sort of monitoring is in place to make sure that their service providers still have enough capital, are operating profitability and, if not, they're putting more capital in to cover the operational risks of running that particular business.

MR COSGROVE: Yes, I guess we have still got a question in our minds as to why any superannuation trustee should be able to operate without some capital of its own. No other part of the financial sector can do that. This is a sector where investments are growing very rapidly. It's already I think something like 20 per cent almost of total private sector wealth tied up in superannuation, yet anybody can pretty well walk in off the street - having satisfied APRA in terms of the disqualified person test - and away they go. Does that seem sufficient?

MR COOGAN: Yes, well, I think our view on it is it really gets back to the structure of SIS and where are the risks in trustees operating a fund, whether you're an approved trustee or not an approved trustee. So from an investment point of view, provided the money is invested, under section 52 of the act, in a prudent way, taking into account all those different considerations, then from an investment risk point of view the only real risk is, do the assets exist, do the investments exist.

Now, if funds have custodial arrangements in place - I'm not saying that all funds have custodial arrangements in place but most funds, if they invest through different investment managers, there is an underlying custodian involved with each of those investment managers - or funds may have a master custodian, in which case there is that control mechanism in terms of managing and there's responsibility there. So the trustee has recourse on the custodian or on the manager if there's a problem from an investment management point of view.

The rest of the risk is really one of valuation - credit risk and valuation risk - in the market. I guess we all know that markets can go up and down. So really our

view is that if you look at SIS, provided trustees do their job in terms of selecting managers, investing the money appropriately, it really gets down to valuation risk rather than existence and ownership of different investments.

MR COSGROVE: There are a few assumptions along the way there though, aren't there?

MS KEATING: I guess the other thing we would say is that in terms of setting some sort of capital requirement it shouldn't be, "This fund is this size and therefore has this capital requirement," without looking at the structure of that fund and does this fund, for example, administer internally and therefore does it have greater operational risk than one that outsources? So it shouldn't just be a matter of looking at a fund and just saying, "Okay, this particular capital requirement will relate to this fund," without understanding what is behind the way that fund is structured. So it's not as simple as applying some percentage of operating costs or percentage of fund size.

MR FRENEY: That becomes difficult. You might see a sort of a different shaded approach for, say, operating capital requirements according to the nature and the circumstances of the fund.

MS KEATING: Yes, that's right, and I think that we would support that to be the case, that there should be different requirements because they are bearing different risks. I mean, ultimately they're bearing the same risk but how they defuse that risk can be different.

MR COOGAN: But again if you get down into the issue of investment reserves rather than capital.

MS KEATING: Operating reserves.

MR COOGAN: Yes, operating reserves or investment reserves.

MR FRENEY: It seems to me that you could have a relatively small fund that outsources all the functions, so it's a shell entity. Now, one of those functions may collapse that it's outsourcing, say the administration because the administrator gets a new software package that won't run that particular fund and you suddenly have to find a new administrator with a new software package. You've got to unscramble some wrongly credited moneys and you start to unscramble. I can't help coming back to the point that the trustee entity itself should be able to access some money quickly to be able to deal with a situation that needs to be dealt with quickly, or you simply get compounding problems developing as time goes by.

Now, one way of doing that of course is to, I suppose, raise the administration charge against member accounts or realise some assets to cover the cost of immediate operational requirements. But do you have a comment on that and how

would that work in practice? Can a shell trustee find some money quickly if it needs to address that kind of problem, for which it is ultimately responsible? It can't necessarily rely on recourse on a custodian or an administrator fixing it quickly.

MR COOGAN: Yes. I guess when situations like that do arise the trustees do need to have access to members' money to actually transition to another administrator and in the process they've still got recourse to the previous administrator. Now, as to how much they can potentially recoup becomes an issue. But at the end of the day they'd be dipping into any reserves, operational reserves, that they may have for situations like that. If they don't have reserves then yes, it's really coming out of members' money through potential additional levies or expenses being charged to the members.

MR FRENEY: It sort of raises the issue as to whether it's better to have a pool of operating reserve readily available to handle emergencies, a sort of disaster recovery situation.

MR COOGAN: Yes.

MR FRENEY: Or whether you can do it better by taking it out of members' accounts quickly. I don't know whether you can take money out of members' accounts quickly if you needed to.

