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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 WEDNESDAY, 31 OCTOBER 2001, AT 9.02 AM

Continued from 30/10/01

MR COSGROVE: We will resume our Melbourne hearings now. Our participant this morning is the Corporate Super Association. Would you please identify yourself for the transcript, Mark, including the capacity in which you're appearing today?

MR CERCHE: My name is Mark Nicholas Cerche. I'm chairman of the Corporate Superannuation Association.

MR COSGROVE: Thank you. Thank you for your further submission to the inquiry. Would you like to make any remarks in connection with it?

MR CERCHE: I think the submission puts our position briefly, and I don't think there's any need to elaborate, except to say that in respect of not-for-profit superannuation there are various categories of it, and that has to be recognised. There is what I would call categories which are established for the purpose of providing retirement benefits and have been organised that way for many many years and have a history of good returns, low costs and relative safety. There's another category which has been permitted to exist under the regulations, and has in fact been protected by the regulations in many respects, and that's the smaller end, if you like, of the not-for-profit organisation where there is some confusion as to the basic objectives of what the fund is all about.

My organisation represents the first category, and is rather proud of the fact that it represents perhaps the most efficient delivery of retirement benefits in the Australian environment; efficient in the sense that it produces consistently higher returns than any other sector at a significantly lower cost, and in what I call the properly organised corporate superannuation arrangements there has been to my knowledge no failure at all. Failures which have occurred in my opinion are referable to two categories: the first category is a failure to diversify investments and to take advantage of rules which allow income-producing property to be held by a fund where it is used by an entity which is related to the fund, which is a very risky enterprise indeed, but any small fund which holds a lot of real estate is also in that position.

So the problem in that area, I think, is one of rule and it would be a relatively simple matter to prescribe restrictions which would not allow such investments to happen. In my area there are very large holdings in real estate and infrastructure projects and the like, but they are not in any way connected with any of the employer sponsors in any meaningful sense, so that the prudential double-whammy risk isn't there.

The other area of failure is, I think, where operators - and I call them operators - are in the superannuation industry to make gains which are not contemplated by the rules. We go close to fraud or other activity, which is certainly not consistent with the basic principles on which these funds are supposed to be managed, and where that happens and there's a failure, then people say, "Well, why is there a failure?" The answer is the rules haven't been complied with. That's an enforcement issue.

The Corporate Superannuation Association's position is that a properly organised scheme should be allowed to continue to exist in the regulatory framework which currently exists.

That model has produced consistently better returns and at lower cost and, with the benefit of some work done by a lady called Hazel Bateman, it's been demonstrated to us that the higher end of the corporate system is at least one percentage point better on the cost side than the retail markets, and the outworking of that over a 30-year career is a 20 per cent higher benefit, which is significant. So the cost of the for-profit as opposed to the not-for-profit sector, properly organised, is in the region of 20 per cent of benefit, which is a scary figure. Ms Bateman's figures also indicate that the Australian retail superannuation industry is the most expensive in the world, which is a worry, and no doubt market forces will affect that from time to time, but at the moment that is clearly and demonstrably so.

The Corporation Superannuation Association's solutions to the problems, which perhaps the prudential regulators are grappling with but not necessarily a primary concern to you, is to simply prescribe rules which restrict in-house asset or associated investments and, in the case of funds below a certain level, not to permit the responsible entity to do the investment process at all; require them to outsource that type of activity and, if there's a fear on the administration side, to require such funds to outsource administration. The advantage of continuing that model is that it will be less expensive than the other, because there will be somebody there who is watching the costs and who is protecting the members against costs which, dare I say it, doesn't seem to abound in the retail sector in this country at the moment.

That, I think, summarises our position as best I can. I'm happy to take any questions that you would like to put to me.

MR COSGROVE: Thanks very much, Mark. You mentioned early in your remarks this morning some notion of confusion about the purpose of the small end of the corporate super fund market. What did you have in mind there?

MR CERCHE: My mind was directed primarily to an example where the trustees of a fund decided that it would be a good investment for the fund to invest in purpose-built real estate which is to be occupied by the employer sponsor. There's a confusion there as to what we're doing.

MR COSGROVE: Misconstrued investment strategies.

MR CERCHE: Yes. That was essentially a confusion as to what we were doing and rolling the two up. It's a confusion as to whether we're investing for the benefit of members or whether we're investing for the benefit of members with a side advantage to the employer sponsor, and when you get that confusion you invariably get problems. But I also would say, in relation to that particular investment strategy, had the real estate been occupied by another employer sponsor, it would have been

just as risky because if the other employer sponsor had failed the same outcome would have ensued, and the problem there was too great a weighting towards a purpose-built building which is just crazy, in my opinion. Smaller funds should not be permitted to follow such investment strategies, and it's a relatively small matter to say that they can't.

MR COSGROVE: That was one of your three points on the third page of your submission, the first point in fact, I think. Do you have any advice for us in terms of the minimum level of assets above which one would not be required to use a professional investment manager? APRA, for example, have spoken about corporate funds with less than $5 million in assets as being in its area of potential concern.

MR CERCHE: The bigger superannuation arrangements in this country can't make investments directly. I refer to the Commonwealth schemes. Both of those funds are required to invest only through investment managers, which is interesting.

MR COSGROVE: Required by the?

MR CERCHE: The act.

MR COSGROVE: The act?

MR CERCHE: Yes. My thinking would be between 20 and 50 million dollars.

MR COSGROVE: As high as $50 million?

MR CERCHE: Yes. I would feel that, to get diversification and the benefit of spread of risk, a fund smaller than - my preference would be keep it lower end, but perhaps a higher end is more prudential - would give almost absolute investment security in relation to those, provided that the spirit of the legislation were complied with. I had in mind that a rule could be developed along the lines that funds below a certain level must engage professional investment managers or must invest through a pooled superannuation trust or similar entity which is externally managed. However, if you then put $50 million into a pooled superannuation trust, the only asset of which was 35 Collins Street, that would be very silly.

Sometimes there's no helping the silly of this world, but professional licensed investment managers make such investments, as we have all found out. So it's a question of having acceptance of the principle that there be (a) diversification and (b) outsourcing of decision-makers by licensed persons, within parameters established by the trustee.

