

CHAPTER 4

REGULATION OF SUPERANNUATION FUNDS

The superannuation system which is proposed by the present Government is perhaps unique by world standards. It will be a curious combination of compulsory but private sector located funding. It has the potential, as we see it, to be the best combination of features in the world, comprising competition, in the free market sense, and prudential government guidance. But we make a very strong proviso to that, that these ingredients be blended in the right balance.

Ken Dance, ASFA, Evidence p 643.

4.1 Under OSSA, the rights of members to receive benefits must be fully secured at all times. This provision has meant that a superannuation scheme is usually set up as a trust. A trust is an arrangement under which assets are held by specified persons (the legal trustees) who are legally bound to use those assets for the benefit of other persons (i.e. the beneficiaries of the trust).

4.2 The general duties of a trustee are:

- to observe the terms of the trust deed and carry out the duties defined in the deed;
- to act impartially;
- to act in the best interest of members;
- to act personally, i.e. not to delegate responsibility;
- not to derive a profit from the trust;
- to keep proper accounts and to provide information to members;
- to properly invest trust funds; and
- to avoid conflicts of interest.

4.3 A paper by Lord Browne-Wilkinson notes the differences between traditional and superannuation trusts. These differences include the points that, in superannuation trusts:-

- the beneficiaries are not volunteers;
- there is an underlying contract of employment;
- the size of the trust fund is variable;
- the employer continues to have a financial interest; and
- the trustees have power to amend the scheme.¹

4.4 Nonetheless, he concluded that with codification of certain aspects of trust law, trusts were the appropriate entity for superannuation funds. This was a view shared in many submissions to the Committee including those from the ISC, the ASC, the Attorney-General's Department, Treasury, ASFA, LIFA and others.

¹ The Right Honourable Lord Browne-Wilkinson *Equity and its Relevance to Superannuation Today*, paper presented to a National Conference for Lawyers on Superannuation, February 1992, pp 1.5-1.10

4.5 Given the strong preference for retaining the trust structure of superannuation, the Committee has focused on the areas where it believes current prudential controls are inadequate.

What is Prudential Supervision?

4.6 The goals of prudential supervision have been identified by the Government as being to ensure that:

- superannuation remains a secure, efficient and viable means by which people can provide for their own retirement; and
- the superannuation industry contributes to the Government's broader economic goals of promoting savings, efficient investment and sustainable economic growth.²

4.7 Within these broad macro-economic goals, the ISC sees the primary objective of prudential supervision as placing superannuation savings at the lower end of the risk spectrum thus enabling them to perform an effective role in the retirement income system³. This is a view shared by the Treasury which argues that the primary purpose of supervision is to provide appropriate security for retirement savings while not inhibiting the accumulation of adequate retirement income from superannuation⁴. In this context, Treasury noted that:

- absolute security of superannuation benefits is not attainable;
- there are significant costs to an inappropriate level of supervision; and
- there are 'moral hazard' dimensions to prudential supervision.⁵

4.8 The ASC traverses similar ground and suggests that:

... the primary goal in the regulation of superannuation should be to promote efficiency in the capital markets by ensuring that investor protection and investor confidence are maintained and by encouraging competition through the creation of a 'level playing field' between superannuation and other comparable investment products and between their issuers.⁶

² *Statement on the Prudential Supervision of the Superannuation Industry*, released by the Treasurer concurrently with 1991/92 Budget.

³ Sub No. 151, p 2.

⁴ Sub No. 195, p 20

⁵ *ibid* p. 21

⁶ Sub No. 186, p 3.

4.9 The Committee supports these goals and believes that the appropriate regulatory framework is one in which:-

- the duties, powers and responsibilities of trustees and directors of corporate trustees are clearly defined;
- the rights of members to information, action against trustees and directors and alternative dispute resolution mechanisms are unambiguous; and
- the powers of the regulator to protect members' interests are identified in legislation.

