

**SUBMISSION BY THE  
SUPERANNUATION PRACTICE COMMITTEE  
OF THE INSTITUTE OF ACTUARIES OF AUSTRALIA  
TO THE FINANCIAL SYSTEM ENQUIRY**

**REGULATION OF THE SUPERANNUATION INDUSTRY**

The Institute's views on superannuation relate essentially to items 3(a), (b), (c) and (d) of the specifics of the inquiry's terms of reference. These items cover the regulatory arrangements affecting the operation of superannuation funds.

In October 1991 the Institute made a submission to the Senate Select Committee on Superannuation. Part 3 of our submission covered "The Adequacy of Prudential Control Arrangements applying to Superannuation Funds". A copy is attached. Our views on this matters have not changed since then.

In addition to the points made in the attachment, we make the following points.

**The Trustee Structure Applying to Superannuation**

The regulation of superannuation funds is currently heavily reliant on the application of the trustee structure, as is the case in many overseas countries. We believe there are compelling reasons for continuing to rely on the trustee structure in regulating superannuation in Australia. Reasons include:

- The trustee structure has applied to superannuation for a very long time, both in Australia and overseas. It has proven itself to be a highly successful regulatory structure.
- There is a well established body of statute and common law principles applying to trustees which have evolved over a long period.
- There are over 100,000 superannuation funds in Australia. Direct regulation of these funds by a Government body is impractical. The numbers are very different from the numbers of other types of financial institution, where the more manageable numbers make some direct regulation a more viable proposition. For superannuation funds, a significant degree of self-regulation is inevitable.
- The presence on trustee boards of member elected trustees, who have a strong personal interest in the running of the fund, means that in general trustee boards have the necessary incentives to make a largely self-regulatory process work successfully.

- Another ingredients in a successful self-regulatory process using the trustee structure are:-
  - (i) a well informed membership and
  - (ii) a well educated trustee board.

We believe most funds already have these ingredients and that the ISC and the superannuation industry have in recent years taken the necessary steps to move all funds towards this position.

- Over the last thirteen years previous Governments have made an enormous number of changes to the superannuation system. In 1993 the Superannuation Industry (Supervision) Act introduced a whole new regulatory structure for superannuation funds. The Act significantly strengthened the powers of the ISC and supported and strengthened the existing trustee structure, placing many new obligations and responsibilities on trustees. The superannuation industry has only recently come to terms with all the changes implemented by this Act. To move away from this approach now would create extensive confusion and uncertainty about superannuation amongst the superannuation industry and the public. We strongly believe that a period of stability in the superannuation system is vital to restore the public's confidence in, and understanding of, superannuation.

### **The Government Regulator**

We believe that a significant level of Government regulation of the superannuation system is necessary. The Maxwell case in the UK demonstrated that self-regulation alone will not provide adequate prudential safeguards for members. To some extent it is the Maxwell case which triggered the development of the Superannuation Industry (Supervision) Act (the SIS Act).

We believe that legislation along these lines is necessary, and that a Government regulator with powers similar to those of the ISC are necessary. However, we believe the ISC's powers are if anything too extensive, as are the powers of the Superannuation Complaints Tribunal. We also believe the provisions of the SIS Act are overly onerous. As a result the costs of superannuation regulation to funds (and hence members) is too high. As support for our views we note that:

- The members of the Maxwell fund may end up recouping much or all of their superannuation monies.
- Cases such as the Maxwell case are extremely rare.
- There is evidence that employers who previously voluntarily provided superannuation over and above the statutory minimum requirements are moving away from voluntary provision, in part due to overly onerous regulatory requirements.
- Administrative costs have risen significantly in recent years, due to onerous government requirements.

- Government requirements are pushing trustees into short term investment policies, which are not in the best interests of members or the country as a whole.

Therefore we see significant scope for streamlining the amount of Government regulation of superannuation, but we believe the broad principles are appropriate.

We strongly believe that a specialist superannuation regulator is essential. Superannuation is different to other financial products and vehicles in a number of respects:

- It is longer term in nature than the remainder of the financial services industry.
- For reasons explained earlier, we believe the trustee structure should apply to superannuation.
- The numbers of superannuation funds are higher than the numbers of other financial institutions.
- Superannuation is compulsory, unlike most other financial “products”. Therefore there is a need for fairly strong prudential supervision.
- Superannuation is complex, requiring specialist regulatory staff.
- Superannuation involves concepts which just do not apply to other financial products, such as preservation, vesting etc.
- There is a very wide variety of superannuation funds, requiring a flexible supervisory process. These include approved deposit funds, industry funds, master trusts, excluded funds, pension funds, allocated pension funds, personal superannuation funds etc etc.
- Superannuation generally involves the employee/employer interface and therefore cuts across employee relations issues.