MR COSGROVE: So you would still favour this type of fund operating as a not-for-profit fund because of the cost angles that you were referring to before instead of simply putting the employees' and, I suppose, the employers' superannuation in the hands of a pooled trust or master trust?

MR CERCHE: Putting Dracula in charge of the blood bank is not a good idea. This is not intended to be a severe criticism: the for-profit sector exists to make money out of the system. They're in the business to make money out of it. There is therefore a tension between that objective, which is their proper objective, and their role as looking after other people's money. In the properly organised corporate sector, and the industry funds, too - properly organised - there is not that conflict.

MR COSGROVE: Is the conflict severe, though? One can only operate a commercial venture if you attract clients so that you can generate enough revenue to earn a profit. One would think that if in, colloquial terms, they're charging over the odds for the provision of a service of managing superannuation savings, then they won't have clients.

MR CERCHE: You would think that was so. I'm glad Prof Fels isn't here. There is competition in the sense that the professional players charge approximately the same rates. Their profitability depends on the funds under management, and the bigger the player with the more funds under management, the more profits. That's very clear because of the prices which we see paid for fund management businesses in this country. Extraordinary amounts of money have been paid for the acquisition of money, money under management, funds under management. The objection that I think lies in my concern is that the fee that is charged for the provision of the service has nothing to do with the cost of the provision of the service. That's universal in this industry, so far as I can see.

Whilst there may be breaks in rates of fees - ie, if an individual has over $50 million the rate may go down from 1.75 to 1.5, and that may be seen as an advantage - but again the amount paid bears no resemblance to the cost of the provision of the service. The challenge, I think, for the industry and for members of these funds is to work out arrangements whereby real competition applies and super profits aren't made out of money, and super profits are being made out of money. It's demonstrably clear to me that companies that can pay $13 million redundancy benefits to financial officers - we're not talking about investment managers here; we're talking about financial officers, accountants - there is something wrong.

MR COSGROVE: That may well be a broader issue than we should pursue here.

MR CERCHE: Indeed.

MR COSGROVE: The other comment that you made this morning was about the so-called operators who did not comply or somehow or other managed to avoid the rules for people engaged in provision of superannuation fund services. In a way that was part of the reasoning behind some of our recommendations, in particular the notion of capital adequacy requirements so that the cost of being allowed to enter this area would be raised, with the possible result that similar types of operators might be precluded.

MR CERCHE: The principal failures have been amongst people who have met those capital adequacy requirements.

MR COSGROVE: You mean the approved trustees? Well, yes, there have been some, but there are a few in the not-for-profit area as well, I think. We've had the Harts Staff Superannuation Fund problem recently, requiring the appointment of an acting trustee by APRA. Prior to that was the - I've forgotten the precise title of the fund, but it was a correction officers fund.

MR CERCHE: Correction Services Fund.

MR COSGROVE: Yes.

MR CERCHE: There was an industry fund in Queensland that ran into difficulties. In today's paper there's a reference to Ansett, which is not a problem.

MR COSGROVE: Some were exceptional circumstances.

MR CERCHE: It's not a prudential problem or any other sort of problem. It's a problem which would arise in any superannuation fund in this country which provided an excessive retrenchment benefit, where everybody was retrenched at the same time. No fund properly or prudently would fund to that catastrophe, and there there's no question of the accrued benefits not being there. It's just that the super benefit is not there; super in the sense of additional benefit is not there.

MR FRENEY: Is there a particular additional retrenchment type benefit provided through that fund over and above the pure retirement income pension build-up, Mark?

MR CERCHE: Yes. There would be a formula redundancy benefit, no doubt negotiated at the halcyon days of the culmination of the pilots' strike, which would be generous, and it wouldn't have been funded to. If an actuary were sitting here - and he certainly is not - he would tell you that you can't predict redundancies. You can predict deaths, you can predict this, but you can't predict that, and obviously a prudent actuary would assume 10 per cent of the workforce may be made redundant and there would be that amount of fat in the fund, but 100 per cent in one event is a catastrophe and one would not have expected any fund in Australia, or indeed anywhere else, to be funded to that level.

MR FRENEY: So this is what might be described an ancillary purpose - - -

MR CERCHE: Yes, indeed.

MR FRENEY: - - - under the terminology of section 62. This would be an ancillary purpose. It's just interesting to get a sense of the order of magnitude of an

ancillary purpose, if it can be that significant that it becomes difficult, if not impossible, to fund it at the time of a disastrous situation.

MR CERCHE: Yes. There has been for a long time a debate - - -

MR FRENEY: It does cause you to realise the potential significance of these ancillary purposes.

MR CERCHE: It's an ancillary benefit which one would expect to see included in most superannuation arrangements. Most funds do have a redundancy benefit because it enables employers to, in a more efficient way, manage redundancy costs. But the expectation is that not everybody is being made redundant at the same time. That would be uncontrollable. The purists would say the redundancy is not a superannuation issue. It's an employment issue and shouldn't be in the fund at all, and that's so, but historically that has not been the case.

This issue has not been a new one. In fact, there was a disaster back in the 70s, with a fund called the James Miller Fund, where there was an exceptional redundancy benefit there and the administrators, being Messrs Crawford and Poulton of KPMG, terminated all the senior management, day one, with the result that all the senior management became entitled to the entire fund. That was an error, and I notice today that the administrators and the trustees have taken notice of that and avoided that outcome. It's regrettable that the redundancy benefits haven't been fully funded, but they are super benefits. The accrued retirement benefits and the withdrawal benefits and the death benefits are all safe. It's just that additional benefit that isn't there, along with a lot of other employee benefits apparently.

MR COSGROVE: Coming back onto the capital adequacy side again, so far as the not-for-profit sector is concerned, our draft report recommendation was solely about what we called, I think, working capital or operating capital. I would be interested to know what you think about that as a concept. Related to my question is the statement in your submission that the association has estimated that the costs - this is under the heading of Capital Adequacy and Licensing, the fourth dot point on the second page of your submission - for consumers - and I take it you mean by that superannuation contributors - would be around $400 million each year.

MR CERCHE: In respect of our membership.

MR COSGROVE: Your membership?

MR CERCHE: Yes.

MR COSGROVE: Can you explain the basis of that figure?

