SUPERANNUATION:
The Minimisation of Risk

Submission to the Wallis Inquiry

By

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SUMMARY OF RECOMMENDATIONS

• It is important from the point of view of the consumer that the present confusion over the relative “safety” of bank deposits over superannuation be dispelled, and in so far as Government policy is concerned, that the relationship be clearly placed on a “pari passu” basis.

• A mandatory competitive tendering and contracting procedure for the 42 public sector, 62 industry and 4896 corporate superannuation funds be introduced. A competitive tendering process would achieve greater transparency, help build confidence on the part of superannuation contributors and ensure the accountability of trustees and provider performance.

• Regulations under SIS should be reviewed to ensure that identifiable information necessary in a more competitive environment is available to contributors.

• Compensation under SIS legislation is currently limited to proven fraudulent conduct or theft. The grounds for compensation should be extended to include “negligence” where it can be proven that the trustees or managers of superannuation funds acted without due care or diligence and fund contributors suffered loss as a result.

• That compulsory minimum standards for indemnity insurance be incorporated into the SIS regulations.

• The Government should examine introducing a compensation system funded from Revenue, self funded on the basis of contributions, insurance based or a mixture of the above, designed to cover a “minimum” position which could include the SGC compulsory contributions or a “maximum” position which could provide compensation up to a level of benefit e.g. 50% of AWOTE, and allow for some proportion of voluntary contributions to be included.

• Consideration should be given by the Commonwealth Government to the effect of demographic trends on whether fund trustees insuring or not insuring against the risks outlined above is significant, and the potential cost of major fund failures on the demand for pensions.
SUPERANNUATION: THE MINIMISATION OF RISK

INTRODUCTION

The purpose of this submission is to question whether, in view of the significance of compulsory “supersavings”, prudential supervision alone is adequate to safeguard both the interests of individuals and the economy. It is recommended that compulsory trustee indemnity insurance is necessary to reduce the risk to contributors.

The compulsory element in superannuation savings raises the issue as to whether the Commonwealth Government should do more than prudentially supervise the manner in which funds are invested, and whether superannuation trustees or fund managers should be required to meet minimum standards of professional conduct, accept responsibility for their investment decisions and arrange adequate indemnity insurance to protect themselves and the assets under their control.

PROBLEMS OF SUPERANNUATION MANAGEMENT

The Financial System Inquiry Discussion Paper states that there is no Government guarantee provided for bank or financial institution deposits, nor is there any insurance scheme to back deposits in the event of a bank failure. Although left unstated, this position also applies to superannuation funds. Consequently, the contributor of funds must rely almost entirely on the quality and effectiveness of the regulatory process to provide adequate prudential supervision.

Despite this legal reality there is a general public perception that banks have a special relationship vis a vis the Reserve Bank of Australia. Consequently, savings in the banking system are seen as inherently safer than other alternatives including superannuation which is continually subject to the vagaries of Government policy and the financial markets.

We are not proposing that the Government should provide a guarantee for either bank deposits nor superannuation contributions. However, the perception that there is support for banks vis-a-vis superannuation and the lack of commitment by Government to offer any form of guarantee either implied or actual, for the latter may be a factor in the generally unsatisfactory level of public confidence in the long term security of superannuation. This was identified in the 1995 Australian Tax Office study which suggested that confidence will only improve if superannuation is made more simple, predictable and relevant to the medium and long term needs of contributors.
COMMONWEALTH RESPONSIBILITY?

Unlike bank deposits which are entirely voluntary and carry a high element of choice together with a perception of low if any risk, the Superannuation Guarantee Charge (SGC) regulations require virtually all Australian employers by law to contribute up to 6% of wages towards employee superannuation (which will increase to 9% by 2002) in addition to any voluntary employee contributions. These funds are an important component of Australia’s domestic savings and will continue to rise.

According to the Insurance and Superannuation Commission (ISC), by September 1996 superannuation assets reached $261 billion. It is estimated that by 2015 they will grow to $1500 billion on the basis of a contribution rate of 15% per annum.

Recommendation

It is important from the point of view of the consumer that the present confusion over the relative “safety” of bank deposits over superannuation be dispelled, and in so far as Government policy is concerned, that the relationship be clearly placed on a “pari passu” basis.

