Trustee Corporations Association of Australia

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

November 2001

COMMENTS ON PRODUCTIVITY COMMISSION'S DRAFT REPORT ON SUPERANNUATION LEGISLATION

The Trustee Corporations Association of Australia (the "Association") is the national industry body which represents 18 organisations, comprising all 7 Public Trust Offices and all but one of the private statutory trustee corporations. Members have been operating for over a century and provide a wide range of services in the areas of:

- private wealth management including estate planning, tax, superannuation, wills and powers of attorney,
- corporate activities including funds management, securitisation, custody and compliance monitoring, and
- charitable trusts.

Members in aggregate currently have capital of about $600 million and manage or hold on trust for beneficiaries around $300 billion of assets.

The Association welcomes the opportunity to comment on the Productivity Commission's draft report on the *Superannuation Industry (Supervision) Act 1993 ("SIS")* and certain other superannuation legislation.

1. Prudential supervision of superannuation

The Association offers in this section some general comments on prudential supervision of superannuation. We propose to make a more detailed submission on this matter to next year's broader review of superannuation recently announced both by the Minister for Financial Services and Regulation and the Opposition.

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Superannuation is a "special" type of managed investment product which, for well-documented reasons, falls within the responsibilities of the financial system's prudential regulator (APRA). Other managed funds are supervised under the MIA regime administered by the disclosure regulator (ASIC).

We believe that, as a general principle, the prudential supervision framework for superannuation should be at least as robust as that applicable to managed funds. Recent problems with some superannuation entities (albeit a relatively small number), which caused large financial losses and emotional stress for thousands of people, highlighted the community's expectations for better investor protection.

We see three broad types of risk as relevant:

(i) **Investment risk** - crystallised by changes in the value of assets held.

We see it as appropriate that both superannuation members (at least in the case of accumulation funds) and managed fund investors should bear the risk that a fund or scheme might "underperform" because of adverse market conditions.

(ii) **Concentration risk** – crystallised when a portfolio shows losses due to insufficient diversification.

The Association agrees that APRA's prudential supervision of superannuation funds should seek to limit concentration by encouraging, or indeed requiring, appropriately diversified portfolios.

This approach, however, is not appropriate for managed investments. A scheme operator or promoter offers a managed fund to potential investors on the basis of a particular investment strategy as set out in the prospectus. That strategy may well involve a concentration of investment – such as in a mushroom farm or an olive plantation - and be relatively risky, but investors knowingly choose to participate on that basis.

While ASIC will have a concern about adequate disclosure by the scheme operator, it is not required to address the prudence of such a scheme's investment strategy.

(iii) **Operational risk** – crystallised by losses due to maladministration, negligence or fraud.

We believe that neither members of superannuation funds nor investors in managed funds should be expected to bear the risk that inadequate regulatory arrangements result in loss due to these reasons.

Suggested framework

The Association submits that the prudential framework for superannuation needs to be strengthened and should comprise a number of elements.

(a) **Licensing**

An appropriate licensing system should be introduced to enable the regulator to assess the credentials of an applicant prior to the commencement of operations [refer **draft recommendation 7.1**].

It is unacceptable that a fund can simply elect to be regulated under section 19 of SIS, without the regulator having advance input into the size, nature and competency of the population that it is expected to supervise.

This situation can be compared with managed funds, where ASIC must register each scheme in advance, and license the responsible entity (RE) which is to operate the scheme.

In deciding whether to grant a licence, ASIC takes into account the expertise and character of the RE's responsible officers and the capacity (including financial capacity and adequate operating systems) of the RE to perform its duties.

(b) **Prudential standards**

As for other supervised entities, APRA should have specific powers to set standards for the prudent operation of superannuation funds, and to enforce those standards. Those standards could cover matters such as governance (including outsourcing), prudent investment strategies, liquidity, and appropriate financial underpinning (capital and/or insurance).

(c) **Independent compliance function**

Licensing and prudential standards are of little use unless fund operators comply with these requirements. In order to minimise the likelihood of losses arising from non-compliance, as well as from maladministration, negligence or fraud, the compliance function presently undertaken by a fund's independent auditor should be strengthened and performed on a more regular and timely basis.

The compliance entity's role would be to:

- monitor the adequacy of a fund's compliance plan,
- monitor the trustee's performance in relation to its obligations under SIS and the fund's trust deed by assessing its compliance with the compliance plan,
- ensure that competitive prices are negotiated on an arm's length basis for services provided to the fund,
- report periodically, say quarterly, to the trustee, and as necessary, but at least annually, to APRA and members on the trustee's compliance procedures and the conduct of the fund, and
- act as the members' representative in pursuing remedies against the trustee, its directors and agents (as relevant) should it become aware of fraud, negligence or maladministration on their part.

We believe that entities other than auditors, which would be licensed by APRA as having the necessary skills, should be permitted to take on this role [refer **draft recommendation 4.3**]. The requirement that the compliance entity be independent of the fund operator is critical for member protection and should be retained.