MR CERCHE: The management expense ratio of the average corporate fund is .4, and the average retail fund is 1.7, or thereabouts.

MR COSGROVE: What are you gearing against those proportions? What additional amount of capital have you - - -

MR CERCHE: The capital is not in one system and the capital is in another, being the shareholders' funds typically, or a bank guarantee. In the bank guarantee situation, the cost of a well-regarded fund is about $17,000 per year. In the case of a for-profit organisation, the cost of servicing the capital is what the capital is, and that depends. This is just looking rawly at the amount that comes out of the fund by way of cost.

MR COSGROVE: Yes, but to meet what requirement, is my question?

MR CERCHE: We haven't got that information.

MR FRENEY: If there was a shift of all of the assets that are currently held in your membership superannuation funds, if all of those assets were driven out of your membership for whatever reason - because if licensing or capital happened to close all of your membership and all of those assets were shifted out into for-profit retail funds - then the differential in the MER would give you that sort of $400 million per annum cost difference.

MR CERCHE: Correct.

MR COSGROVE: It seemed a large figure and I was wondering how it had come about.

MR FRENEY: That's how I interpret it.

MR CERCHE: That's exactly the calculation. It's simply an outworking of the difference in the average expense ratios. I might draw the commission's attention to a paper prepared by Hazel Bateman which was delivered at the OECD conference in Beijing last week, which is on the OECD web site. It goes into some detail about these costs and the differentials and the outworkings of them, which is very illuminating and it does, I'm happy to say, support our position and perhaps we're being conservative. With respect, there are some errors in that paper because there's an assumption that in the defined benefit funds the members bear the administration and other costs, whereas that is not so. But if one ignores those technical issues, the arithmetic and the force of that paper is very very strong.

Now, capital adequacy, it has been put to me - and having read your paper of course - the issue is what protection does a capital amount held by the responsible entity bring to the argument? That really depends on, after the event, what the failure is, how the failure arose, whether the capital is anywhere near significant enough to make any impact on that and, from our point of view, the question is having the rule precludes us from operating. That's the point. There is no way a well-organised

corporate superannuation fund could prevail on its employer sponsors to contribute a minimum level of capital to the responsible entity.

MR COSGROVE: We haven't recommended that in the case of not-for-profit funds.

MR CERCHE: What have you recommended then?

MR COSGROVE: We've recommended that they have - - -

MR CERCHE: A reserve.

MR COSGROVE: - - - an amount of operating capital which is a proportion of their expenses. We haven't specified what proportion, because we thought that was best left to the experts in this field to assess. That was why I was wanting to explore the assumptions underlying your $400 million calculation. You seem to be saying that the combined effect of an operating capital requirement and of licensing conditions would wipe out the not-for-profit corporate sector; turn those operations into the commercial sector.

MR CERCHE: It may be a misconstruction on our part as to what you were precisely saying. When we see "capital adequacy", we interpret that to be - rightly or wrongly - $5 million of net assets or some money which is held by the responsible entity which does not belong to the fund. In either case, typically that doesn't arise, and there's no real potential for it to arise. Indeed, we would say there is no need for it. In the well-organised corporate fund, the role of the trustee is really a gatekeeper - to make sure that everybody associated with the fund does their job properly - and typically there would be enough insurance around to cover any capital adequacy type issue of that magnitude.

MR COSGROVE: Insurance held by service providers - - -

MR CERCHE: And/or the trustee.

MR COSGROVE: - - - and the trustees?

MR CERCHE: Yes. Most trustees now have PI cover and fidelity cover.

MR FRENEY: Mark, my understanding would be that most of your membership would have incorporated entities as the trustee structure running the superannuation fund underneath it.

MR CERCHE: Correct.

MR FRENEY: What would be the sort of typical balance sheet - - -

MR CERCHE: $2.

MR FRENEY: - - - of those corporate entities? What would be the cash flow through them? They'd have a $2 - - -

MR CERCHE: They would have a $2 capital. One share would be held for the benefit of the members, the other would be held by the employer sponsor. The sole function of that share would be to appoint and remove directors, and no other role in relation to the company. Typically there would be no cash flow through that trustee at all. In some cases there is a charge made to recoup costs. For example, if the trustee lodges an annual return, which it's required to do, or do those sorts of things, there's a modest charge coming through to recoup those costs.

MR COSGROVE: From the fund itself?

MR CERCHE: From the fund itself. But that would be no more than $1000. Often now there are sitting fees in some funds, particularly the industry funds which are also not-for-profit. There would be a sitting fee because a person who is engaged in the work of the trustee would typically not be remunerated by the employer when he's doing that, so there would be perhaps a $1000 sitting fee four times a year which either is paid out of the fund directly or goes through the books of the trustee. Typically, it would not. In my experience those companies are kept as nominee companies. Since there have been changes to the superannuation laws and the Corporations Law designed for this purpose, the cost of PI cover can be paid out of the fund, whereas previously that couldn't be the case. That was an inhibitor. But that has been changed for quite a few years now. The superannuation law always permitted it more or less, but the Corporations Law expressly precluded it. But that has been changed.

MR FRENEY: In terms of other costs of running the fund, like the ordinary hum-drum admin costs of maintaining a corporate entity, of submitting returns and having some staff committed to calling meetings and put out, as you said, an annual report, there's a flow of work that is associated, even with having a $2 company, to what extent would that be subsidised by the employer company? Would it be fairly considerably sustained by the employer company?

MR CERCHE: In some cases wholly. In a typical defined benefit fund, the employer would bear all of that cost, and there is a tax reason for that. In the other model, it's usually up to the administrator to do those sorts of things, for a fee, and the average administration arrangement with an external administrator would oblige them to provide a secretariat.

MR FRENEY: A thought that was somewhat in our minds when we were putting forward as one possibility to have some operating capital requirement in the trustee entity itself is that the trustee entity is the responsible entity under the act and, while it might delegate virtually all of the running functions in terms of administration,

custodian, funds management, asset allocation and advice, actuarial advice - all of those things - at the end of the day it's the trustee that is the responsible entity, and no matter what insurance and indemnities and anything else you might like to have - disaster recovery plans, whatever, that those individual service providers might have - there can be occasions when the trustee entity becomes liable - is always liable under the SIS Act.