MR COOGAN: The trustee has powers under SIS to, I guess, increase administration expenses and effectively that comes out of members' money. So that's nothing under SIS that stops them from executing their duties to protect members' money and to keep the administration going and that. I think potentially what we're talking about here is having capital for the sake of having capital, quite frankly. We could end up with a situation where all funds have capital and it just sits there unnecessarily and I think we're really talking about isolated cases of things going wrong. I think we need to sit back and put it all into context.

Now, each fund is different. Each approved trustee is different. Funds these days do spend a lot of time, from risk management point of view, understanding what their exposures are and, you know, if they are, for example, 100 per cent outsourced to different service providers and a lot of them do recognise that things do go wrong and they do have operational reserves in place for a rainy day, just in case things do go wrong. Other funds feel that, based on their structures and the way they operate and where their money is invested, the types of investments that they're in, who their administrator is and different things like that, that they don't really need too much in the way of reserves to cover unforeseen circumstances. There are straightforward accumulation funds rather than necessarily complex or hybrid type funds with an mixture of defined benefit pensions, member investment choice with all sorts of different unit pricing systems. A lot of it gets down to what sort of fund are we talking about and what are the risks.

MR COSGROVE: I have a question about your remarks in 6.6 of your submission on successor fund transfers. You end that section saying as an alternative approach, "Trustees should be required to demonstrate due process in using these transfers." Do you have anything particular in mind about the nature of the due process or simply showing that the trustees have consulted properly with members or their representatives? I wasn't quite sure what that was including.

MR COOGAN: No, I guess our point there was really that, you know, don't just look at the legal side. What's involved in a successor fund transfer is that the old trustees need to be comfortable that where their members are going to is as good as or better than what's currently being provided.

MR COSGROVE: Yes, I've forgotten the phrase, something to do with benefit.

MR COOGAN: Yes.

MS KEATING: Equivalent.

MR COSGROVE: Equivalent rights, is it? Yes, that's right.

MR COOGAN: So our point there is, what sort of process has the trustee been through from, I guess, a due diligence point of view, rather than just looking at the legalities of the transfer? So looking at the investment options, what's happening from an administration point of view, whether the level of service or the service standard is as good, the insurance arrangement is as good, what's their stacked-on cost? You know, what impact does it have from the employer point of view? Are there any surplus issues, reserve issues, what's happening with reserves and surpluses and things like that - the whole quality of the service and communication, rather than just focusing on the legal side.

MR COSGROVE: Thank you. I think that's all on that page. On the next page this question of - you've called it approved financial auditor. I think that was probably our suggestion, that people other than approved auditors might do compliance audits. Is that it?

MS KEATING: Yes.

MR COSGROVE: We had some discussion in Sydney on this matter and some interesting points were made, I think rather along similar lines to those you're making here, that there's already a fair degree of synergy in a sense between a financial audit and a compliance audit. Is that the case? So it's not as obvious as might have been thought at first that you can conduct these separately and through increased competition on the supply side, perhaps reduce costs to members.

MS KEATING: There are a number of areas that would be looked at as part of the financial audit, that would also cover some of the SIS compliance, and some of the

things I'm thinking about there are whether a fund has borrowings. From a financial audit perspective that would be covered. Some of the rules in relation to investments you would be covering as part of the financial audit and therefore to add them on as a compliance audit is not a significant extra piece of work.

MR COSGROVE: But there are a number of other elements of a compliance audit I think which are essentially testing whether certain tasks have been performed.

MS KEATING: Yes.

MR COSGROVE: But you don't think that latter group is sufficient in itself to make a separate compliance audit operation economical?

MS KEATING: I guess that's probably a decision for the trustee and some trustees do have some compliance functions reviewed by their legal advisers. But in terms of whether that should be a requirement or whether it's likely to add any benefits as opposed to the cost, I don't believe so. I guess the other issue is, from APRA's perspective they check whether the auditor is a registered company auditor, what sort of reviews or what sort of comfort would they want to get on behalf of a legal adviser carrying out some of that work.

MR COSGROVE: Well, I guess it's not very different from what they do in the case of the accountants. They just declare a certain category of membership of authorised associations to be of sufficient qualification to undertake the work. I don't know, a member of the Law Society, or whatever it is, could be a similar vehicle used by APRA.