(d) **Independent custodian**

Each fund should be required to appoint a custodian independent of the fund operator, and licensed by APRA. Its role would be to:

- identify and hold fund assets separately,
- reject instructions from the trustee if it has knowledge of fraud, and
- identify and refer to the compliance entity cases of suspected self-dealing by the trustee.

Financial underpinning

We do not see it as appropriate to attempt to impose capital requirements on a superannuation fund itself.

However, the supervisory framework should ensure that the various commercial parties involved in the operation of a fund do have adequate capital and insurance to address operational risk, including lack of compliance with relevant prudential requirements.

(a) **Approved trustees**

We believe that Approved Trustees for <u>small APRA funds</u> and <u>public offer funds</u> should be required to have appropriate financial underpinning. This should comprise a meaningful minimum level of NTA (or approved guarantee or combination thereof), plus adequate insurance [refer **draft recommendation 4.1**].

Provided NTA is appropriate, we do not see a need for a separate "operating" capital requirement [refer **draft recommendation 4.2**]. Rather, as part of APRA's licensing regime and ongoing supervision, those entities should be required to demonstrate that they have an appropriate policy in relation to the working capital needed to deal with matters such as replacement of record keeping systems.

Tougher licensing criteria for Approved Trustees might cause some exits from the industry. However, this should not necessarily lead to a reduction in competition given that currently there are about 160 such entities. Further, a smaller number of Approved Trustees would lower the cost of APRA oversight.

(b) **Compliance entities and custodians**

To further strengthen the financial underpinnings of the superannuation sector, the independent compliance entity and independent custodian each should be required to hold an appropriate minimum level of NTA, and adequate insurance.

(c) **Corporate and industry funds**

For corporate and industry funds, where there is more affinity with self-managed funds and less focus on operator profit, we do not see the need to impose minimum capital requirements on the operator [refer **draft finding 6.2**]. Rather, we believe that requiring those funds to appoint well-capitalised and insured independent compliance entities and custodians will provide the necessary financial substance.

The requirement for an external compliance entity will also add considerable technical expertise to corporate and industry funds.

Conclusion

The proposed approach would leave the trustee responsible for the overall prudent management of a superannuation fund. Further, by ensuring clarity of roles, independence for the critical investor protection roles of compliance and custody, and adequate financial underpinning, the current arrangements would be both simplified and strengthened.

We believe that the proposed framework would be cost-effective, especially given the recognised need for greater protection of fund members. Competition among compliance entities and custodians with access to economies of scale, together with an expected reduction in outsourcing by fund operators to related parties without market testing of prices, should put downward pressure on costs.

The expanded private sector compliance function would also ease the pressure on limited regulator resources and, importantly, through increased focus and timeliness lessen the likelihood of failures and the consequent calls for possibly costly taxpayer-funded Government bail-outs.

2. Other issues

(a) Draft recommendations

9.1 Financial assistance to funds

The Association supports the concept of maximum transparency in the granting of financial assistance by Government to a superannuation fund that suffers a significant loss as a result of theft or fraud. We also believe that the relevant information should be made public as soon as practicable.

The presence of a financial support scheme for superannuation raises the issue of "moral hazard"– that is, knowledge of a safety net could contribute to looser controls by a fund in respect of theft and fraud than might otherwise be the case. Members might be prepared to accept this situation because of the Government "guarantee".

In Australia, expectations of taxpayer-funded bail-outs have been heightened by recent events such as the HIH debacle.

For this reason, the Association believes it is critical that appropriate "preventative" measures, or early warning systems, be in place to reduce the likelihood of major losses in a fund.

(b) Draft findings

5.1 Lodgment period for Small APRA Funds (SAFs)

The Association reiterates the concern it expressed in its initial submission in May that the lodgment period of four months for SAFs is unrealistic given the information that needs to be received from other entities, such as managed funds, before the annual returns can be prepared.

We submit that it is also inequitable to impose a shorter lodgment period on SAFs than on self-managed superannuation funds (SMSFs) supervised by the ATO. An extension in the lodgment period for SAFs to 6 months would be a step in the right direction.

9.1 Funding supervision of self-managed superannuation funds

The Association agrees that the supervision of SMSFs by the ATO and of SAFs by APRA should be funded separately and be based on full cost recovery. Further, both ATO and APRA should publish the costing of that supervision.

Despite discussions with APRA, we remain concerned that the fees it charges SAFs do not appear to bear a clear relationship to the work involved in supervising them.

(c) Requests for information

7.1 Duplication of compliance

The Association supports the removal, where practicable, of duplication of compliance requirements between superannuation funds operating under SIS and managed funds operating under the MIA.

However, we would not support changes that reduced the already-inadequate level of protection afforded investors in managed funds and superannuation.

As noted in the Commission's draft report, ASIC's surveillance findings clearly raise questions about the effectiveness of the compliance regime under the MIA.

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