The question then becomes one of, in the event of problems arising, do you tap into the assets of the fund itself to pay for any work that needs to be done? It might either be a making of the trustee entity or making of one of the service providers that can't actually deliver. Would you have a comment about that? As a responsible entity, why should not the entity have a belts-and-braces reserve or an operating capital supply?

MR CERCHE: Well, it doesn't.

MR FRENEY: Why should it not?

MR CERCHE: Yes, should it not. If something goes wrong and it's the trustee's fault, then the question is in the usual case, does the trustee have insurance? Answer usually yes. If the trustee doesn't have insurance the next question is, is the trustee permitted by law to have access to the funds to meet that liability? The answer to that may be yes or no, depending on the nature of the thing. If the answer to both of those things is no, the question is, are the directors liable and what are the personal assets of the directors? That's a much more focused analysis from a director point of view than having $5 million worth of capital floating around or, indeed, some other sort of reserve sitting somewhere - either in the fund or in the books of the trustee company.

My response to that is, we're dealing here with people who are elected by the members and appointed by the company to look after members' moneys. They are required to be prudent and, in my experience, are painstakingly prudent at the proper end of the market, to the point of sometimes overprudent to the detriment of members. But leaving that aside, they typically do not take risks on these issues. There are failures, clear there are failures, and you wouldn't expect there not to be failures. The failures, in the main, on the administrative side are errors in payments which are usually incorrect information given to the administrator or the administrator mucking up, and it being discovered by way of an exception report in the administration report, either on audit or in some other way.

In those circumstances the money is usually a relatively small amount, unless it's systemic. In any event, the administrator should be, and usually is, responsible. The administrator usually, and invariably in a properly constructed arrangement, has adequate insurance to cover that. They're the things that do go wrong at the practical level. But the thing that the not-for-profit trustee brings into the equation is that the administration charge is appropriate and the investment charges are monitored,

reviewed and, where necessary, investment managers are hired or fired. That's what they bring to the argument.

As I have said, provided that there is a clear focus on carrying out what the Superannuation Industry Act says you should carry out - ie, you're there to provide retirement benefits and not be confused by Myercards and distractions such as that -- then all should be well, and typically it is, and it's better than well because it's far more competitive than the other. If you were to say to me, "Would it be possible for a corporate superannuation fund to exist if you required some capital adequacy?" I would immediately say, "Well, if you mean capital adequacy by way of capital, the answer is no."

MR COSGROVE: That was not our proposal.

MR CERCHE: If the proposal was there would be some mechanism whereby some assets would be available, I would ask the further question, "Well, do you mean insurance?" The answer to that is yes. Well, that's fine. We would do that and, typically, that's now certainly the thing. As soon as it is a requirement of course the premiums will increase, but that's market pressure. And insurance is not a happy thing, just as we sit here. But that is manageable. If you say you have some sort of money in the trustee company, the question is, how does it get there? It can only get there by a charge against the fund, so why bother?

A charge against the fund incurs an income tax. It sits there. It has to be invested in separately managed, and why bother, if what we're concerned about is a risk which is otherwise insured, either directly or outsourced and insured. My view would be that, provided all the requirements are in place, then there should be no additional need. So far as licensing is concerned - - -

MR FRENEY: Sorry. Could I just interrupt to ask before you go onto licensing, I was wondering whether an alternative approach - and maybe some of your members already use it - is, in terms of having reserves within the accounting framework of the superannuation fund itself, rather than as you were saying a preference not to have deductions out of the fund and going into the concept of operating moneys in the trustee entity, within the fund itself? My understanding is quite a number of funds have reserves for various reasons and some have administration reserves. I don't know to what extent those administration reserves are for purely ongoing running of the fund or to what extent there may be some contingency holding for things going wrong or for improvements in computer systems and the like. But is there an alternative possibility there in terms of the use of reserves, Mark?

MR CERCHE: I think we need to look at that in two steps. In the case of a defined benefit fund, on one view the whole fund is a reserve because the whole of the fund is not allocated and it meets all the costs, and the ultimate contributor to that on the risk side is the employer. So in that case you would have a reserve in your terms if the assets of the fund exceeded a proper assessment of the accrued liabilities.

Most of the defined benefit funds in my organisation are in the happy position where that is so, by quite a margin. So there is a slot there that is available, without detriment to members' benefit, to meet administrative costs - and it is - and to the extent to which those administrative costs increase because of some error on the part of the trustee which is neither insured or not capable of being attributed to some other person, then provided the employer is still there and solvent, the employer bears that cost as part of the arrangement, and that has been so for many many years.

When you talk about defined contribution or accumulation funds, there are reserves for a whole range of reasons, but typically the administration costs, including any rectification work which is solely the responsibility of the trustee, is worked out on an annual basis and allocated as a reduction of income. That to my mind is perhaps a fairer way of dealing with that issue, rather than keeping a reserve, because a reserve simply means that a part of the fund isn't allocated to members currently, and when a member leaves, whilst there's a reserve in existence, then the question is, has that member left anything on the table, as they say.

In my view the appropriate places for reserving are where you have a single pool fund and you have decided to adopt a smoothing investment policy, then there is a place for a reserve there, even though there is the potential for an individual member to come in at the wrong time and go out at the wrong time and lose, which is something that people are focusing on and trying to fix, because that's not fair. The other possibility is where there's an investment which may or may not realise the value ascribed to it, and in that case it would be appropriate, I think, to make a reserve in an accounting sense because to not make a reserve and to do a write-off may have a deleterious effect on the tax side and may have different complications for members going in and out. So in that case there might be an appropriate case for making a reserve.

But for a requirement that it be reserved, be established to meet administration failure, in my mind would be unfair because it would be taking away money from the current members which may or may not be needed and my view is that the better way of dealing with a failure of that type would be in the traditional way and that is to take care of it in the administration charge and to have the trustee responsible for that, in the sense that he, she or it has to report to the members that there has been an increase in administration charges - "This is the reason" - and leave it then for the legal system to sort out whether that's appropriate or not.

MR COSGROVE: Even in that case, though, I guess there can be unfairness amongst the membership because the investment might have been made a decade ago and the administration charge is borne by the current members, so it's a more or less intractable issue, I think.

