CORPORATE SUPER ASSOCIATION

SUBMISSION TO PRODUCTIVITY COMMISSION

ON

THE NATIONAL COMPETITION POLICY REVIEW OF THE SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993 ("SIS ACT") AND CERTAIN OTHER SUPERANNUATION LEGISLATION

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CONTENTS

SUMMARY OF ISSUES

Background

The Corporate Super Association ("the Association") is Australia's dedicated representative body for major corporate superannuation funds and their corporate sponsors.

The assets of Association members now exceed $53 billion, representing approximately 70% of total corporate superannuation sector assets in Australia, and some 750,000 individual employee fund members.

Summary of position

For regulatory purposes, it is essential that the distinction be maintained between two very different methods of provision of superannuation currently in existence:

- the For Profit provision of superannuation, where the fund is managed and controlled by parties external to the fund, for whom the generation of profit is their only interest in the provision of superannuation products; and
- the Not For Profit provision of superannuation, where the fund is managed by trustees whose Boards represent the interests of the participants in the fund, i.e. the employers and the members.

The existence of both types of fund promotes competitive pressure, enhances prudential control and reduces costs to the community.

The SIS Act enables major corporate superannuation funds to operate at substantially lower costs than either smaller corporate funds, or For Profit service providers through a Master Trust.

Management expense ratios per annum, as a percentage of assets, are summarised as follows:

Median major corporate fund	0.7%
Minor corporate fund	1.22%
For Profit Master Trust	1.43%.

The reduction in expenses in Not For Profit, major corporate funds, as compared with For Profit Master Trust arrangements, are estimated to save individual Australians in excess of $350 million per annum – increasing their benefits in retirement and reducing the strain on the Commonwealth purse accordingly.

For the members of many corporate Not For Profit funds, benefits exceed minimum employer support required under the Superannuation Guarantee (Administration) Act 1992 ("SG minimum"). For employers, such benefits are provided in a cost-efficient way. In addition, the trustee management structure of such funds plays a strong role in ensuring independent prudential control, limiting costs and in promoting competition in the provision of services to the funds.

Moreover, corporate Not For Profit superannuation arrangements provide the only satisfactory way of delivering defined benefits, whereby the investment risks are transferred from the individual member to the corporate sponsor.

The Association notes that current trends in regulatory change, such as those exemplified in the 2001 Financial Services Reform Bill ("FSRB") are directed to the efficient management of For Profit funds. It is a matter of concern that, in an effort to improve the regulation of such funds, a uniform regime is proposed which fails to recognise the Not For Profit and For Profit distinction.

There is further concern that the flaws inherent in the FSRB approach may be continued in future initiatives. Initiatives which the Association understands to be under consideration are:

- repeal of the SIS Act; and
- requirement for all funds to be managed by licensed corporate trustee regulated under Corporations Law provisions.

The Australian community and the Association are eager to see the Productivity Commission Review and Report give a fair hearing to the reasons for concerns on these matters.

The uniform regime supported by the FSRB and more recent proposals would impose constraints and compliance requirements on the Not For Profit funds which do not fit their current constitution. The result would be increased costs and compliance complexity. The process of compliance may also require Not For Profit funds to shed many of the attributes that are the sources of benefit to the participants and to the broader community.

Ultimately, a common template approach across the antithetical elements of For Profit and Not For Profit superannuation arrangements will almost certainly force the employers sponsoring the Not For Profit funds to cease the current arrangements. Individual Australians would then suffer reduction in benefit through:

- loss of competition;
- loss of those additional benefits being paid above SG minimum;
- loss of real involvement in the management of their benefit vehicle;
- increase in administrative, investment and other service costs;

- potential reduction in investment returns as a result of strategies designed for short term marketing advantage of the manager;
- loss of defined benefits; and
- loss of choice.

Productive areas for review

The Association supports the opportunity presented by the current Review to

- streamline legislation and reduce redundant areas;
- prune elements which are not essential to core policy and which are difficult or costly to comply with;
- promote competition and structures which maintain competitive pressures on costs; and
- raise standards through improvement in the regulatory regime, in particular as they apply to licensing and accountability of commercially driven financial service providers.