The specialist regulator could be a stand-alone regulator or part of a mega-regulator. In practice we have no strong views either way. The key points are that a specialist superannuation group is required, with a specific regulatory regime designed solely for the superannuation industry.

## Other Issues

1. While we have a compulsory, funded, private sector superannuation system, we believe it is essential that:-
  - a) There is an extensive member disclosure regime in place so that members are properly informed (a stronger disclosure regime is required prior to the introduction of any legislation regarding “choice of fund”).
  - b) The government should assist in ensuring members and trustees are adequately educated in relation to superannuation and investment matters.
2. We support a tax regime which provides for tax deferral, but not tax avoidance. By this we mean that a dollar invested in superannuation and used to provide retirement income should have broadly the same after tax purchasing power as a dollar spent today. Currently **employer**-financed superannuation meets this principle but any significant additional taxes on superannuation would breach the principle.

To meet the principle outlined above, additional tax support, preferably by way of a rebate, on all **personal** contributions would be desirable.
3. Following from our views on superannuation regulation (which include the view that all superannuation should fall within the ambit of a single superannuation regulator), if banks are to offer Retirement Savings Accounts, then we believe that either:-
  - i) The operation of RSAs should be subject to regulation by the ISC (or whichever new regulatory body regulates the rest of the superannuation industry) and any financial institution should be allowed to offer them; or
  - ii) RSAs should not be used for “genuine” superannuation savings but should be limited in scope in a similar way to the Superannuation Holding Accounts Reserve i.e. they should be restricted to being a short term holding account which would be transferred to a superannuation fund once the amount in the account reached a certain size.
4. If the Government goes ahead with increasing individual choice in superannuation eg) by providing for mandatory choice of fund, this will **increase** the need for strong Government regulation. The need for an adequate disclosure regime and for improved education of the public would increase significantly under such a new regime.

We believe the superannuation industry should not be left to meet all the burden of such an education process. We would also point out that development of an adequate disclosure regime could take a lengthy period of time if the life insurance industry is any guide.

5. We recommend the Government considers ways of reducing regulatory costs and burdens on the superannuation industry, by seeking to simplify the legislative framework and reducing the pace of legislative change with which the superannuation industry has to cope.
6. There is currently some inconsistency and confusion in the regulation of those providing financial planning advice to individuals on superannuation products, particularly retail products. If the adviser is a representative of a life insurance company, regulation is almost entirely in the hands of the life insurance arm of the ISC. For other advisers some aspects are the responsibility of the ASC and some are the responsibility of the superannuation arm of the ISC. In the last few years there has been a major improvement in the level of co-ordination of ASC and ISC activities, and in the reduction of inconsistencies in requirements for life insurance based products and other products. However a restructure which further brings those areas together would be welcome provided it does not achieve uniformity by just imposing all current requirements of any of the three regulatory groups involved on all products

There is a definite need to increase the quality of financial advice provided to the public on superannuation matters. This will become increasingly important as superannuation savings rise.

7. Because we are concerned at the growing volume of legislation covering superannuation and the burden it is placing in terms of higher administration costs, we recommend that a regular assessment of the value of superannuation legislation be made, together with a comparison against the corresponding costs.

### **Summary/Key Points**

- We support reliance on the trustee structure as the key element of superannuation regulation.
- We support that strong Government prudential control of superannuation is necessary.
- We believe there is scope for streamlining and simplifying the current prudential regime governing superannuation.

Any questions on the Institute's views on superannuation regulation should be directed to:

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### 3. THE ADEQUACY OF PRUDENTIAL CONTROL ARRANGEMENTS APPLYING TO SUPERANNUATION FUNDS

#### 3.1 Summary

The Institute believes that it is appropriate for a measure of prudential control of superannuation funds to be exercised, preferably by a single regulatory authority.

Regulation should not extend to all activities of superannuation funds because in many areas existing disclosure requirements to members of superannuation funds, and requirements for audit and actuarial certification, are entirely appropriate.

A summary of our main suggestions is set out below.

#### 3.2 Entry Conditions for Providers of Services

##### (a) *Investment*

Uniform licensing standards should apply for all **investment managers** of superannuation fund assets above a minimum size, including trustees who manage investments in their own names. These standards should address the investment management competence of the principals of the investment management firm (or of the trustees collectively if self management is undertaken).

##### (b) *Insurance*

Existing arrangements for:

- (a) **insurance** policies effected with life insurance companies; and
- (b) **self insurance** within defined benefit superannuation funds,

are both desirable and satisfactory.