MR CERCHE: It is. It's sort of the luck of the draw though, isn't it, in a sense? In an ongoing arrangement you can't push yesterday's mistake into the future. It has to be recognised when it's recognised - - -

MR COSGROVE: Exactly, yes.

MR CERCHE: That is so in any investment which hasn't got a daily valuation to it.

MR COSGROVE: Yes, indeed. Mark, on the public indemnity and fidelity insurance arrangements that you've said is usually the practice of your member trustees, is that a significant or very minor expense - the premiums involved?

MR CERCHE: As soon as it's mandatory, it will double. That's cynicism on my part. The typical policy would be the $20 million or $10 million cover. Where you have $20 million, when you really look at it it's two lots of 10 and not a whole lot of 5s. But that sort of cover, I think, is about $32,000 per year for a well-run trustee.

MR COSGROVE: Does it vary with the company's assets or, in the case of a defined benefit scheme, perhaps liabilities? Or is it a flat premium?

MR CERCHE: The answer is I don't know.

MR COSGROVE: It's probably related to the amount of cover rather than the characteristic of the fund.

MR CERCHE: I think there are two providers in the market now, and I think at the moment they're reasonably competitive on price. The variables on the price is the deductable and the scope of the non-cover. The arguments are always on the second point, not the first point. Most large corporate funds would accept a $1 million or $2 million deductable, which really does significantly reduce the costs, because spread over a $5 billion fund, that's a drop in the bucket. For example, that may decrease the cost from $32,000 to $8,000, because it's the first level of problem where you typically have a problem. It's a $200,000 incorrect payment of a benefit or something like that; that's where you have the problems, and typically the funds, the larger funds, where that is the cost.

MR COSGROVE: In this same general area of operating capital and other ways of dealing with it, your third dot point in the list 1, 2, 3 on page 2 talks about, "Threshold tests of appropriate systems, resources and capability requirements for each fund should be introduced." What do you actually have in mind there? As I was reading it, one possible interpretation was this might well be a kind of operating capital arrangement, but that I guess is not what you had in mind.

MR CERCHE: No. The problem that's always thrown up against our position is the small funds. The small funds get into trouble for the reasons we've gone over. It strikes me that if we were to say a fund under $20 million has to outsource investment and administration and carry insurance, then there is no need for that fund, if it still wants to exist, to have any capital adequacy. There's no need because

it's got external advisers in place who should have insurance and that could be made a requirement, and they themselves can have insurance. Then they can sit back and say, "Well, look, should we be doing this?" and the answer to that is probably yes because they'll still be cheaper, ironically. That's the sort of thing that we had in mind there.

But when you get to a Telstra fund - I can speak about Telstra because I don't act for Telstra and I can only speak from the public record - that's a fund of some $8 billion, $4 billion of which is owed to it by the Commonwealth in the form of - coming out of the consolidated fund. That fund has its own internal administration, it has its own service providers, its own insurances and all those sorts of things. To impose capital requirements on that would be - it's at $5 million. The corporation would have to put its hand in or the trustee would have to do a public offering, and then it would have to service that capital by way of some charge against the fund, and the question is why, when it's not needed?

If the fund is sufficiently broad, with sufficient assets and insurances to cover the risk that we've been identifying, then the only risk there is the investment risk and you simply can't insure that. The larger funds in this country, touch wood, haven't failed, and should not fail. There is no reason why there should be any concern about them.

MR COSGROVE: Which funds are you referring to in this third point? Are these again the funds which have, let's say in terms of the numbers you've been using, less than $20 million?

MR CERCHE: Yes.

MR COSGROVE: The systems, resources and capability requirements that they would be required to have are what - their capacity to hire a commercial investment manager?

MR CERCHE: They would be required by regulation to outsource investment, effectively importing what the Commonwealth has done in respect of its own schemes.

MR COSGROVE: So it's really a reinforcement of what you have in your first point, is it?

MR CERCHE: It goes further, because you could compel them to outsource administration.

MR COSGROVE: Yes, I see.

MR CERCHE: And you could compel them to maintain a level of insurance as an operating standard. Those sorts of things would then, I think, bring it into a context

of something which is manageable, as opposed to something which is not manageable.

MR COSGROVE: Anything more on the capital side, Roger?

MR FRENEY: No, thanks.

MR COSGROVE: On the licensing, you've drawn a sharp distinction, I think, between commercially driven funds or service providers and the not-for-profit sector, with licensing being seen as appropriate for the former but certainly not for the latter - "totally inappropriate" are your words. I wonder why that is the case. I was looking back at our proposal in respect of licensing. Apart from certain procedural matters, like applications for a licence being made by a trustee and provisions being in place for revocation of a licence and that type of stuff, what we had suggested as examples - because, again, we're not sufficiently expert in all of this to fully design a system - was that in addition to the entity having some minimum operating capital which we've already discussed that the trustee should be required to satisfy the regulator that they have the capacity to manage the fund; that they provide the regulator with an investment strategy; that they use an independent auditor and an approved dispute resolution scheme. If we leave aside the minimum operating capital element, is there anything in those other suggestions that would trouble you?

MR CERCHE: All but the first one are already required. You must have an auditor; must be independent. You've got to have a dispute resolution mechanism. The act requires an internal one, and then there's the Superannuation Complaint Tribunal, where I had some sympathy for your position on that. The other one was satisfy the regulator and get a licence. Now, the licence that we have is given directly by the members and by the company. We're appointed by them. We're not there to make a profit for anybody else. We have to demonstrate that we're not criminals. We have to have an investment strategy. If we have to provide that investment strategy for comment to the regulator, the regulator would therefore be assuming some sort of responsibility for the outworking of that, which the regulator probably wouldn't want. So the licensing would simply give the opportunity to the regulator to impose some arbitrary qualifications or criteria on our ability to manage our funds - - -

MR COSGROVE: Which might not be very high. For example, one possibility which I think we mention somewhere in the report is that trustees of not-for-profit funds should have been required to undertake some training with an approved scheme.

MR CERCHE: There is no reason in the world why that couldn't be a requirement. In my experience with licence applications, they have been extraordinarily difficult where you haven't got capital. I've had experience in I think the solicitors' fund in this state and for one of the university funds, both of which were extremely time-consuming. Admittedly, this was before APRA and not before ASIC. This was

a licence issued for an approval to trade. The whole issue was capital.