MS KEATING: APRA actually do - the auditor provides the auditor registration number and as I understand it, APRA confirms that that person is properly registered. I don't know how that would work on the legal side.

MR COOGAN: There's probably a couple of other issues in there. One is, in auditing a superannuation fund you do get down into the administration - as part of the audit you're working on administration systems, so you're testing the processing of contributions, benefit payments and things like that. That's really the control environment of operating a superannuation fund, and from a compliance audit point of view, when you're doing that internal control testing which I guess you could say is financial audit related, you're also testing compliance with SIS in terms of all the regulatory requirements to deal with processing the contributions and paying benefits. So there's the potential for overlap if they are separated, I guess.

I guess in practice in a lot of ways they're very much integrated and a lot of funds are also - there's nothing stopping funds and a lot of funds already use other people besides auditors to check compliance.

MR COSGROVE: But in the end on any approval - - -

MR COOGAN: But in the end the auditor has to review that work that's been done by others, whether it's compliance officer or other internal audit people or whatever, in forming an opinion on compliance and retesting, things like that.

MR COSGROVE: I didn't quite follow what you were driving at in the next point where you thought that the changes we'd suggested would be immaterial and pose - or open up the process to new risks, eg, old accumulation plans. Could you explain what's involved there? I think this may relate to the issue of whether or not actuaries should be required by the legislation to do their work on accumulation funds as distinct from defined benefit funds. Is that right?

MR COOGAN: Yes, that's right, and whether administrators or accountants could do a lot of the work on accumulation funds.

MR COSGROVE: Yes, that's right.

MR COOGAN: The point that we were trying to make there is that a number of the accumulation funds aren't fully vested. There are vesting scales involved in a number of accumulation funds that are linked to years of service. So from an actuarial point of view there are different levels of discipline and history involved in some of these accumulated funds.

MR COSGROVE: These are typically older plans.

MR COOGAN: Yes, traditionally older plans. So you get into the situation where you've got hybrid funds with a mixture of defined benefit and accumulation, so it's better to have someone that's got the total picture as well. The other thing I think is - I'm not sure that - we've got to be clear who's responsible for what and different roles. I think the role of the accountant and auditor is really to make sure that the investments are there, that they're properly valued, the tax is taken into account and so on, to come up with the net asset position of the fund. Determining crediting rates and things like that which is indirectly what we're talking about here, there is some complexity even in accumulation funds on how to credit member accounts. So we very much thought that there is definitely a role there for actuaries.

MR COSGROVE: Even including in, what you might call, new accumulation plans?

MR COOGAN: It really gets down to the complexity and the size of some of those accumulation plans.

MR COSGROVE: Thank you. I think unless you wanted to tell us anything more we can conclude our discussions. Is there anything else that you had on the slate that we haven't discussed?

MR COOGAN: There's only one point, back on 6.3 with policy committees, one point there I think is given the changes in the market the role of policy committees is becoming increasingly important and we as a firm feel that the role of policy committees will change over time. As we see more larger corporates outsourcing I think historically what's happened with policy committees is that they have catered for, I guess, a lot of the smaller corporates. But as we see larger corporates outsourcing, we feel that the role of the policy committee is going to become increasingly important and it shouldn't be used as lip service. There is a real role there to make sure that the master trusts and the industry funds or whoever the approved trustees are, are being appropriately monitored - not to the same extent of having a separate trustee board but in making sure that the service standards are right, that they are being benchmarked; communications hitting the mark with members and is representative of particular corporate members rather than necessarily generic; that the investments and investment performance and management of the investments is being properly benchmarked and communicated through so that it is being prudently managed. They're just a couple of things. We feel that's an area that APRA and others need to start to focus a bit more attention on as the market is changing.

MR COSGROVE: Thanks for that.

MS KEATING: Thank you.

MR COSGROVE: Thank you for making your valuable time available for our inquiries.

MR FRENEY: And also for getting your group together fairly early on in this process. We found that the feedback from that group, as well as from yourselves, is very valuable, so thank you for that as well.

MR COOGAN: Thank you.

MR COSGROVE: Our next participant is the Law Institute of Victoria. For our transcript, would you please identify yourself and the capacity in which you're here with us today?