The Institute suggests these existing arrangements for self insurance for defined benefit superannuation funds (which involve actuarial certification) should be extended to defined contribution superannuation funds.

##### (c) *Administration*

There is no existing prudential supervision of **administration** services to superannuation funds. The present arrangements are satisfactory due to audit requirements.

#### 3.5 Controls on Service Providers

The investment mix of superannuation funds should not be regulated.

Existing regulations of superannuation fund investments are satisfactory, except that the Institute suggests that the maximum 10% amount which can be held by a superannuation fund in a single investment (except Government issues or guaranteed securities or pooled investments) should be disclosed not only to members of superannuation funds with five or more members but also should:

- (1) form part of superannuation funds' annual returns to the regulatory authorities; and
- (2) be disclosed to members of superannuation funds with less than five members.

Existing arrangements for control of and information provided by insurers and administrators of superannuation funds are adequate.

### 3.4 **Trusteeship**

Corporate trusteeship should not be forced upon small superannuation funds due to cost requirements.

Trusteeship should be available to as wide a class of person as possible.

The Institute suggests that investigation should be made as to whether current standards for eligibility as a director of a proprietary company could apply also as the test of suitability for superannuation fund trusteeship.

### 3.5 **Prudential Controls of Superannuation Funds**

Prudential controls of superannuation funds can be achieved through:

- (1) **direct** controls exercised by the regulatory authorities, or by the auditing profession and the actuarial profession being required under legislation to certify that certain standards are being met by superannuation funds; and
- (2) **indirect** controls through requiring trustees to provide certain information to members of superannuation funds.

This second indirect regulatory mechanism is covered in Topic 8 of our submission. Membership of superannuation funds is often employment based and employees may be required to join the superannuation plan as a condition of employment.

We consider that some form of **direct** prudential controls is necessary and must be exercised in conjunction with indirect controls.

Direct prudential controls over superannuation funds can be exercised at three points:

- (1) entry conditions for providers of services to trustees in each of the major service areas of:
  - (i) investment;
  - (ii) insurance; and
  - (iii) administration;
- (2) ongoing information provided by, and controls exercised over, service providers to trustees in each of the above areas; and
- (3) conditions of entry to trusteeship itself of superannuation funds.

### 3.6 **Conditions for Providers of Investment Services**

#### ***Investment***

Investment management services for superannuation funds are provided through one of three main avenues:

- (1) registered life insurance companies;
- (2) by companies holding a dealers licence provided by the Australian Securities Commission (ASC); or
- (3) directly by the trustees of the fund themselves.

The life insurance industry is regulated closely by the Insurance and Superannuation Commission. Minimum standards of adequacy of capital apply, and there are significant, regular disclosure requirements, and tests applied as to the fitness of persons to be involved in the management of life insurance companies. However, these tests do not extend necessarily to cover investment management competence.

The licensing requirements for dealer's licences (which are required by the ASC to be held by those investment firms providing services to superannuation funds), are considerably different from those which apply to life insurance companies as set out above. Under these licensing requirements, greater emphasis is placed on investment management competence and on the financial strength of the investment manager, and less emphasis is placed on capital requirements and regular reporting of investment management activities.

Under the current supervisory regime for superannuation funds, it is possible for trustees of superannuation funds to invest directly the assets available to provide the benefits for the members of the superannuation fund of which they are trustee.

Two questions arise:

- (a) how trustees of superannuation funds who invest in their own name ought to be licensed; and
- (b) whether the dealer's licences issued by the ASC to investment management firms and requirements for life insurance companies ought to be brought into line?

It would be impractical to apply such standards to very small superannuation funds. Possibly the provisions would not apply to superannuation funds with less than five members.

Any of these provisions would not apply to trustees whose only direct investment is a bank account held by the trustees for liquidity and benefit payment purposes, because such bank accounts are not long term investments of the superannuation fund.

The Institute also suggests that it be a requirement of holding an investment dealer's licence that adequate professional indemnity insurance is held by the investment management firm.

### **3.7 Conditions for Providers of Insurance Services**

Many superannuation funds require insurance protection to cover benefits in the event of death, disability or continuation of life.

Currently, under the Life Insurance Act, these insurance arrangements are required to be effected with registered life insurance companies, except in the case of disability income benefits which can be effected with registered general insurance companies.

The Institute believes that the existing prudential supervision arrangements for life insurance companies and general insurance companies are adequate and that no changes are needed in this area.