Areas of concern

The Association understands that key focus areas of the National Competition Policy Review ("the Review") are to include:

- whether the SIS Act restricts or promotes competition;
- the extent to which the SIS Act adds to costs or confers benefits on business and the community as a whole; and
- the extent to which the trustee governance model underpinned by the SIS Act imposes costs or confers benefits on business and the community as a whole.

The Association understands that the following options are amongst those being considered:

- full or partial repeal of the SIS Act;
- regulation of the management of superannuation funds through the MIA (or similar) provisions complemented by those of the FSRB; and
- requiring all superannuation funds to be managed by licensed corporate body rather than by a Trustee which meets the basic equal representation principles set out in the SIS Act.

The Association does not support the options mentioned above for the following reasons.

Full or partial repeal of SIS Act

- The SIS Act provisions relating to **prudential safeguards** and **retirement income policy protection** are necessary, in the context of the current retirement income policy, and would have to be retained either in their current form or in some similar form.
- The SIS Act contains provisions tailored to the regulation of trustee boards representative of the interests of members and sponsors, i.e. Not For Profit trustee structures.
- The SIS Act facilitates competition by imposing no barriers to entry.
- The SIS Act should not be held responsible for restricting competition by imposing excessive compliance burdens. The increase in compliance costs over the last five years can be attributed squarely to other superannuation legislation imposed during that period.

Requiring all superannuation funds to be managed by licensed corporate body rather than by trustee

- A move towards a uniform, inflexible regulatory regime relying on management of every fund by licensed professional manager has the potential to drive Not For Profit funds out of existence, to the detriment of competition and community best interests.

- The enforcement of uniformity of structure, and restriction of diversity in sources and methods of providing benefits, will almost certainly restrict competition and increase costs.

- If an approved professional manager is universally required, the management of superannuation is restricted to entities whose interests must be separate from those of the members. In fact it could be said that, since such bodies set their own remuneration, their financial interests are in conflict with those of the members. Independent cost monitoring ceases to occur. Employers will no longer be prepared to provide defined benefit superannuation arrangements.

- If the Not For Profit trustee board structure is abolished, a layer of risk protection is removed. The clear and unacceptable dangers in removing this extra layer of prudential protection of individual Australians' pension arrangements are best illustrated by historical facts. The track record of For Profit financial institutions in Australia has been chequered, whilst bona fide corporate sponsored funds managed by Not For Profit trustee representatives of sponsor and beneficiaries have not suffered conspicuous fraud or abuse.

- The Not For Profit fund structure has great value in **limiting costs** to business and to the community at large. With annual cost structure at a median of 0.7%, large corporate Not For Profit funds suffer half the cost (1.43% per annum) of the typical Master Trust. This cost saving of 0.73% translates to over $350 million per annum for major corporate funds and represents pension fund assets that would be removed from the individual Australian's pension fund and transferred to the bottom line profit of service providers.

- The Not For Profit fund structure has great value in **promoting competition** between entities which provide services to funds.

- The Not For Profit fund structure where the employer has some input gives the employers the confidence to continue defined benefit arrangements.

Attached appendices address in more detail the following:

- representation of the Association – a substantial section of the workforce;
- structure and benefits offered by the Association's funds;
- sourcing of services provided to Association funds;
- information on typical costs of the above;
- comparison of typical (Not For Profit)corporate fund with typical For Profit fund;
- costs and competition: Not For Profit and For Profit funds;
- qualitative issues associated with For Profit management entities and Not For Profit trustee boards;
- costs and competition: the SIS Act and other superannuation legislation.

Recommendations

- It is essential that the disparate nature of Not For Profit and For Profit funds be maintained.
- The value of Not For Profit funds to the community should be acknowledged for their role in:
  - promoting competition and choice in type of superannuation arrangement;
  - limiting costs to the community; and
  - improving ultimate pension benefits to individual Australians.
- The need to retain legislation tailored to regulation of the Not For Profit governance model should be acknowledged.
- The proposed uniform regulatory template needs to be modified to accommodate the differences between the For Profit model and the Not For Profit model. An approach based exclusively on Corporations Law may well be the appropriate regulatory regime for the governance of For Profit funds, but does not accommodate the Not For Profit model.

- Most of SIS Act provisions relating to retirement income policy protection need to be retained (if current Retirement Income policies are to be maintained).
- Certain SIS Act provisions are unnecessarily restrictive and should be trimmed.
- Certain positions adopted by APRA under the SIS legislation are unnecessary and tend to increase compliance costing.