RISK MANAGEMENT

The issue of Risk Management is complicated by the fact that Government policy, when implemented, will introduce a much higher level of “freedom of choice” for individuals to select investments and transfer funds between superannuation schemes and products. The Treasury in its submission appears to argue that portability and choice places a greater responsibility on individual contributors to carry the risk. However, it is unrealistic to expect, even with the provision of greater information, that individual contributors could effectively make choices which maximise outcomes unless Government regulation specifically requires what additional information will be available so that the management of superannuation is transparent to the consumer who must make the decisions.

Most employees in recent years have had their superannuation covered by award provisions determined by the Industrial Relations Commission (IRC). Under awards, trustees of industry funds have been given a virtual monopoly to receive and invest employer and employee contributions, subject to the laws governing trusteeship and the regulations under the administration of the Insurance and Superannuation Commission (ISC). The adequacy of these regulations can be questioned. e.g. The selection of fund managers and all other professional service providers by trustees is generally arbitrary and not subject to any full due diligence process prescribed in the SIS Regulations.
Recommendation

A mandatory competitive tendering and contracting procedure for the 42 public sector, 62 industry and 4896 corporate superannuation funds be introduced. A competitive tendering process would achieve greater transparency, help build confidence on the part of superannuation contributors and ensure the accountability of trustees and provider performance.

Regulations under SIS should be reviewed to ensure that identifiable information necessary in a more competitive environment is available to contributors.

TREASURY SUBMISSION

The Treasury submission to the Inquiry emphasised that present regulatory arrangements governing the financial system are either “prudential” or “disclosure” based in nature. It asserts that provided sufficient information is disclosed, individual investors can make informed decisions. Having done so, they must then accept responsibility for the outcome.

We would agree with the Treasury that there should be adequate regulatory arrangements to provide prudential supervision which minimise the risk of failure and maintain investor confidence. However, in an environment of greater freedom of choice there is obviously increased risk. Consequently, we do not accept the Treasury’s assertion that “the approach should be to rely more on the discipline the market imposes on institutions to maintain prudent behaviour through requiring the disclosure of information about institutions, financial position, risk attributes, adequacy of control procedures etc.” While theoretically sound, in practice, how many “professionals” on the New York Stock Exchange anticipated the collapse of 1987 or the bond collapse of two years ago? If the experts cannot get it right how can mere mortals?

Treasury evidently believes that savers and contributors cannot expect the Government to ensure the “unquestioning solvency of banks” or their superannuation funds. Consequently, assuming a regulatory regime which enables members to have greater choice of funds and the necessary information to make intelligent choices, “savers in superannuation schemes will have to accept responsibility for their investment decisions”.

While these views are consistent with the philosophy of open financial markets, increased disclosure is not a substitute for effective prudential supervision, nor is the latter a panacea for contributors who may risk losing their retirement savings due to the negligence of others who should be held accountable for their conduct. Both must be tested against the realities of the current and anticipated marketplace for superannuation products dominated by a Government imposed mandatory savings system.
IMPLIED GOVERNMENT GUARANTEE?

As previously noted, there is a strong element of compulsion in the provision of superannuation. Consequently, if the Government takes no action on the present de facto “guarantee” for bank deposits, it will only be a question of time before the community expects at least a similar arrangement to cover compulsory (if not voluntary) superannuation contributions which will make up an increasing proportion of household savings into the next century.

EXISTING COMPENSATORY ARRANGEMENTS.

On the basis of the industry’s experience to date, the case histories identified in the submission by Phillips Fox-KPMG to the Inquiry, and the evidence contained in the Annual Reports of the ISC (see 8.1), it would be foolish to presume that there will be no serious failures in future.

The Superannuation Industry (Supervision) Act 1993 (SIS) makes provision for application to the Minister for financial assistance where funds which have suffered loss as a result of fraudulent conduct or theft (but not negligence) and where the “loss has caused substantial diminution of the fund leading to difficulties in the payment of benefits” (ss. 227, 228 and 229). To date this provision has not been used. It was envisaged that all superannuation funds would be required to make a contribution to the statutory fund (the Superannuation Protection Account (ss. 234, 235)) in the event of a failure, but no details of the level or mode of payment are contained in the Act. Compensation may also be paid out of the Advance to the Minister for Finance (consolidated revenue) and may be liable to be repaid (ss. 235 and 238).