MR FRENEY: This was with respect to an application to be an approved trustee of a public offer fund.

MR CERCHE: Correct.

MR FRENEY: Which is a little bit different to the rest of indicative - - -

MR CERCHE: Having dealt with regulators for 25 years, when you give them the power to give or withhold a licence, with respect to them, they tend to overreact to problems. To my mind, certainly there should be some minimum requirements, and there are invariably.

MR COSGROVE: It's really the capital proposal in this that troubled you, not the other parts of it.

MR CERCHE: No. Licensing is just a diversion, and I am concerned that the regulators tend to add conditions and hurdles which are artificial and which don't reflect the fact or the acceptance of the fact that perhaps not-for-profit have an integrity which doesn't need to be looked behind, not to be double-guessed.

MR COSGROVE: On the other hand, we had some information from another participant yesterday that in some cases the employee representatives appointed to the trustee board of a not-for-profit fund might not be, in a sense, genuine; that they were to some extent in the pockets of the employer. Amongst your membership, are there any such cases that you've become aware of? I'm raising the question because it might provide some justification for the regulator actually running an eye over the proposed board's membership.

MR CERCHE: In my experience, the elected members certainly accept their charter and from the employers' side they are informed in no uncertain terms that it's not their fund. I've not in my experience seen evidence of that. Anecdotally you hear. The classic case was of course the man who took the dive from the ship in England, whose name I've forgotten.

MR COSGROVE: Maxwell.

MR CERCHE: Maxwell. There's the classic case of somebody who appeared to bully everybody, including the banks. There is that potential, but there's that potential in any institution.

MR COSGROVE: Is election of employee representatives very common as a means of having them selected?

MR CERCHE: Yes. It's almost universal now.

MR COSGROVE: Could you say what proportion? Almost universal, is it?

MR CERCHE: Almost universal amongst the larger funds. There is a vigorous election program. I keep hearing people saying, "It's very difficult to get people to stand," and I've been the returning officer for a number of funds now, and believe me I have my staff counting for a couple of days.

MR COSGROVE: And that's still the case after the introduction of the strict liability rule?

MR CERCHE: The strict liability rules are of no concern to us.

MR FRENEY: There's not a significant shortage of nominees for - - -

MR CERCHE: Certainly not in my experience. The last one that I did was for a mining company for three vacancies. There were 17 candidates. It was quite vigorous. There was a vigorous campaign and an election, and they elected some very capable people. These people are capable. My hackles do go up when I hear people saying, "These people aren't qualified." They're very qualified. They may not have a master of business administration, but they know when things are wrong and they have an understanding of when they're trying to be snowed.

MR COSGROVE: They have a capability to ask the right questions, you would say?

MR CERCHE: The wrong one usually catches everybody. Everybody prepares for the right question. It's the wrong question that catches the underperforming person out.

MR COSGROVE: The so-called dumb question?

MR CERCHE: Yes, exactly. It's the one that catches. I'm a very strong supporter of this system because it actually does work. I've seen it in a very hostile environment where there was complete war between the members of the trustee board and the company, and that sorted itself out to the benefit of the members and to no detriment to anybody. That's been the exceptional case. In every other case I've found it to work pretty well, but again, I'm working in an area where there are substantial funds, they are very well organised and they do comply meticulously with the requirements, whatever they be.

MR COSGROVE: Are there any industry funds in your membership or are they all genuine employer corporate - single employer corporate - - -

MR CERCHE: How can I put this? We're not supposed to have them but we do.

MR COSGROVE: I see.

MR CERCHE: We do have a maritime fund which is a multi-employer fund, but it's a real corporate fund in the sense that the corporate has an interest in it and deals with it and actually appoints members. The other is a university fund where it's a similar model, and that's an unusual one because it is a defined benefit fund but the employers are actively involved in the administration of the fund. That, I think, is our line of differentiation. We're the Corporate Superannuation Association where the corporate does play an active role, whereas in the industry funds typically the employers don't. There are mechanisms for getting employer reps onto the board, and I'm sure they're worthy people, but the corporates simply pay their 8 per cent, or 3 per cent if that's what they're required to do, and have no further interest or involvement. That's certainly not so in our organisation.

MR COSGROVE: You wouldn't draw any distinction in terms of the matters we've just been discussing, between the few industry funds and your regular membership?

MR CERCHE: In my view, I have to say that the industry funds I've seen in another capacity have been extremely well run. There was a time when there was a suggestion that industry funds were in fact union funds. I think that view still pertains in some places and I still think that there's an uneasy closeness in some respects, but from a purely superannuation point of view, with one or two exceptions, I think they have carried themselves in an exemplary way and in quite a prudential way.

MR COSGROVE: Towards the end of your submission - in fact, it's the second-last dot point - you have a somewhat cryptic point there about strongly supporting the recommendations in the draft report where, "The SIS legislation be amended in specific areas to remove unnecessary restrictions on competition" - I don't think we found too many of those, but there were one or two - "but without more radical modification such as restructuring or partial repeal." Could you elaborate on that?

MR CERCHE: .When I read that I asked the question, "What was meant?" I think what we're trying to say here - and I'm not the author of this document, as I hope you will appreciate - our position is that the only recommendations where we take issue with you concern any licensing proposal or any capital test. Your other recommendations we support.

MR COSGROVE: You mentioned a few moments ago, as you're just implying now, you're agreeing with what we had to say about the Superannuation Complaints Tribunal.

MR CERCHE: Yes.

MR COSGROVE: Could you comment at all on that in any detail?

MR CERCHE: This is privileged?

MR COSGROVE: Sorry?

MR CERCHE: This conversation is privileged?

MR COSGROVE: No, not at the moment.

MR CERCHE: Okay.

MR COSGROVE: It's difficult for us to take evidence in privilege. We could, but we can't use it, even if we do.

MR CERCHE: My experience of the tribunal is it's an expensive risk for superannuation funds. In my opinion - and this is my opinion - the tribunal misconstrues its power and it is not a place where appropriate decisions are taken. It's the substance of what goes on there. If I can illustrate this. I have a great regard for the chairman and I know several of the members of the tribunal, and I do have this conversation with them. Their legislation says that they're required to affirm a decision of a trustee which is fair and reasonable in relation to the complainant, and when the legislation was prepared that provision was put in there to say what it meant. It was meant that if the decision was fair and reasonable in relation to the complainant, then the decision had to be affirmed.