APPENDICES

1. Representation of the Corporate Super Association

As indicated above, the Association represents the interests of sponsors and members of the major corporate sponsored superannuation funds in Australia. The assets of Association members now exceed $53 billion, representing approximately 70% of total corporate superannuation sector assets in Australia, and some 750,000 individual employee fund members.

Thus, the Association represents the superannuation interests of a substantial percentage of Australia's work force.

2. Structure and benefits offered by the Association's funds

The Superannuation Guarantee (Administration) Act 1992 ("SGAA") has effectively imposed a minimum level of employee support on all employers, calculated as a percentage (currently 8%) on the relevant earnings base. For some employers the provision of these SG minimum benefits has represented a steadily increasing obligation. By contrast, our members typically have been providing support to their workforces since before the introduction of SGAA obligations, often at a level well in excess of SG minimum.

The most easily understood and easily measurable way to provide SG minimum support is by way of support in an accumulation fund, to which the employer contributes on a regular basis at the prescribed rate on the prescribed earnings base. An employer who has no interest in doing more than meeting statutory obligations need do no more than contribute to a master fund or industry fund, if available, at the required minimum rate.

The Association represents a group of funds whose sponsoring employers wish for involvement in the provision of employee superannuation benefits, and who in many cases currently prefer to continue to provide more than the minimum support.

Many of our member funds offer defined benefits, or a mixture of accumulation and defined benefits. Defined benefits are so named because they are defined in terms of a salary or other applicable measure. The sponsoring employer takes on the risk associated with making the defined benefits available when service ceases. Hence, the employer accepts the investment risk and other risk factors associated with salary increases, premature retirement and death. Where accumulation benefits are provided, the person bearing the investment risk and much of the other risk is the member.

For SG purposes, the adequacy of the defined benefits so provided is actuarially certified. In many cases the level of support, actuarially measured, substantially exceeds the SG minimum, and has the additional advantage of the reduced risk profile (for the employee) mentioned above.

Thus the Association' funds offer:

- benefits which exceed SG minimum in most cases;
- where defined benefits are provided, secure guaranteed benefits for the member;;
- where accumulation benefits are provided, a system to maximise investment returns and minimise investment risk;
- a prudential "overlay" system to reduce service providers' costs substantially, and correspondingly to increase Australians' benefits in retirement by these costs saved;
- a prudential overlay system to maximise competition and encourage competitive tendering for service providers; and
- greater level of commitment on the part of the employer.

3. Sourcing of services provided to Association funds

The following data have been provided by our members in response to an Association survey conducted in late April 2001, as well as from other market information.

Trusteeship

Outsourcing of trusteeship is the exception rather than the rule.

Administration

Our members report varying amounts of in-house involvement in the administration function. These range from:

- overseeing the external administration function, administration of trustee board function; to
- full in-house administration.

Investment management, custody

Outsourcing is the norm, although one fund reported that 40% of the portfolio is managed in-house, the rest by specialist managers. Trustees will typically use a varied panel of investment managers, chosen under a competitive bidding process, and will seek specialist independent asset consulting advice in order to optimise diversification, reduce risk, maximise returns and minimise costs.

Custodians are selected by Trustees from the range available and are impartially chosen, not necessarily related to any of the investment managers used. The criteria used for selection will be entirely separate from those used in the selection of investment managers, again reflecting the specialist nature of the service and the fact that different providers have strength in different areas.

"Bundling" of the administration, investment and other functions

For the typical large corporate Not For Profit fund, entrusting all functions to one supplier is to be avoided for normal, prudent business considerations. Our members recognise the diverse nature of the functions and will generally seek specialist expertise, seeking terms and performance standards on the basis of market competition for both quality and cost of service. Reviews will be overseen by the trustee, on a regular basis, and the underlying gamut of service providers kept subject to ongoing competitive pressures to minimise costs and maximise return and quality of service.

4. Typical costs of services to the funds

We have obtained the information shown below from the following sources:

- survey of association members, representing the major corporate super funds;
- "Choice of Superannuation Fund: Costs & Benefits to the Community": report prepared by Phillips Fox, Actuaries and Consultants, for the Investment & Financial Services Association Limited, November 1999. Extracts of information from this report are included by kind permission of IFSA.