4.10 A regulatory framework which satisfies the above criteria will promote investor protection and ensure equity between members. **Provided the regulatory framework does not discriminate between different providers of superannuation, such a regulatory structure should also enhance the efficiency and competitiveness of the industry and contribute to broader macro-economic goals.**

Current Arrangements

4.11 Currently, regulation of retirement investments is arranged on institutional rather than functional lines. As a consequence:

- life insurance companies offering superannuation are governed by the ISC;
- banks offering superannuation are governed by the RBA, the ISC and the ASC;
- friendly societies, building societies and credit unions are governed by various pieces of State legislation;
- managers outside these structures must comply with both ISC and ASC regulations.

Figure 4.1

the need for supervision

Prudential supervision of the superannuation industry is necessary because:

- the Government has mandated national retirement incomes provision in the private sector and has made it clear that it will not provide either an implicit or explicit guarantee for superannuation funds;
- superannuation savings have an important place in the national economy, currently representing 5% of GDP and are forecast by the year 2000 to increase to 6-7% of GDP;
- for most people, superannuation represents the second largest asset after the family home; with the SGL superannuation will become increasingly important;
- superannuation is relatively illiquid and the individual has little or no choice of fund into which contributions are made; and
- substantial tax concessions are given to superannuation.

4.12 All submissions received by the Committee recognise that the Commonwealth Government has a role to play in enforcing minimum prudential standards. The OSSA currently contains prudential and reporting standards (see Figure 4.2) and new

information disclosure standards will apply from 1 July 1992. Requirements under the Corporations Law and LIA are shown in Figures 4.3 and 4.4.

Figure 4.2

the existing prudential and reporting standards under OSSA are:

- equal member and employer representation on trustee boards of funds which have 200 or more members (to apply to all large funds from 1995);
- a prohibition on borrowing by funds other than for short term cash flow purposes (i.e. a prohibition on gearing);
- a requirement that investments by funds other than in in-house assets must be at arm's length (i.e. must be on commercial terms);
- a restriction on loans to, or investments in, an employer sponsor to 10 per cent of total assets, subject to some transitional provisions;
- a requirement that the rights of members to benefits be fully secured and not subject to lien;
- a prohibition, subject to some transitional provisions, on a fund lending money to members;
- a requirement that the fund's accounts must be audited once a year by an independent auditor;
- in the case of defined benefit funds, a requirement that actuarial reports be prepared at least once every three years;
- a requirement to report to members when they join a fund, annually, on termination of membership and on request; and
- a prohibition against reduction of accrued benefits, other than with the approval of all members or with the approval of the Insurance and Superannuation Commissioner.

There are also specific requirements under OSSA relating to pooled superannuation trusts and approved deposit funds.

4.13 The new information disclosure requirements (reproduced in the Attachment to this chapter) have generally been endorsed by the industry and will substantially improve the level of investor protection by making the financial details and investment policies of the fund readily available. Notwithstanding the existing and proposed new requirements, OSSA is fundamentally flawed because:-

- the penalty for failure to comply with the legislation (withdrawal of tax concessions) detrimentally affects members' entitlements;
- members can only take action against trustees for mismanagement or fraudulent behaviour through costly and uncertain court action;
- the rights, powers and responsibilities of trustees are not defined in the legislation;

- the ISC has no powers to appoint judicial managers to preserve the assets of the fund or to take other action to protect fund members;
- the responsibilities of fund managers, auditors and other financial advisers to trustees and members are not clearly identified;
- the legislation is silent on the ownership and disposition of surpluses; and
- there is no alternative dispute resolution mechanism.

Figure 4.3

Superannuation arrangements which are subject to the Corporations Law are subject to the following requirements:

- a prospectus must be issued in respect of offers and invitations to acquire an interest. That document must contain all the information material to make an informed investment decision;
- all persons involved in preparing the prospectus are liable to compensate investors for loss as a result of false or misleading statements in, or omissions from, the prospectus;
- the management company is required to hold a securities dealers licence. In order to obtain such a licence, an applicant must satisfy the ASC of the educational qualifications and experience of its office holders. In addition, the ASC must believe that the applicant will perform its duties efficiently, honestly and fairly;
- the ASC usually requires, as a condition of the licence, that the management company maintain an adequate level of liquid assets;
- the arrangement must be constituted by a deed approved by the ASC in relation to which there is an approved trustee. In determining whether or not to approve a trustee the ASC has adopted the policy of not doing so unless it is satisfied that the trustee and its officers have the necessary experience, qualifications, knowledge and skills to discharge their functions adequately. The trustee must not be associated with the management company;
- the independent trustee holds the assets of the trust and is charged with protecting the interests of investors;
- the approved deed is required to contain certain covenants which are generally aimed at protecting the interests of investors. A contravention of these covenants is a contravention of the Corporations Law, giving rise to civil consequences; and
- generally speaking, funds must not be lent, or invested, in the management company or trustee or their associates. The ASC has an extensive range of powers to conduct investigations and to enforce the Corporations Law.