It wasn't to be a tribunal where the whole matter was looked at again. It was rather, "Did the trustee do the right job, and was the outcome within fair and reasonable?" So you did that thing first, and then you decided - on the assumption that the trustee had not acted in a fair and reasonable way, you said, "No, he didn't," and then you'd look at the second question. But the tribunal - and they would say that they're entitled to do so under the legislation, but I disagree with that - they would say that the authorities support the proposition that, "If we were to come to a different decision, then the result is that your decision must have been unfair and unreasonable."

MR COSGROVE: I see.

MR CERCHE: So they are conducting de novo reviews of trustee decisions and often they do so on the basis of information which is produced to them after the trustee has made the decision.

MR COSGROVE: Meaning the trustee didn't have that information?

MR CERCHE: Correct. Typically what would happen is that in a long-running dispute the trustee would have made the decision saying, "No," in the case of a total

and permanent disablement claim. The member would have come back and said, "Here's another report." The trustee still says no. At that point the tribunal is imbued with jurisdiction because it's been through the internal complaints process. The matter goes to the complaints tribunal and then another report is prepared which the trustee doesn't have the chance to critically look at and, lo and behold, that report is the winning report. I mean, that's unhappy. But that's my quibble with that process.

The other aspect of it which is of concern is that there's no downside so far as the member is concerned. Even a little gate would - they're on a free ride. They've got nothing to lose, if you like, and that does add cost, and the statistics are, to my mind, quite troublesome, and I know in a number of cases correct decisions have been overturned, in my opinion.

MR COSGROVE: Thank you. Of course our recommendation was that the act which established the tribunal be repealed and that industry operated disputes resolution schemes be used in place of the tribunal. Do you have any experience with those industry schemes, at least those that have been approved by ASIC?

MR CERCHE: Very little, chair. I'm usually before the tribunal or the courts. I'd much rather be before the courts. The process there is fairer. There needs to be an alternative to the courts.

MR COSGROVE: Yes, we agree.

MR CERCHE: I do agree. If the complaints tribunal were more balanced and took a different view of their legislation than the one I've put to you, then I would be happy.

MR COSGROVE: Yes, I see.

MR CERCHE: The real question is whether the review of the decision is to be a full merits review or whether it's to be a process review.

MR COSGROVE: An assessment of fair and reasonable.

MR CERCHE: In my view there's no point in having a dog and then letting somebody else do the barking, which is what a full merit review is. There is a cost in this. There is a substantial cost in dealing with a complaint before the tribunal so far as the trustee is concerned.

MR COSGROVE: Even though the internal review itself will have presumably gone a fair way towards having established the material which the tribunal requires, you think there are still additional costs?

MR CERCHE: There is. There's a submission and a response to a submission, and at that point it's typically outsourced. It goes to a third party. Occasionally one gets

the papers and says to the trustee, "No, you're wrong here for this reason," or, "I think you should think about that," in which event it's resolved before the tribunal deals with it. But that's self-serving. The short answer is that there is some expense, but that's a necessary corollary of giving members a right of review. My question is, what sort of review is appropriate?

MR COSGROVE: Yes, I understand.

MR CERCHE: In every other place, when you talk about reviews, it's typically a process review. The courts in relation to trustees conduct a process review. They don't conduct a merits review unless the trustee invites them to do so.

MR FRENEY: Just a fairly obvious point of clarification or confirmation from Mark, I suppose: I understand what you're saying is it's a question rather of the tribunal's interpretation of its role and powers under the act rather than the provisions of the act itself that you are commenting upon, or would you say that the act would be better recast to make clearer its objectives?

MR CERCHE: I think a critical point is to determine what the role of the tribunal is, and then to cast the legislation accordingly. If it's to be a full merits review, well, say it is a full merits review and get on with our lives. But what we've got is a provision which says if the decision of the trustee is fair and reasonable it's required to be affirmed. Well, what does that mean? The way that has been tortured is that the tribunal has said, "If we take a different view, then your decision is not fair and reasonable." Well, I take umbrage at that. That's not right. Our decision is unfair and unreasonable if no reasonable person, acting honestly, could have come to that view. Decisions are within the realm of, "Here is unreasonable. Beyond either side is unreasonable."

Unfortunately the case of total and permanent disablement, it's a very critical decision and, dare I say it, the trustees are, despite what the tribunal thinks, usually in favour of the member. There's nothing in it for the trustee to decline a bona fide claim. There's been a recent case where a person has been awarded a total and permanent disablement benefit by the tribunal and, lo and behold, a year later the tribunal is dealing with another total and permanent disablement claim in respect of the same member. So it was hardly total and permanent disablement the first time - and dealing with it seriously, though, which is the greater concern, rather than simply saying, "Hey, you can't be twice." It's interesting, isn't it?

MR COSGROVE: In the light of what you've been saying, I imagine you might not agree with one of our recommendations in this area, although I invite you to tell me what you do think, and that's the one about the tribunal being required to publish the names of superannuation funds that have been the subject of complaints to the tribunal. Would you be worried about that? No?

MR CERCHE: I have no concern about that. Of course, the wrong conclusion can

be drawn by that. For example, I have no doubt that if a mining town were to close there would be a lot more complaints against a particular fund in that year than would otherwise be the case, and you might draw from that an inference which is not justified, and I think that's a concern that people have. But I don't share that concern. Provided the member's name is also disclosed, then I don't see why it should be a matter of any embarrassment at all.

MR COSGROVE: Thank you.

MR FRENEY: I'll just take this one step further perhaps. I think in our discussion I've interpreted what you're saying, Mark, that you feel that the objectives of the legislation might be more clearly specified with respect to this area of reviewing trustee decisions.

MR CERCHE: Correct.

MR FRENEY: And that the legislation itself might be more clearly written, having identified more clearly what the objective is.

MR CERCHE: Yes.

MR FRENEY: I'm interpreting in shorthand what you've been saying. Is that a reasonable interpretation, firstly?