Survey of Association members

Information collated from Association members indicates that the median Management Expense Ratio ("MER"), i.e. fees including investment management, administration and trustee costs, is 0.7% per annum, with a range from 0.3% of funds under management to 1.2%. The respondent funds included a mix of funds ranging from those whose administration was principally outsourced and those who perform the bulk of administrative functions in-house.

The MER quoted includes all fund costs including the cost to employers of making trustee board members available for fund business during working hours, which was 0.01% for the median corporate fund.

Information from the Phillips Fox report

The report prepared by Phillips Fox, mentioned above, contains comparative data relating to expenses for superannuation market segments, including the corporate fund sector, industry funds and master trust funds.

Data in the report relating to corporate funds was assembled in relation to 28 defined contribution funds with average assets of $86 million at June 1998. Hence, the funds included in the Phillips Fox survey have lower asset levels than those of the Association's membership. As the data indicates that the expense ratio generally declines as fund assets increase, it is to be expected that the results for those corporate funds surveyed will be

biassed towards lower asset levels, and correspondingly higher costs, than those applicable to the average Association member fund.

The data assembled indicates that corporate funds with assets over the $60 million mark had the following expenses in the 1997-98 year:

Fund size (All figures in table in $million)	Aggregate fund assets	Expenses charged to members	Expenses subsidised by employer	Aggregate expenses	Expense as percentage of assets
100+	33320	290	49	339	1.02%
60-100	18049	189	32	221	1.22%

Comparative data for Master Trusts was as follows:

Fund size (All figures in table in $million)	Aggregate fund assets	Expenses charged to members	Expenses subsidised by employer	Aggregate expenses	Expense as percentage of assets
100+	350	5	N/A	5	1.43%
60-100	350	5	N/A	5	1.43%

5. *Comparison of typical (Not For Profit) Association fund with typical retail For Profit fund*

When considering the management of superannuation funds, it is necessary to differentiate between:

- For Profit funds, managed by trustees who are controlled by operators for whom the generation of profit is of paramount importance; and
- Not For Profit funds, managed by trustees whose Boards represent the interests of the participants in the fund, i.e. the employers and the members, on a mutual basis.

The existence of both types of fund promotes competitive pressure and hence reduces costs to the community. However, certain critical differences must be emphasised. These have an impact on:

- economic aspects of the management process; and
- the appropriate regulatory focus.

Not For Profit funds

The governance of the traditional employer-sponsored fund has evolved so that the interests of the trustee body are aligned as closely as possible with those of the participating employer and the members. A major focus of the SIS Act has been to ensure that this situation is maintained and enhanced, through equal representation provisions. It is apparent that the management of a fund by a body representing the interested parties, with no commercial interest in deriving fees from the fund, has the greatest chance of acting in the best interests of those parties.

The majority of the trustees, apart from independent expert board members, of these Not For Profit funds receive no payment for their services, although many of the employee and employer representatives are compensated for their time by virtue of being permitted to perform their duties during the working day. The members of the typical trustee body will have no financial interest in the potential service providers and will be able to contribute to a disinterested review of the capabilities of rival contenders.

The trustee body in a Not For Profit fund imposes an additional level of ongoing supervision over the necessary specialist providers of service to the fund. This additional layer of supervision is effectively absent in a "for profit" fund managed by a "professional" trustee.

"For profit" funds

These funds are relative newcomers to the market, when compared with the traditional employer sponsored fund. They meet particular demands in the market, including that from employers who seek minimum involvement in managing the provision of SG minimum benefits to their employees, or for whom close involvement in the process of provision of superannuation benefits has become unattractive.

The value of the service provided by these funds is accepted. The major concern with their management, however, is that the continued existence of each such fund depends most critically on the generation of profit for those who own and control the trustee body. Typically these will be the shareholders of the financial institution which owns the trustee body. The day to day running of the trustee body is performed principally by direct or indirect agents of the financial institution. In practical terms, the fund members can never control or have material influence over the For Profit trustee.

Hence there is a separation of the interests of the proprietors of the trustee body, and those of the members of the fund. In addition, the interests of the trustee are typically aligned with those of at least one (if not all) of the providers of services to the fund, with the cost and other competitive disadvantages noted below.