MR NELSON: Yes, Mr Chairman. Frank Nelson, I'm the general manager superannuation of the Law Institute. I suppose I'm wearing two hats, however. The Law Institute is the administrator of two legal profession funds. It also, however, has a committee of practitioners - the superannuation committee - which meets regularly and develops views on superannuation, where it should go and - - -

MR COSGROVE: General policy issues related to - - -

MR NELSON: - - - generally there. So I'm here in both capacities in a sense, Mr Chairman. The second one in particular is dealing with the final page of my written submissions, where a number of the issues that have been raised in the draft recommendations are canvassed. The principal matter of this paper concerns, however, draft recommendations 4.1 and 4.2.

MR COSGROVE: Yes.

MR NELSON: Those are the ones that I will be mostly focusing on in the present context. As I indicated during the intermission there, David Coogan has more or less said what I would be saying in that regard, from the point of view of funds which are not for profit funds. Both of ours are in that category. That's spelt out in the paper and I don't think it's necessary to go into it now.

MR COSGROVE: We have read the paper.

MR NELSON: But broadly speaking, we have two trustee companies, which have very helpful and useful and informed boards of directors but no assets, no income and no profits. From that point of view we would find it very difficult - and I'm sure many other people are in the same boat - would find it very difficult to meet a requirement of having some mandatory asset backing for the trustee company itself. The fund of course has many assets.

That's the major concern that we have. We feel that the draft report has not perhaps focused adequately on the difference between the not for profits and the commercial funds. Obviously if you are a commercial fund running your own operation you will need capital to do it. In our case, and I think in the case of most funds in our position - although David Coogan's remarks are very apposite. Every fund is different. But looking at people who are in the position of our funds anyway, operations are outsourced. We have an administrator, which in this case is the Law Institute itself, and it has been doing that for the last 40 years. There is an investment consultant who advises us on our choice of assets. We follow that advice religiously. I can't recall any case where we have failed to do that. It's Mercers, in our particular case. Investments are all made in pooled vehicles, PSTs or other such funds.

So the trustee itself is simply there to make the basic decisions, on advice invariably. With due modesty, we believe it operates very effectively and we have done very well for our members. We're in the happy position that, like the industry funds, we can concentrate simply on the members. We don't have to worry about making profits for shareholders. We don't have to worry about making enough money to pay the planners and other salesmen who sell the commercial funds for their own commission. So that saves quite a lot of money for the members.

I think the commission is aware of the work that was done not long ago by Hazel Bateman on comparisons of industry funds, or not for profits as I would call them, and the master trusts, where she indicated that over the life of an account the administration costs of the master trust - small master trusts anyway - were more than double those of that of an industry fund. We're trying to help our members.

This is where the capitalisation requirements causes problems, because in our trustee structure we have no use for capital. We wouldn't know what to do with it if we had it. I guess we would have to invest it, but we don't want to take the punt of having an investment that might not produce enough money to service the investment itself, because who's going to invest in us and - we're not a good risk. That's the basic concern that we have in all this.

Our belief is that funds of our kind do a very good job for the members and we would like to continue doing that, within the structure of a mandatory capitalisation, be it $2 million, $5 million, whatever - whatever Mr Hockey might have in mind at the moment. It just does not fit with that situation.

I have not in the paper indicated that I thought APRA should have some discretion in these matters, but I would have thought it certainly is an option. Again quoting David Coogan, every fund is different. If APRA can look at the good performers and the bad performers and make a judgment and is prepared to do so, that might be an answer to the sort of things that concern me. I don't think I need take the commission's time much more on that. You have already heard it.

MR COSGROVE: Yes.

MR NELSON: Is there anything on that aspect, Mr Chairman, that you would like me to develop?

MR COSGROVE: Well, I think there are a couple of questions. Perhaps one factual question concerns the nature of the membership of your funds. I take it that you would probably have people other than professional lawyers as members, would you?

MR NELSON: Yes.

MR COSGROVE: Secretaries and filing clerks and - - -

MR NELSON: Well, sorry, we have two funds. One is an industry fund, which is the legal industry superannuation scheme. The other is a self-employed solicitors fund.

MR COSGROVE: I see.