4.14 . There is widespread agreement that prudential supervision needs to be improved and that there needs to be a lot more certainty and clarity in the law. However, there is divergence about how this might be achieved.

4.15 ASFA believes that the philosophy underpinning reform to prudential supervision should be:

*To enhance trustees' capacity and willingness to represent members properly, not to interfere with their decision making.*⁷

However, a number of caveats were attached to this statement. In particular, ASFA:

- supported minimum entry requirements for trustees;
- supported the equal trustee representation standards that have been put in place;
- considered there should be a range of sanctions to fit the transgressions made by trustees;
- supported increased member disclosure;
- considered that implementation of an industry-wide alternative disputes resolution mechanism was perhaps desirable; and
- considered some trust law principles could be codified and included in Federal legislation.⁸

4.16 ASFA's views were shared by many submissions to the Committee. However, LIFA suggested that any new rules must consider factors such as the need for enhanced education and training of trustees and the new accounting standards for superannuation funds.⁹ LIFA is strongly opposed to superannuation trustee incorporation and suggests that the Government should draw on the pensions power contained in the Constitution to legislate on trustee matters.¹⁰

⁷ Evidence, p 643.

⁸ *ibid.*

⁹ Sub No. 114.

¹⁰ *ibid.*

Figure 4.4

The prudential requirements of the LIA are:

- Applications for registration as a life insurance company must contain detailed information covering:
 - constituting documents and articles of the company
 - ownership of the company
 - board and management structures and experience
 - auditor and actuary for the company
 - detailed new business strategy, plans and supporting documents
 - detailed financial projections for at least 10 years
 - source and extent of financial support for the company.
- Proposed changes in the ownership of control of life insurance companies must be notified to the ISC for prior screening and approval.
- Life companies must have a Principal Officer who is resident in Australia and primarily responsible for its local operations. They must also have an Approved Auditor and an Appointed Actuary. Persons who are convicted of an insurance offence or dishonest conduct or who are, or have been, bankrupt or insolvent are disqualified from being a Director, Principal Officer or Appointed Actuary.
- The life insurance business of the company must be conducted through statutory funds which are akin to trust funds for policyholders. Each statutory fund must have separate and distinct assets which cannot be mortgaged or charged for any purpose other than to secure a bank overdraft.
- In addition to the solvency requirements applying to statutory funds there are minimum capital requirements outside of statutory funds. Shareholder companies must maintain \$10 million in paid-up capital and share premium. Companies without share capital must maintain assets of \$10 million outside of statutory funds. In both cases \$5 million of these assets must not be invested, directly or indirectly in a related company.
- The ISC requires life insurance companies to lodge financial and statistical returns at regular intervals, including actuarial reports on their financial position.
- The annual accounts of a life insurance company must be audited by an auditor approved by the ISC.
- A registered life insurance company must have an Appointed Actuary who is responsible for carrying out all the actuarial tasks required by the legislation, which are:
 - certification as to the suitability of the premium rates for any life insurance product before it can be issued by the company;
 - an annual investigation into the financial condition of the life insurance company, including the valuation of its policy liabilities; and
 - approve of the allocation and distribution of any surplus disclosed by a valuation.
- All single premium and regular premium life insurance products can only be sold to individuals via a Discharge Statement which must contain generalised information about the product being sold. For all products there must also be an annual statement on the performance of the policy provided to policyholders.
- For regular premium products a policy information statement is required to be issued to the policyholder when the policy document is provided. It must contain a clear statement in plain English of the nature of the contract, the level of guarantees and policy specific early termination values.
- The ISC has powers to investigate any life insurance company which appears to be in financial difficulties or has breached the Life Insurance Act. Such an investigation may lead to the ISC directing the company as to the operations of its life insurance business or the ISC applying to the Court for the appointment of a judicial manager or for the winding-up of the company.