6. Costs and competition: Not For Profit and For Profit Funds

Costs and competition in the investment market

As a preliminary, it is important to note that the superannuation "industry" is unique in that it does not in itself create wealth. The limit is the wealth being created in the wider economy, which is the source of the investors' increase in wealth. Investors in aggregate cannot exceed the increase in wealth generated by the wider economy, so all the "pie" that can ultimately be available is the aggregate return less costs. Hence, the only role available for competition to play is in the limitation of costs. It is only if investors' costs are minimised that they can, in aggregate be better off, or rather subject to minimum reduction in their returns.

Costs in Not For Profit funds

In a fund where the trustee's interests are broadly aligned with those of the members and sponsor, there is a strong incentive to minimise costs, to the extent that this is consistent with the maintenance of quality service. Not For Profit funds will seek to achieve this by seeking competitive quotations and tenders for services. In many cases they will seek separate quotations for each category of service, e.g. administration, custody, investment advisory, investment management, actuarial, legal and taxation. This is done for reasons of quality and cost. Greatest expertise in all areas will not be generally found within one organisation; in addition, organisations compete with varying effectiveness in different fields. There may be situations where a "bundled" approach provides benefits, but the trustee body would need to weigh this against alternatives.

The above approach should buy good quality service in a cost-effective manner. The statistics provided above on typical costs of services to large corporate funds support this hypothesis.

Costs in "for profit" funds

Crucially, the corporate sponsors to these funds have limited ability to negotiate fees levied on funds under management. Once a decision has been made to enter a master fund, the power to negotiate such fees in future is negligible.

With all services to the fund now controlled, and often provided, by entities related to the professional trustee, the interests of the fund members and of the trustee's owners diverge. The shareholders of the financial institution controlling the trustee would hope that any services which could be provided by the financial institution to the fund would be so provided. There is no regulatory compulsion on the trustee to seek competitive tenders for all separate services from the market. Although there is an argument for smaller corporate funds that economies of scale result from "bundling" the services, there is an absence of competitive review. Research referred to above indicates that the median

cost structure for Not For Profit major corporate funds is less than half that of an average Master Trust.

The US experience

In the context of cost competition, particularly in regard to investment management fees, the messages presented by John Bogle in his book *John Bogle on Investing: the First 50 Years* (McGraw Hill, 2001), are consistent with the above. John Bogle is the founder of the Vanguard Group, the world's largest no-load mutual company, and named by the US *Fortune* magazine in 1999 as one of the four financial giants of the twentieth century. Bogle discusses the performance of US mutual investment funds. These broadly provide the equivalent function in the US market to that provided by investment unit trusts in Australia. Mutual funds dominate investment in the US stock market: by the year 1999 such entities held one third of the total of US equity market. These funds are reportedly the favoured investment medium for US families, and accommodate themselves to tax favoured retirement savings via Individual Retirement Accounts and 401(k) plans.

Like our publicly offered master trusts, most US mutual funds are managed by entities whose proprietors are not the funds' investors. Similar conflicts of interest to those described above as arising in Australian master trusts, arise in most US mutual funds from the separation of the interests of the manager and the investors. Bogle consistently conveys the message that the returns to the investors for these funds are excessively eroded by the following:

- high and increasing management costs, which the investors, generally lacking a voice in the management and cost control process, do not have the power to limit. Bogle produces statistics which indicate that investors are suffering an average expense ratio of 1.55%, as well as transaction costs of around 1% per annum. He points out that these costs are less apparent in a rising market than they would be in a declining market, where they would be highlighted when consuming a much higher percentage of investment earnings;
- unnecessarily frequent turnover of stocks resulting from attempts to second-guess the market, rather than the adoption of longer-term "buy and hold" strategies consistent with buying into businesses which are worthwhile investments. Frequent turnover arguably reduces long term returns to investors, and certainly increases transaction costs, particularly taxes on capital gains;
- charging of costs to the fund which are incurred with the objective of bringing more investment monies under management – these can hardly be said to be reflected in increased benefits to the existing investors.