Part of the three yearly actuarial valuation of a defined benefit superannuation fund is to examine the insurance arrangements which are in force and for the actuary to certify as to their adequacy. Such certification includes examination of the adequacy of assets of insurance arrangements for pensions in the course of payment.

The Institute believes that such arrangements for defined benefit funds are satisfactory and desirable.

However, no such arrangements exist for defined contribution superannuation funds at present.

The Institute recommends that part of the annual audit of a defined contribution superannuation fund by its registered auditor should ensure that adequate insurance arrangements exist and where full coverage by insurance of death, disability or life pension payments does not exist, and such benefits are self insured, that an actuarial certificate as to the adequacy of such self insured arrangements is provided. This requirement would parallel similar provisions in the Tax Act requiring actuarial certification as to the tax deductibility of self insurance costs and the size of pension assets.

### **3.8 Conditions of Providers of Administration Services**

Currently, there are no entry requirements for firms providing administration services to superannuation fund trustees. Of course, superannuation funds are subject to annual audit and this audit examines closely the administration arrangements, and in particular the accounting records of the superannuation fund.

The Institute believes that the current audit arrangements for superannuation funds are a satisfactory check on the administration services being provided to the superannuation fund or by the trustees directly.

The Institute does not believe that increased prudential supervision of administration arrangements above those already in place, is necessary.

### **3.9 Controls on Investment Service Providers**

Current regulation of the investments which are permitted for superannuation funds can be summarised as follows:

- (a) a prohibition on borrowing by funds other than for short term cash flow purposes;
- (b) a requirement that investments by funds other than in-house assets must be at arm's length;
- (c) restriction on loans to, or investment in an employer sponsor to 10% of total assets;
- (d) a prohibition on lending money to members.

These current regulations are desirable.

The Government may be giving consideration as to:

- (i) whether the mix of investments between the major investment sectors (equities, properties and fixed interest) is to be regulated; and
- (ii) whether there should be requirements to ensure an adequate spread of investments within each sector.

Different superannuation funds will have different purposes requiring different investment management strategies. Recent Government announcements ensure that from 1 July, 1992, adequate communication will be provided to members, and that trustees will be fully responsible for the investment strategy adopted.

Therefore, the Institute recommends that the investment mix of superannuation funds should not be regulated.

We also consider that disclosure to members of individual investments above the 10% level (as is proposed by the Government) is adequate protection for members.

On balance, the Institute suggests that disclosure is sufficient at this time, with the proviso that this situation should be monitored.

The Institute believes that the arrangements for annual audit of superannuation funds and therefore of investment management transactions is sufficient prudential control of superannuation fund investment management arrangements.

### **3.10 Controls of Insurance Providers**

Contracts provided by life insurance companies to superannuation funds are subject to actuarial certification as to premium rates and terms and conditions. Also, the Insurance and Superannuation Commission can request copies of such documents and refuse the life insurance company permission to continue issuing such contracts at the discretion of the Insurance and Superannuation Commission.

The Institute believes that these existing prudential controls are adequate.

### **3.11 Controls of Administration Providers**

There is a substantial test placed on administration of superannuation funds through the requirement to provide very detailed annual benefit statements to members.

Also, the annual audit of the superannuation fund will cover the administration system of the superannuation fund and ensure adequate information has been provided.

### **3.12 Entry to Trusteeship of Superannuation Funds**

Superannuation fund trusteeship can be exercised either:

- (a) through a corporate trustee and its directors; or
- (b) through individuals acting in a personal capacity.

The Government is investigating whether it should be a requirement for superannuation fund trusteeship to be performed by a corporation.

The legal aspects of this investigation are not matters on which it is appropriate for the Institute to comment. However, the Institute understands that the audit costs and Government charges for maintaining a corporate trustee structure are approximately \$1,000 to \$2,000 p.a., in addition to other administrative costs.

Clearly, changes to require a corporate trustee structure for relatively small superannuation funds need to be developed with these costs in mind.

The Institute believes that superannuation fund trusteeship should be open to as wide a class of person as is possible and that significant entry requirements for superannuation fund trusteeship should not be required.

Standards exist for persons who may be appointed as directors of proprietary companies. The Institute suggests that these standards be examined to see whether the same qualifications should be applied to trustees of superannuation funds.

A corporation in liquidation, receivership or under official management should not be permitted to be a trustee of a superannuation fund.

Arrangements for member representation on superannuation trustee boards will be compulsory for superannuation funds with more than 200 members after 1995. This, and the adoption of the recommendations set out above, should be sufficient to ensure adequate prudential supervision in this area.

There should be a requirement that trustees (if not corporate) be at least three in number where the fund has at least five members.