4.17 Mercers suggested in their evidence to the Committee that there were four arms to regulation aimed at achieving the objective of a simple, easy to run system and one which would increase the level of safety. These were member trustees, regular, understandable disclosure, diversification of assets and regular financial examination.¹¹

4.18 The ISC in its submission suggested that the measures announced in the 1991/92 Budget should provide an adequate level of protection for members' benefits while not restricting the competitiveness and efficiency of the superannuation industry.¹² It suggested that:

it is essential that the ISC should have the necessary powers to ensure that the fund members are adequately protected. However, such powers should derive directly from the OSS legislation, not from trust deeds of individual funds....It is our view that this should involve codifying in the OSS legislation the more important trustee obligations under trust law.¹³

4.19 The ASC believes that the current regulation of collective investments, of which superannuation is a part, is inadequate for both investor protection and competitive neutrality between different types of collective investments¹⁴. It suggested to the Committee that:-

- superannuation trusts should be held in the name of a responsible entity which is totally responsible for the administration of that trust;
- if that responsible entity puts investments with a custodial trustee, then the custodial trustee should be an approved depository;
- if the responsible entity is carrying on investment, that investment manager must hold a dealer's licence;
- the regulator for superannuation funds should have sufficient power to be able to act extremely quickly in relation to perceived fraud or mismanagement by responsible entities, and be able to act very quickly in relation to removal of directors or removal of the entire responsible entity.¹⁵

4.20 AMP, County NatWest, BT, Westpac and others all stressed the importance of a specialist regulator. BT told the Committee that:

¹¹ Sub No. 79, pp 37-38.

¹² Sub No. 151, p 13.

¹³ Attachment to supplementary submission, Sub No. 151.

¹⁴ Evidence, p 1301.

¹⁵ Evidence, Hartnell, pp 1301-02.

... there is a great difference between an approach to regulation which is supervisory, based on information and understanding of the risks in the products and developments in the industry, and looking to take early action like the Reserve Bank does to steer the whole system in the right direction ... the other extreme [approach] is prescriptive, relies on writing down rules and perhaps even on force-fitting new types of institutions into existing rules – in this case force-fitting superannuation into a corporation law framework – and relies mainly on ex post prosecution when something goes wrong.¹⁶

4.21 In its recent report on collective investments, the ALRC recommended that the law should provide that the conditions under which a superannuation fund, ADF or a PST attract taxation concessions include a condition that, at all times during the relevant year of income, there was a 'responsible entity' for the fund and that the responsible entity would be regulated by use of either the corporations power or the pensions power.¹⁷

4.22 It was also suggested at the public hearings that it might be more appropriate to separate the legal rights and responsibilities of directors and members of superannuation schemes and the access to tax concessions. The ASC suggested that:

... the major problem with collective investments generally is that, to the extent the trustee is a company, the company has high fiduciary responsibilities to the beneficiaries but the directors who are running the company do not. So the law will not personally impose on those directors an equivalent responsibility to the high fiduciary standard that is on the company. That effectively means that one can get a trustee company going into liquidation but the directors do not have the same personal level of responsibility in respect of the high trust that the company carried.¹⁸

4.23 Mr Langfield-Smith in his evidence to the Committee suggested the ISC continue to regulate the taxation and prudential aspects of superannuation but the ASC consider all the relevant aspects of investor protection¹⁹. He went on to argue that the ASC takes:

... a more effective stand in terms of attempting to get wide input to all their policy statements, which indicates the way in which they exercise their discretionary powers and it is now a requirement that they hold a public hearing before they formulate a policy. That is the sort of thing that the Insurance and Superannuation Commission does not do, although it tends to consult the people being regulated

¹⁶ Evidence, p 840.

¹⁷ ALRC, Report No. 59, p 31.