Bogle points out the advantages of member-owned mutual funds where the proprietors of the mutual fund management entity itself are the fund's investors. In these entities, the profits of the management entity itself are reflected in the returns to the fund's investors. There are fewer barriers to competition between potential service providers. In such a fund, focussed on long term returns, Bogle indicates that management costs can be reduced to as little as 0.2%. This cost ratio is of course based on a low cost index fund which minimises transactions, and where the funds under management are large enough to produce significant economies of scale. Nevertheless, it is true that the funds to which Bogle refers have a winning edge both in investment returns and in low cost ratios.

Arguably, Australian corporate Not For Profit funds occupy an equivalent position to the US member-owned mutual funds, in providing for long term savings. Given the advantages of a structure where the interests of the investors and the managers are aligned, regulatory change which could threaten the position of such funds should be avoided.

7. *Qualitative issues associated with For Profit third party professional management entities and Not For Profit trustee boards*

Advocates of the suggestion that all trustee boards should be replaced by a For Profit third party professional management entity put forward two principal arguments supporting this approach:

- lack of "professionalism" of trustee boards; and
- risk associated with absence of asset backing for trustee boards.

Lack of "professionalism" of trustee boards

One only has to examine recent experience in For Profit financial institutions, to realise that "professional" management provides no guarantee that prudent management procedures will be followed, that investors' best interest will be served, that systems failure will not occur, that the appropriate compliance procedures will be followed, that directors will act responsibly to avoid loss for stakeholders:

- Commercial Nominees Australia Ltd: collapse through loss of invested capital: trustee status revoked in February 2001;
- HIH Insurance: collapse in March 2001.

A less spectacular event has been the imposition on Tyndall Investment Management, an MIA Responsible Entity, of a rectification program for significant compliance problems, put in place by ASIC, April 2001.

By contrast, instances of dramatic loss of assets, systems collapse, serious compliance failure, or evidence of lack of due diligence on the part of trustee board members are conspicuously absent from the record for large corporate superannuation funds. The SIS Act prudential regulatory regime has evidently been highly successful.

Risk associated with absence of asset backing for trustee boards

In light of the excellent track record under the SIS Act regime, any requirement for asset backing for the trustee of a major corporate fund appears redundant. The practical value of the required asset backing for approved trustees is also questionable. In the event of systems failure or other collapse, the required asset base is unlikely to be adequate to make good the damage. The required capital backing for these entities serves more as a barrier to entry to the approved trustee function, than as a practical source of financial insurance.

8. Costs and competition: the SIS Act and other superannuation legislation

Questions have been raised as to the role of the SIS Act in inhibiting (or promoting) competition.

Barriers to entry

The legislation does not impose barriers to entry for any size of fund, nor is it prescriptive as to the source of support or structure of benefits. As a result a very wide variety of arrangements is accommodated and regulated under the legislation.

Cost and compliance barriers

The wide range of superannuation arrangements currently in place, including a large number of very small funds, indicates that the burden of compliance with the SIS Act is not prohibitive. A consistent message from Association members has been that, aside from changes to preservation rules, it is not the SIS Act and related legislation that has contributed to increases in costs over the past five years. SIS Act costs have remained static. Ballooning of administration, systems, tax and other compliance costs is attributed to the following:

- surcharge legislation compliance;
- introduction of the GST;
- franking credit reporting;
- coping with the impact of tax reform; and
- divorce legislation requirements.

The only SIS Act development which is reported to have had an impact on costs is the change to the preservation requirements – a change driven by tax hygiene requirements.

One superannuation fund manager has commented that he administers both a New Zealand scheme and an Australian scheme. In terms of cost of compliance with prudential regulatory requirements, there is little difference between the two. New Zealand funds are operated as trusts with no particular prescriptive legislation. The manager attributes the similarity in costs to the fact that the SIS Act seeks to codify best practice for trustee management of superannuation. In this respect its provisions provide no extra compliance burden but provide a mechanism for policing gross divergence from good practice.

CONCLUSION

- Far from erecting barriers to competition, the SIS legislation actually promotes competition through its flexibility in permitting a large range and variety of superannuation arrangements, many of these available to a number of different employer groups and individuals;
- the SIS Act is not the major culprit in recent increases in compliance costs;
- the SIS Act actually encourages freely competing market forces on a continuous basis through its Trustee-governed framework;
- The SIS Act enables and obliges Trustees to act in the best interests of their members by minimising costs.
- As indicated above, the use of Not For Profit trustees in Association funds saves an estimated $350 million per annum for the Australian public.