Recommendation

Compensation under SIS legislation is currently limited to proven fraudulent conduct or theft. The grounds for compensation should be extended to include “negligence” where it can be proven that the trustees or managers of superannuation funds acted without due care or diligence and fund contributors suffered loss as a result.

MANAGEMENT IN A COMPULSORY SYSTEM

The inherent problems in maintaining integrity in the Funds Management system are by no means academic. In the most recent report of the Insurance and Superannuation Commission (ISC) 17.12.96 it was stated that “50% of funds have shortcomings which, if not rectified, would create potential risk to the interests of members” and “5% of superannuation funds have serious shortcomings, including breaches of SIS, which have required immediate and intense ISC attention”. This evidence must lead to the conclusion that a regime heavily dependent upon disclosure would not in any way guarantee the operational soundness of superannuation funds, and that effective prudential supervision will continue to be necessary together with more sophisticated
insurance arrangements.

THE AGE PENSION

It can be argued that while Australia continues to have a “needs” based welfare system which provides a pension linked to 25% of AWOTE no superannuant who may have suffered serious loss will be left destitute. Furthermore, while an individual may take civil action against trustees for alleged negligence, even if successful, the trustee may not have the necessary funds to pay compensation unless they had adequate professional indemnity insurance cover.

From the point of view of the over 8 million fund contributors on whose behalf employers have made compulsory contributions, access to a minimum age pension in the event of a failure would not be seen as adequate compensation for their denial of income over many years.

PROFESSIONAL INDEMNITY

The present level of professional indemnity insurance carried by most trustees is probably inadequate and certainly not universal.

According to a recent ASFA survey 142 funds (68.9%) have taken out indemnity/liability insurance in 1996. 29 funds (14%) have not taken out indemnity/liability insurance and 21 (10%) are considering it.

<table>
<thead>
<tr>
<th>Number of Funds</th>
<th>Percentage of Funds</th>
<th>Indemnity/liability Insurance provided</th>
</tr>
</thead>
<tbody>
<tr>
<td>58</td>
<td>28%</td>
<td>Between $1-5 million</td>
</tr>
<tr>
<td>37</td>
<td>17.9%</td>
<td>Between $6-10 million</td>
</tr>
<tr>
<td>12</td>
<td>5.8%</td>
<td>Between $10-20 million</td>
</tr>
<tr>
<td>2</td>
<td>0.09%</td>
<td>Between $20-50 million</td>
</tr>
<tr>
<td>3</td>
<td>1.4%</td>
<td>More than $50 million</td>
</tr>
</tbody>
</table>

This survey demonstrates the uneven nature of indemnity cover and suggests that while larger funds have cover, some intermediate and smaller regulated funds have little if any cover. It is probable that failures are more likely to occur at this end of the superannuation market than among large funds which would have adequate resources to cover a crisis situation. The question of what is an “adequate” level of cover has not been addressed in this submission.

The purpose of indemnity insurance is ultimately to protect the interests of the fund members and to ensure that contributors are protected from the negligent acts of trustees. It is important to note that trustees are generally indemnified from fund assets through the provisions of the trust deed.
COMPULSORY VS VOLUNTARY INSURANCE

Over recent years the superannuation industry has debated the relative merits of a compulsory versus voluntary regime for liability insurance. It must be noted that the duties of trusteeship are very onerous and equate with the highest standards of professional conduct. Proponents have argued that, like other professionals e.g. lawyers and accountants, trustees of superannuation funds should be indemnified for their professional negligence. Insurance not only protects the “professional” but also the “consumer” of professional services. The opposing arguments include:

- concern that a compulsory regime could create a “deep pocket syndrome” which would encourage litigation against trustees;
- if trustees were indemnified on a compulsory basis for professional negligence, their “moral duty” to safeguard the fund assets would be reduced; and
- the availability and costs of commercial liability insurance is not stable and the trustees liability market has until recently, not been “mature”.

These arguments can be adequately refuted. At the end of the day surely it is the interests of the fund members which must prevail. Furthermore, there is little argument that other professionals such as lawyers and accountants have “moral hazard” as a consequence of their compulsory professional indemnity insurance schemes which helps to protect the consumer of professional services.

There is now a vigorous and mature professional indemnity insurance market both locally and internationally which provides liability insurance on a very competitive basis to the trustees of superannuation funds.