¹⁸ Evidence, pp 1314-15.

¹⁹ Sub No. 156, p 1.

*and ignores employees*²⁰

4.24 Taking a slightly different tack, AM suggested that it would be appropriate to introduce certain prudential standards for public funds in a similar way to the current specific rules for industry funds.²¹

4.25 Evidence that the Committee received from individuals and welfare and consumer groups indicates that the ISC is seen as a 'captive' of the industry. There was a clear perception that ISC staff did not consult with consumer groups or devote sufficient resources to consumer issues. AFCO, in its evidence to the Committee, stated that the ISC had low credibility with consumers.²²

Proposed New Framework

Regulator

4.26 As many witnesses stressed to the Committee, the superannuation industry does not necessarily need more rules but rather, it needs a consistent industry-wide framework in which to operate over the long term. As already noted, the ASC regarded superannuation as one form of collective investments and argued that it should be subject to the same rules as other collective investments. The Commonwealth Bank argued strongly for a common set of regulations for the industry because:

*it will certainly increase the scope for efficiency of the industry by reducing the administrative burden and hence reducing the costs of running superannuation, which ultimately will reflect in the price of products to the consumer.*²³

4.27 BT, Rothschilds and the IFA have canvassed the possibility of superannuation and other forms of collective investments being subject to separate legislation with the one regulator administering the rules.

4.28 Westpac told the Committee that it:

firmly believes that a single, superannuation regulator for all investment products, including superannuation, is not desirable given the complex technical differences that exist among various investment products. We believe that the ISC should continue to be the lead regulator for superannuation and should be able to use powers under the corporations law to review, audit, investigate and monitor the activities of superannuation fund managers and trustees. It already has significant experience and knowledge of the superannuation industry and has developed a

²⁰ *ibid.*

²¹ Sub No. 96, p 5.

²² Evidence, p 1941.

²³ Evidence, p 822.

sound and informative style of consultation with the industry. The benefits associated with consultation include a non-adversarial dialogue between providers and regulator and a relatively free transfer of information.²⁴

4.29 The Committee considers that superannuation differs from other collective investments in a number of important respects. Firstly, superannuation generally is a condition of employment and therefore is not chosen in the same way as investments in unit trust arrangements. Secondly, superannuation is illiquid and frequently the member may not be able to access the benefit until age 55, implying that it is an investment which is held for decades rather than a number of years. Finally, superannuation is an essential part of the Government's retirement incomes policy and consumers are therefore entitled to clear, consistent regulation for all superannuation products. Accordingly, the Committee believes that there is a need for a specialist superannuation regulator.

4.30 Bearing in mind the rapid growth of the industry since 1983, along with the product innovation and substantial regulatory change, the Committee believes that the ISC has the technical expertise and understanding of the superannuation industry to assume primary supervisory responsibility.

Recommendation 4.1:

The Committee recommends that the ISC become the sole regulator of superannuation products to give certainty and clarity to the operation of the industry.

However, the Committee acknowledges that the RBA and ASC may consider it necessary to impose some additional requirements on institutions which fall within the ambit of their regulatory responsibilities. If this is the case, there is clearly a need for greater effective co-ordination between the regulatory authorities than occurs at present.

The Committee recommends that the RBA, ISC, ASC and TPC liaise both formally and informally on a regular basis.

4.31 If the ISC is to remain the primary regulator of the superannuation industry, its level of resources needs to be addressed. The Committee examined the Budget allocation for the ISC and the ASC, along with their respective responsibilities.

4.32 The ASC is the sole national authority responsible for the administration of the national Corporations Law regulating corporations, securities and futures markets. Some of the companies that report to the ASC are public superannuation funds and fund managers. The ISC is the primary regulator of the superannuation industry and is responsible for administering OSSA, LIA and the Insurance Agents and Brokers Act.

²⁴ Evidence, p 673.

4.33 Superannuation funds and life offices hold around 20 per cent of the total market capitalisation on the Australian Stock Exchange.²⁵ If foreign companies listed on the Australian Stock Exchange but not having operations on a significant scale in Australia are excluded, the figure is towards 30 per cent.²⁶ There is thus a need to ensure that the ISC has adequate resources to be an effective regulator.