MR NELSON: Victorian Solicitors Superannuation Fund. The latter is purely lawyers. It's a small fund and what its future will be is still being worked out.

MR COSGROVE: Yes, I see. But the larger, more recent fund is - - -

MR NELSON: This, yes, is a mixture of lawyers and law staff.

MR COSGROVE: Office staff, as you say. Yes, well, it was on the basis of that nature of the membership that I was wondering - at least in terms of our suggestion for operating capital to be held by all trustees - that you're operating a fund which, as you say, has no capital. The institute itself, which is the trustee and the administrator - - -

MR NELSON: No. The institute is the administrator.

MR COSGROVE: Yes.

MR NELSON: We have a service agreement with the trustee corporation.

MR COSGROVE: Right, okay.

MR NELSON: The trustee company has a board of nine, four nominated by the institute, four nominated by the ASU, and an independent chairman.

MR COSGROVE: I see, yes, okay, and no assets.

MR FRENEY: Could I just ask in that respect please, in a sense would that be categorised as an employer sponsored fund?

MR NELSON: Yes, technically it's an employer sponsored fund.

MR FRENEY: Right, having the equal representation - although in a sense there's not one employer - - -

MR NELSON: Well, the same with any of the industry funds.

MR FRENEY: Industry funds, that's right.

MR NELSON: They're all in that structure.

MR FRENEY: Yes, thank you.

MR COSGROVE: Even so, I think my question was whether, under this arrangement, there mightn't be a case for some capital coverage against risks of operating failures on the part of the institute in its role as administrator. It's not as though, in other words, you are relying - I realise you have an external custodian.

MR NELSON: Yes.

MR COSGROVE: But apart from that, all the administrative functions of making sure contributions go to the right accounts and that the computer programs are operating as they need to that coverage against those risks might make some sense in your case. If something goes wrong - maybe it doesn't or hasn't, but if it did - how would you cover the costs of putting things back on track. Would that just be a reduction - - -

MR NELSON: This would be the responsibility of our administrator which in this case is the Law Institute, and the trustee would hold the administrator to its contract to perform. We have of course risk control arrangements in place which are regularly monitored by the trustee, but basically is the administrator is unable to perform, the trustee will hold it to account.

MR COSGROVE: The Law Institute as the administrator would bear the cost of putting that right.

MR NELSON: Yes.

MR FRENEY: This opens up in a slightly more general way a case of administrators who may not have the wherewithal to deal with a disaster. I'm ignorant, frankly, as to what their indemnity in insurance arrangements are but there will be other players in the superannuation as you yourself were saying a minute ago. There's all sorts of different kinds of superannuation funds and service providers and one of the difficulties of legislation, I guess, is to casting legislation in a way that can apply to all or that gives the regulator some discretion to accommodate different circumstances. But I guess one of the things that's in the back of my mind is that the trustee is ultimately responsible. It can put the onus on its service provider to provide the service but sometimes these situations break down big time and you then ask the question, how is it going to be fixed up?

I have seen the odd occurrence of that which is sort of one of the arguments really underlying that the trustee should have some ability to deal with, say, disaster situations. So, as I say, most unlikely to apply in your circumstances but these are the sort of circumstances that somehow have to be provided for, either in the law or by a regulator.

MR NELSON: I would have thought that - well, again as David Coogan was saying - at the end of the day if the administrator proves to be a man of straw or something and of no use to the members from a recovery point of view, the trustee has to operate the fund - and here again I'm looking at an accumulation fund - and whatever expenses have to be paid would have to come out of the fund. Yes, it would end up at the doorstep of the members, but there are only so many options. But I would have thought that if the members were given the choice of having capitalisation of the trustee for which they would bear the cost as a certainty or the possibility that they might have to have an administrator who falls over and expense incurred that way, they would probably go for the latter case, because it's wasted money.

MR COSGROVE: Yes, although you have a little bit of arithmetic in your submission to us saying that a capital requirement of $2 million would cost your members of the main scheme an additional $119 per year.

MR NELSON: I think that actually was VSSF News.

MR COSGROVE: The VSSF, yes, sorry. Well, one wonders whether - that's right, it's the original scheme - they might not think that wasn't a relatively small cost for the additional security - you think not?

MR NELSON: Well, it would make their MERs quite high. We are in competition with all these other people out there too.

