Trustee Corporations Association of Australia

Second Submission to the Productivity Commission's Review of Superannuation Legislation

June 2001

Prudential Supervision of Superannuation

1. Introduction

This is the second submission by the Trustee Corporations Association (the "Association) to the Productivity Commission's review of superannuation legislation[1]. It comments on the prudential supervision aspects of current arrangements, including points raised in APRA's recent submission.

2. The "Investor Protection" Gap – a General Concern

The community has a reasonable expectation that monies entrusted to licensed and regulated entities will be safe, even though returns can fluctuate from year to year due to market movements.

Recent well-publicised failures in Australia's financial sector have rightly focused attention on the degree of protection that the current regulatory framework provides to investors, insurance policy holders, and superannuation fund members.

The Association remains firmly of the view that, in the collective investments sector, the introduction of the Managed Investments Act in 1998 had the effect of reducing the protection of investors. It did this by eliminating the requirement that an independent, well-capitalised and well-insured trustee company monitor the activities of the fund manager on a real-time basis.

A typical trustee corporation fee under the pre-MIA arrangements was 5 to 10 basis points (0.05 to 0.10% or $10 to $20 pa for an average investment of $20,000) and covered custody, settlement, banking and "on-the-spot" compliance monitoring. That cost was a small fraction of the charges levied by the fund managers.

The cost of that layer of protection provided by trustee companies was also low in relation to the burden that can fall on the taxpayer when the government is obliged to bail out a failed financial institution.

The HIH and Commercial Nominees episodes have highlighted that "after-the-event" monitoring by auditors and regulators, and recriminations when things go wrong, is no substitute for effective prevention of problems.

Nor is it desirable that taxpayers' funds be put at risk to ameliorate the consequences of the failure of a regulated financial institution.

3. Superannuation

Similar concerns about investor protection arise in the case of the superannuation industry. Those concerns are heightened by the compulsory nature of a significant proportion of superannuation contributions and by the importance of those funds to the expected retirement lifestyles of many Australians.

APRA has noted that the greatest risk of loss tends to lie among those 3,000 or so employer-sponsored funds that APRA permits to operate without an "approved

[1] The TCA's first submission in May dealt with fees and charges under the present superannuation regime.

trustee". That segment represents about one quarter of the total number of members and almost half of the $291 billion of assets that are held by APRA-supervised funds.

Of particular concern to APRA are the 1,800 or so funds with portfolios of less than $5 million. These hold aggregate assets of around $2.3 billion on behalf of about 73,000 members.

Employer-sponsored funds are generally managed by independent employer/employee representatives. However, for the most part those individuals tend to be part-time and often inexperienced, but have the responsibility of looking after very large sums of money in an increasingly complex area.

The superannuation industry is endeavouring to raise the capabilities of those "amateur" trustees through education and training programs.

3.1 Prudential shortcomings identified by APRA

APRA has noted that in the employer-sponsored segment of the superannuation industry the risk of loss to investors stems from a range of identified shortcomings, including-

- **Investment strategies**

  Funds are susceptible to loss through poor investment decisions, non-arm's length transactions, and managers using fund assets for their own benefit.

- **Governance**

  APRA has also flagged the generally poor record of funds in terms of "governance". This can include matters such as inadequate risk management systems, and inappropriate custody arrangements.

- **Outsourcing**

  Similarly, APRA has expressed concern about the risks of fraud or mismanagement inherent in the increasing trend for superannuation funds to outsource various functions to third party service providers.

- **Prudential reporting**

  APRA has noted that its oversight of the superannuation industry is hampered by a prudential reporting framework that is neither timely nor comprehensive compared to other supervised areas. Moreover, late submission of prudential returns is a major problem.

- **Capital adequacy**

  APRA has questioned the capital adequacy arrangements presently in place for the superannuation industry, including the efficacy of the flat $5m minimum capital requirement that generally applies to approved corporate trustees, and the lack of capital requirements for funds without corporate trustees.

3.2 APRA proposals

APRA is looking to address these prudential concerns. Apart from efforts to improve the governance and reporting standards of funds, this involves:

- **An investor protection buffer**

APRA is giving consideration to the development of more structured capital requirements for the industry, encompassing a risk-focused capital regime for approved corporate trustees and broader application of capital charges to funds presently not required to hold a capital buffer.

- **Portfolio diversity**

As regards fund investments, APRA sees a need to ensure that funds adopt prudent portfolio compositions so as to avoid undue concentration of risks, although APRA has also conceded that neither the government nor the prudential regulator should set the investment strategies of individual superannuation funds.

3.3 APRA resource constraints

APRA has acknowledged that, even after handing over some 200,000 "Do It Yourself" funds to the ATO, it does not have the resources to closely monitor all of the funds remaining under its wing. Most of those funds are only required to submit returns annually.

Further, APRA staff generally are able to conduct on-site reviews of individual smaller funds only every five years and larger funds every three years, which allows any underlying risks to compound.

4. <u>How Trustee Corporations Can Help</u>

The Association contends that APRA should extend its utilisation of the expertise, experience and culture of trustee corporations, beyond the other 8,500 funds that it oversees, to those 3,000 or so funds that are managed by part-time inexperienced individuals.

Trustee corporations would assist both APRA and superannuation fund members to ensure proper investor protection in the case of both corporate and industry superannuation funds.

In terms of **portfolio diversity**, legislative or regulatory proscription of "appropriate diversity" will be extremely difficult to balance against the desire for freedom of choice. However, professional trustees are well placed to provide guidance to funds in this area, both in setting up appropriately diversified portfolios, and monitoring compliance with the relevant investment strategy.

Trustee companies' particular expertise flows from the fact that for a number of years they have been operating within the legislated parameters of the "prudent person principle" in respect of their powers of investment on behalf of other persons. This rule requires trustees to act prudently both in determining the suitability of a particular category of investment as well as when considering actual investment proposals.

As regards the need for an adequate **investor protection buffer**, the Association agrees that this is critical. Trustee corporations have high levels of capital and insurance.

In relation to **other prudential shortcomings**, trustee companies can utilise their experience of many decades to assist smaller superannuation funds improve their management of outsourcing arrangements, raise the standard of their supervisory reporting, and strengthen their governance practices.

5. Trustee Company Competition and Costs

The Association also suggests that the greater use of trustee companies can ease the pressure on APRA's resources.

There would appear to be scope to lower the number of APRA approved trustees somewhat from the present 158 by raising the minimum licensing criteria. This should improve the quality of service provided without reducing competition in this field. It could also be expected to lower APRA's costs of overseeing those entities. At the same time, economies of scale should ensure reasonable charges for trustee services.

6. Conclusion

Trustee corporations have been protecting Australians' wealth for over a hundred years. They are well-capitalised and insured, and have appropriate experience and culture to assist regulators by providing independent, on-the-spot compliance monitoring of superannuation fund activities.

While most funds may be well managed, the possibility of significant losses, even in the case of larger funds, cannot be ruled out under present supervisory arrangements.

The Association believes that a greater role for (a smaller group of) approved trustee corporations in the superannuation industry would provide a higher level of investor protection than after-the-event monitoring by auditors and regulators, without a reduction in competition.

Options could include strong encouragement, or even a requirement, that each trustee board of management of a corporate or industry fund:

- engage an approved trustee corporation to "sit beside" the board in a contractual advisory role to provide guidance, or

- appoint a representative of an approved trustee corporation to the board, in addition to existing employer/employee representatives.

Any additional direct cost involved would be small, and outweighed by relatively lower regulatory costs, access to expert advice, and the reduced likelihood of serious problems leading to investor distress and the need for taxpayer bailouts.

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