MR CERCHE: I think the legislation should say what it is. I dare say there are constitutional problems here, because this is not a court and there have been, I think, three or four Federal Court decisions which said it was a court and one High Court decision said it wasn't a court, and I think that's an issue about how the legislation is actually framed. But that is the government's problem. My problem is as a user of the service - "What are the rules? If you tell me what the rules are, then I'm happy to engage them." But where the rules say one thing and the tribunal - with some judicial support, mind you - takes a different view, then we're at loggerheads.

As an aside, there are a lot more complaints, I think, against corporate funds as opposed to the retail funds because we do provide different types of benefits and different numbers involved, and typically we don't insure TPD benefits. Often we do, but typically we don't. Typically we're the risk carrier and we, therefore, have an interest as insurer and trustee in the issue, and sometimes we're wrong. We accept that, and we get overturned, and we should be overturned. That's fine. But more often than that, we are right but we are overturned through principles which, when you look at them, it's simply a difference of opinion where a particular report is preferred over another report for no particular reason.

As I've said, in my experience - and I've got nothing in this to say this - the funds I'm involved with are usually generous. They're not the other way at all. If there's substantial doubt, the member doesn't get the benefit, but if there's doubt as to

whether he's disabled or not, then he gets tipped the right way, not the wrong way. So when they decline a claim, they really mean it, and it becomes quite a tense thing where the tribunal relies on the decision of the member's own GP over a specialist. That gets irritating. That's the area of concern. But that's all I need to say about that body.

MR COSGROVE: I think we may have sent you a request a day or two ago.

MR CERCHE: You did, and I have - - -

MR COSGROVE: I was wondering if you are able to give us any responses to that?

MR CERCHE: I can. I was in China and have just got back to Australia so I haven't been orchestrating this information seek. But I can say that we canvassed 22 of our members and we found that there are three models that are in play here. One is completely outsourced and we think that of the 22 we surveyed, which is less than half our membership - where we got responses, because we did it yesterday - over 40 per cent wholly outsource administration. That's the first set.

MR COSGROVE: Yes.

MR CERCHE: Some outsource wholly to the employer sponsor the administration function under a contract, and the employer sponsor outsource is part of that function. For example, the secretariat might be kept within the corporate sponsor, but the record-keeping, administration, would be outsourced. And that's all but three. So if you bear with me I'll work out the percentage. I have confessed I'm not an actuary.

MR FRENEY: All but three do outsource?

MR CERCHE: Outsource either directly or indirectly the administration function.

MR FRENEY: Right.

MR CERCHE: If we take a model, it would be the employer sponsor would agree to provide all administration services that the trustee needs and to do everything that's necessary, with the ability to outsource that to an approved supplier, and all but the secretariat function, or perhaps a little bit more - tax returns or something; if there's a tax department, then they may do the tax work because it's cheaper and this is typically defined benefit funds - but the record-keeping and the membership details and all of that information is outsourced to a Towers Perrin or Mercers or somebody like that.

So of the 22, all but three completely outsourced or had this shandy outsourcing, and the final three are the very large funds and they have their own

stand-alone administration system which is independent of the employer sponsor but managed by the trustee, where they have their own record-keeping capacity and everything. They don't use professional suppliers for administration services, and they're the larger funds. I've already identified one, but there are a couple of others - the banks mainly. They think they can keep records, and they can. I mustn't defame the banks, as everyone else.

I apologise for the smallness of the sample, but that confirms my thinking on the matter. Most of it is outsourced, and where there is no outsourcing, then there's a stand-alone unit which is usually of long standing and very sophisticated. The other question you asked me was custodians, I think, and the answer to that was that almost universally custodians are used. There are some exceptions, and these are usually infrastructure project holdings which, by the very large funds, are held by subsidiaries which may or may not be held by the custodian, but in relation to traded securities and real estate holdings of the ordinary type or prescribed interests, they are universally held by custodians and the reason for that is simply reporting.

The custodians have the system for valuing and reporting and dealing with the investment managers on a day-to-day basis, so it's a functional thing. The statement here is that, "All members use custodians." That's certainly true. I would go so far as to say that 99.9 per cent of the assets are held by custodians. There are exceptions and they are typically things that are not Australian and things that are held through an interposed investment vehicle like a trust or a company, and they would be interested in limited partnerships in the United States and Europe primarily.

MR COSGROVE: Thank you.

MR CERCHE: I think they were the only questions you wanted.

MR COSGROVE: That pretty much covers it, I think.

MR FRENEY: Just one quick one, Mark. Earlier you were talking about the member elected representatives on trustee boards and your experience in the election process. William Mercer have been making a point to us that the cost of elections is quite high, and particularly where you get early retirement by member representatives on trustee boards. They take a bit of exception to the cost of the re-election process. They have put various proposals to us as ways of reducing the cost of replacement. But in your experience, is this a significant matter?

MR CERCHE: I must be the cheapest returning officer in town because I can do it with Allen Arthur Robinson's legal support rates for less than $5000 for a 50,000 member fund. So I don't think that's particularly expensive.

MR FRENEY: That's the whole election?

MR CERCHE: No - act as returning officer, settle all the documents; don't do the

mailing. I don't do the printing. That's typically done elsewhere and I don't know the cost of that; that would probably be a more significant cost. But I do it for $5000 and that's comfortable, whereas some charge a lot more than that. I would not know the cost of doing it. Most funds have rules which say if somebody ceases to hold office, then there's an automatic replacement mechanism. The next candidate in line steps in. In my experience it's rather unusual to hold - - -

MR COSGROVE: Another election before it's normally due.

MR CERCHE: - - - another election before the due term, yes.

MR COSGROVE: Yes, I see.

MR CERCHE: Mercers as administrators may have more experience of this than me, but properly drawn rules should avoid that. We treat it like the Senate, in effect; that the constituents have appointed the first candidate, and then they get the second one standing there as the bridesmaid.

MR COSGROVE: Well, you have given us a very generous amount of time this morning, Mark. I'd like to thank you for that and for the discussion more generally. It has been very helpful to us. Unless you have any further points that you wanted to make to us, I think we'll close.

MR CERCHE: I'm sure you've heard enough from me. Thank you very much.

MR COSGROVE: Thank you. That concludes our hearings on the draft report. We're adjourning now.

AT 10.33 AM THE INQUIRY WAS ADJOURNED ACCORDINGLY

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