Table 4.1

RESPONSIBILITIES AND FUNDING OF THE ASC AND ISC		
	ASC	ISC
Regulatory responsibilities (30/6/91)	892 749 companies	166 general insurance companies 56 life insurance companies 904 general insurance brokers 46 life insurance brokers 100 000 + superannuation funds
Appropriation 1991/92	\$129.622 million	\$14.593 million
Number of Offices around Australia (30/6/91)	Head office: Melbourne 22 regional offices	Head office: Canberra Two regional offices

4.34 The Committee believes that the ISC is inadequately resourced to carry out its present functions, let alone to assume the additional responsibilities envisaged by this report. The Committee notes that the Department of Finance is currently examining the resource needs of the ISC and that RBL administration may be passed to the Australian Taxation Office. The Committee urges the Government to attach high priority to upgrading the resources of the ISC.

²⁵ V W Fitzgerald and I R Harper *Super Preferred or Level Playing Field?*, p 38.

²⁶ *ibid.*

Recommendation 4.2:

The Committee recommends that an independent review of ISC resources be carried out following tabling of the Government's response to this report so that ISC resources are compatible with its increased regulatory responsibilities. The Committee endorses the 'user pays' concept as a means of supplementing budgetary allocations.

The review should include analysis of improvements required to procedures to ensure that the ISC is able to provide figures on the superannuation industry for the previous financial year at the time its Annual Report is tabled in Parliament. The Committee believes that it is unacceptable that statistics produced by the ISC are up to four years out of date.

4.35 The Committee was concerned that welfare and consumer groups saw the ISC as a captive to the superannuation industry. Also, the Committee considered that the ISC was unable to be as frank in its evidence to this inquiry as were the TPC and the ASC. The Committee believes this reflects the ISC's role in advising Government on policy matters. A greater degree of statutory independence would enable the ISC to more fully represent the interests of all those affected by superannuation matters, as well as enhancing the consultative and deliberative processes of the ISC.

Recommendation 4.3:

The Committee recommends that the Government introduce legislation to give a greater degree of statutory independence to the ISC by appointing a panel of commissioners with proven expertise in superannuation from a wide cross-section of the community.

Duties of Trustees

4.36 The Committee supports the continuation of existing arrangements whereby retirement income savings are managed and invested by the private sector. In this context, greater legislative certainty needs to be given to the duties, policies and responsibilities of trustees and directors of corporate trustees. The Committee supports the view put by many witnesses that trust law principles should be codified and included in legislation.

Recommendation 4.4:

The Committee recommends that the Occupational Superannuation Standards Act (OSSA) be amended or replaced so that the duties and responsibilities of trustees and directors of corporate trustees are clearly spelt out, including a duty:

- *to maintain a diversified portfolio unless members advise to the contrary;*
- *to maintain an appropriate level of liquidity;*
- *to limit the level of in-house investment (see Chapter 7);*
- *to keep proper accounts;*
- *to ensure the equitable treatment of members of superannuation funds;*
- *to inform members about matters materially affecting the fund;*
- *to seek independent legal, auditing, and actuarial advice;*
- *to avoid conflicts of interest; and*
- *to be personally responsible for the administration of the trust.*

To facilitate consumer understanding of trust deeds, the Committee recommends that the legislation prescribe the wording of these provisions in trust deeds.

The Committee further recommends that neither the original trust documents nor any amendment of them can authorise a departure from any of the statutory requirements.

4.37 Given the fiduciary responsibilities of trustees, the Committee considers that a 'fit and proper' person test should be applied to all persons nominated or elected as trustees. This would mean that any person who was a declared bankrupt or who had been convicted of fraud or dishonest conduct would be ineligible to act as a trustee.

Recommendation 4.5:

The Committee recommends that all trustees should be Australian residents and be required to pass a 'fit and proper person' test analogous to that required under the Corporations Law.

4.38 In recent months there has been a great deal of discussion about the need for a defalcation fund and/or a reserve fund. The Committee accepts the arguments against a reserve fund but notes that the superannuation regulatory regime centres on trustees and disclosure.