MR FRENEY: It's true that it would add to their MERs but it also seems that when superannuation fund members face capital loss, they have a huge aversion to that, and scream blue bloody murder when it happens. You can see how risk averse they really are when it comes to potential capital loss. So it's a nice question and I don't know the answer to it as to how much higher an MER they would be prepared to countenance for some extra protection of their capital.

MR COSGROVE: Also in terms of the LISS scheme which has many more members, presumably the cost per member would be that much lower.

MR NELSON: Yes.

MR COSGROVE: You may have heard us asking PricewaterhouseCoopers whether there was something odd about a superannuation fund managing substantial amounts of money - as your LISS one does at least - $142 million last June, operating with a share capital of $2. It seems that you might like a little more capital backing when you have exposure to the management of that amount of assets. Superannuation, as we said, seems to be the only part of the financial sector where such an arrangement is possible, and we wonder why that should be so.

MR NELSON: To some extent of course it is historical. It's the way these funds were all structured by the legislation in effect. You were required to have a corporation to come within the corporations power of the Commonwealth. But it works, and not that many have fallen over. Granted one of our confreres in Queensland did and hopefully we can draw some substantial distinction between themselves and ourselves. But by and large - and I think this is the view that APRA takes - you've got, what, 1 per cent perhaps of funds in the at risk category from their point of view and it therefore seems strange to me that you put an arbitrary capitalisation requirement on the 99 per cent when you could very easily segregate the at risk ones with a borderline, which in fact is what I have suggested in the submission here.

MR COSGROVE: Could you transfer that approach though to other sectors like banking or life insurance where again, with very few exceptions, failures are rare yet they have to hold substantial amounts of capital.

MR NELSON: That could be. I wouldn't like to express a view. It's outside my normal purview.

MR FRENEY: I suppose your comments are very interesting and it just makes me think out loud that in a sense SIS does have a differentiated approach now with respect to for profit, if you will, in terms of the approved trustees offering public offer funds or retail funds as they are known. So there are certain capitalisation requirements - the 5 million NTA, although our report comments about that. But there is a differentiated approach at least with respect to that for-profit segment and the not-for-profit segment which doesn't have to hold any net tangible assets or have a custodian that does have to do so. There is a differentiated approach. I was sort of thinking whether there's not a possibility of retaining that basic difference but bringing some more refinements into it in terms of operating capital or whatever. But then my mind really turned to the point that, as you were saying, APRA feels that the problem area is within some of the smaller corporates which they themselves are not for profit.

If they're the relatively high-risk area and you saw any merit in having some kind of risk based requirements for them, such as operating capital or investment risk protection perhaps, if you started to have a differentiated approach you would be beginning to get a differentiated approach within the not-for-profit sector, if you will, the smaller corporate super funds versus the industry funds and funds such as your own. So it would be coming to sort of strike a differentiated approach within the not-for-profit sector. Whether legislation could accommodate that or whether that would be left to a regulator is something to reflect upon. I'm sorry, I was just articulating some thoughts there I don't necessarily expect you to react to, but it was just an opportunity to reflect.

MR NELSON: No, it's a very real issue of course and any borderline that one draws is arbitrary. It's not going to fit everyone. But APRA seems in the past to

have developed an approach that attempts to accommodate odd people such as ourselves, which worked and I think our concern is that in the enthusiasm to adopt new rules we wouldn't wish to see effective and efficient funds such as our own being ruled out of the field, simply to meet an arbitrary criterion, a procrustean bed across the industry. That's what it's all about.

MR FRENEY: I was interested incidentally just in a point of detail, that APRA exercised discretion that the administration company was able to hold the liquid assets and eligible asset requirements which seemed, by the normal standards and the requirements of an approved trustee to be a relatively generous concession on APRA's part, acknowledging I guess the merits of what you were saying.

MR NELSON: Well, yes, but the administrator has got to put things right if they to wrong.

MR FRENEY: Yes.

MR COSGROVE: Yet APRA doesn't take that approach with most such trustees.

MR NELSON: I see.

MR COSGROVE: Who may also use administrators.

MR FRENEY: Because it comes back to the basic concept in law that it is the trustee that is the responsible entity, so that there can be delegation but delegation does not absolve the responsibility of the trustee, so all interesting.