MINIMUM STANDARDS

We are arguing in this submission for the introduction of compulsory indemnity insurance on the basis of a set of minimum standards endorsed by Government and enshrined in SIS legislation. The standards already recommended by the Association of Superannuation Funds of Australia (ASFA) and evidently supported by the ISC should be considered in this regard (see attachment). Insurance premiums are currently allowed as an operating expense, consequently they do not significantly increase the administrative costs of Funds, and if compulsory would not allow for any unfair market advantage.

Currently, under SIS regulations it is a requirement for trustees to advise fund members of the existence or otherwise of trustees liability insurance. However, this may not be a factor taken into account by the Industrial Relations Commission (IRC) when determining the selection of funds under industrial
awards. Consequently, most employees would be unaware as to whether or not their trustees have indemnity insurance, and in any case, awards give a limited choice of funds.

On the basis that the ultimate beneficiary of trustees liability insurance is the fund member it would be in our view a brave trustee who elects not to have this insurance but having said that, insurance is not compulsory and indeed the statistics would show that only 68.9% of trustees have provided for it. Furthermore, under the current “voluntary” regime there is no continuing requirement for those trustees who have arranged cover to maintain the insurance “on a claims made and notified basis”. Consequently, adequate protection is not assured.

**Recommendation**

That compulsory minimum standards for indemnity insurance be incorporated into the SIS regulations.

**OTHER OPTIONS**

There are at least two alternatives to commercial compulsory insurance:-

Government: legislate for the creation of a separate fund which would receive contributions on a per capita basis covering the membership of all non-excluded superannuation funds. These contributions could be used to meet any loss sustained as a consequence of the negligence of trustees, or any serious systemic failure in the superannuation system. For losses sustained as a consequence of fraud, a similar fund is in part already provided for under clauses 234 & 235 of the SIS Act.

Self Insurance: taken out by the contributor with an underwriter by which the latter provides cover in the event that the Trustee or fund manager defaults on their commitment. Premiums should attract a tax deduction up to a specified amount and be an addition to current tax arrangements for superannuation contributions.

**Recommendation**

The Government should examine introducing a compensation system funded from Revenue, self funded on the basis of contributions, insurance based or a mixture of the above, designed to cover a “minimum” position which could include the SGC compulsory contributions or a “maximum” position which could provide compensation up to a level of benefit e.g. 50% of AWOTE, and allow for some proportion of voluntary contributions to be included.
MINIMUM RETURN

This alternative would require the Treasury or Reserve Bank to set benchmarks for minimum profitability levels against which all fund managers would be assessed annually. This approach could cause serious distortions and encourage trustees and fund managers to adopt high risk investment strategies in the knowledge that any failures whether systemic or managerial, would trigger compensation.

It has been recommended by the World Bank that benchmarking should be developed as an indicator of performance. It is already used extensively by pension funds to monitor the performance of asset managers.

“The “prudent man” rule has worked well for defined benefit plans where the investment risk is borne by the sponsoring employers, but it remains to be seen whether it will work equally well for defined contribution plans”. (Dimitri Vittas. World Bank. “Boosting Retirement Savings” LISA-CEDA Seminar Dec 1996).

COMMONWEALTH RISK

Traditionally, the Commonwealth has acted as its own insurer and does not seek reinsurance of risk. Furthermore its own employer liability for Commonwealth employees is on a “pay as you go basis” and covered by the annual Commonwealth Budget that position is expected to continue. However, the question must be posed, what would be the effect on Revenue if there was a serious systemic failure involving many $ billions, resulting in a significant increase in the number of persons qualifying for an aged pension?

As our welfare system is also a “pay as you go” scheme the only appropriate response would be for taxes or Government borrowing to increase to cover any revenue shortfall. This response may not be so attractive beyond 2020 when the age profile of the Australian community will change significantly with an increase in the number of “Baby Boomers”entering retirement, the vast majority of whom will have some SGC superannuation cover.

The demographic implications for retirement income purposes are significant. In 1995 the population aged over 63 years was 2.2 million. This will rise to approximately 4 million by 2021, and to as high as 6.4 million by 2051.

Recommendation

Consideration should be given by the Commonwealth Government to the effect of demographic trends on whether fund trustees insuring or not insuring against the risks outlined above is significant, and the potential cost of major fund failures on the demand for pensions.

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