MR NELSON: But the trustee, if it makes its outsourcing arrangements properly and with due recourse against the administrator, it is suggested, should effectively be able to pass that requirement to the administrator and to rely on the fact that the administrator is liable to come to the party if things go wrong.

MR COSGROVE: The SIS Act I think requires every trustee to have a signed contract with an administrator. Now, whether that contract is required to include a clause on recourse I'm not sure. But it just, as Roger was saying, surprised us that your VSSF has this special arrangement, which we hadn't seen in our, admittedly limited, purview of individual funds.

MR NELSON: I hadn't realised we were special.

MR COSGROVE: Yes, so it seems. So there's this element of discretion apparently available to the regulator which might very well suit many, if not all funds, to have this particular capital requirement placed on their administrator rather than having to carry it themselves. Yet, you know, our general impression was that most of them do carry it themselves. I guess it again raises the question of general versus specific rules for individual funds. There are differences between funds

certainly but there are also many similarities. Yes, it's of interest.

MR FRENEY: Could I ask you a question - and I should know the answer to it, but I don't - whether you are required to have a disaster recovery plan as an approved trustee, say?

MR NELSON: We as a trustee?

MR FRENEY: Trustees, yes.

MR NELSON: In fact both trustees do.

MR FRENEY: Yes. As an approved trustee, it would be part of your licence to have a disaster recovery plan.

MR NELSON: Yes.

MR FRENEY: Probably which also is audited?

MR NELSON: Well, they are audited, yes.

MR FRENEY: An external auditor would see that it is part of its compliance audit, I would imagine, yes. As a trustee of the other fund, do you happen to know whether there's a requirement to have a disaster recovery plan?

MR NELSON: I don't think there is a legal requirement, but in fact the trustee requires it.

MR FRENEY: Just toying with ideas to see whether another possibility would be if you didn't require to have operating capital there could be a disaster recovery plan requirement.

MR NELSON: Yes.

MR FRENEY: And I've thought in the past, part of which could be to have certain line of credit arrangements available that would - - -

MR NELSON: Yes.

MR FRENEY: Now, you have to pay money to have a line of credit of course, so that it's not free. But rather than having operating capital sitting there unwanted and unloved and not servicing the members, another possibility may be to have a - rather than having an operating capital, having a disaster recovery type concept and lines of credit etcetera. But as an approved trustee you do have to have a disaster recovery plan?

MR NELSON: Yes. The line of credit thing is not one that I've focused on before. But I would have thought that yes, it made a lot of sense. Our practice, or it's required by our service agreement, but the administrator in fact reports quarterly to the trustee on the disaster recovery plan and, in effect, asks the trustee to have a look at it and say whether they're still happy with it.

MR FRENEY: In a previous incarnation I've thought about this and I think it as dismissed for various reasons about cost of having one and then whether it really is guaranteed that you would get credit from the line of credit and such issues were raised, challenging the effectiveness of lines of credit. But it's perhaps not an option that you would entirely dismiss.

MR NELSON: By no means.

MR FRENEY: Thank you.

MR COSGROVE: I don't think I have any further questions either. Is there anything else you wanted to draw to our attention?

MR NELSON: No, I don't think so. As I did indicate at the outset, on page 15 there the superannuation committee's happiness with most of the recommendations is expressed. We have not, in that list, mentioned the requirement for an annual general meeting of members. But the feeling at the meeting on that subject was in fact that perhaps it should be in the event of demand by a member for such a meeting rather than committing the fund to have it year by year and perhaps two people turn up or something. But subject to that, no, it all seemed to make very much sense to us.

MR COSGROVE: There was one other thing I was going to ask you. Are you familiar with the superannuation fund arrangements by your counterpart institutes, or whatever their name might be, in other states? Do they operate with a similar structure?

MR NELSON: I know New South Wales does, the list fund. Elsewhere no, I'm afraid I can't be specific.

MR COSGROVE: No, that's fine. Thank you for drawing your interesting case to our attention. Thanks for coming along. That concludes our proceedings for today. We're resuming at 9 am tomorrow, thank you.

AT 4.10 PM THE INQUIRY WAS ADJOURNED UNTIL
WEDNESDAY, 31 OCTOBER 2001

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