FACSIMILE COVER SHEET

Dear Claudia,

RE: - SUBMISSION ON REVIEW OF SIS AND CERTAIN OTHER SUPERANNUATION LEGISLATION
- INFORMATION WITH RESPECT TO THE UK AND CHILEAN EXPERIENCE

I apologise for the delay in forwarding these to you.

Following please find an article from ASFA's Superfunds magazine - April 200 edition, with respect to the UK experience.

I will try to e-mail you additional information tomorrow.

Should you have any queries with respect to this matter, please do not hesitate to 'phone me on (03) 9200 - 4548 or 0409 006 572 or e-mail me at *fgalbraith@jmifa.com.au*.

Yours sincerely

Fiona Galbraith
Manager, Compliance

CHAPTER 11

CONSUMER PROTECTION

Introduction

11.1 Choice of fund will inevitably lead superannuation providers to actively compete for the business of employees to improve market share. Marketing costs will therefore rise. However, in the long run, the Government believes that competition will drive costs down.

11.2 For the first time outside the sphere of optional private superannuation arrangements, employees will encounter providers who will seek to persuade them to direct their SG contributions towards particular products. The Committee received evidence indicating that there is concern in some quarters about whether the consumers of superannuation services and other financial services will be adequately protected from unscrupulous marketing practices. Evidence from officials of the ISC refuted such claims.

11.3 Adequate education and full disclosure of fees and charges represent significant consumer protection measures and the Committee has partially addressed this issue in chapters 5 and 6 of this report. The Committee received evidence relating to a number of other potential consumer protection issues. These include:

- commission driven selling;
- relationships between employers and providers; and
- dispute resolution.

11.4 A number of witnesses urged the Committee to be aware of what they refer to as the "U.K. experience", in which a large number of people in company pension funds were persuaded to change their funds for personal pension plans, to their considerable financial detriment.

The U.K. experience

11.5 The Government of the United Kingdom introduced a form of choice in the mid-1980's. Under this arrangement, employees were given the option of leaving their company pension plans to establish personal pension arrangements. Many employees availed themselves of this option, lured by unrealistic promises about expected benefits.

11.6 Decisions were made in an atmosphere which some analysts believed encouraged members to actively make a choice.

11.7 The repercussions of this decision are still being felt. The Australian Consumers' Association advised the Committee that more than 570 000 cases of mis-selling had been identified, and the total compensation bill is now $AUS10 billion.

11.8 The Committee received a number of expressions of concern in submissions and evidence that there is potential for the U.K. experience to be repeated in this country as a result of the introduction of the choice of fund regime.

11.9 In particular, witnesses expressed concern that providers' agents would induce people to switch funds with little advantage to the employee, but considerable advantage to the provider in terms of the commission they were likely to earn.

Commission driven selling

11.10 William M Mercer Pty Ltd supplied the Committee with information about costs of switching superannuation funds in Chile. Chile operates a compulsory private sector superannuation system in which funds compete actively for members. Mercers advised that according to Institutional Investor Magazine, 29 per cent of fund members in Chile switched funds in the year ending June 1997. Much of this switching is triggered by salespeople who are paid whenever a member switches funds. Approximately 38 per cent of the entire cost of managing Chile's superannuation system is related to costs associated with fund switching. [1] The Committee received evidence that commission-driven sales of superannuation products in Australia may produce similar results to those observed in Chile.

11.11 The Australian Manufacturing Workers' Union was one of several who raised the issue of commission selling. The Union noted that "the large profit driven financial institutions use commission agents to sell their products". The Union considered that polished sales deliveries would unduly influence the choice that employees might make:

> With employees facing the complexities of comparing competing funds, it is axiomatic that personalised service and a smooth sales pitch will go a long way to influencing an employees' choice of fund; and all of this will undoubtedly happen within a backdrop of saturation advertising and promotion in the media by the larger financial institutions. [2]

11.12 The Union questioned whether the diversion of a member's money into promotion and sales activities was in the member's interest and whether the providers' marketing would provide the employee with the information that will allow the employee to make a rational decision.

11.13 The Union suggested that a more orderly and regulated method for the proffering of choice would allow for greater balance in the delivery of sales information. [3]

11.14 Mr Stephen Gibbs, Executive Officer, Australian Institute of Superannuation Trustees (AIST), also viewed commission based selling as undesirable in a compulsory superannuation environment. Mr Gibbs said:

> Commissions are okay for optional personal contributions but, in terms of somebody's superannuation guarantee payments, if you want to be sure of avoiding the U.K. problem, you simply outlaw the payment of commissions in those circumstances. [4]
>
> ...you will inevitably have the sales people there; there is nothing more certain in our mind. When somebody else makes money out of somebody changing funds, people will be convinced to change funds when they should not – inevitably in my view. [5]

11.15 AIST considered that the United Kingdom's experience is a `stark reminder' that there needs to be adequate protection mechanisms in place so that individuals are not sold products that are not in their best interests to buy:

> Caveat emptor is not a concept which should apply when we are dealing with what might be an individual's own savings and ... will be likely to be their major source of income in retirement.
>
> A bad decision early in life might, as people are living longer and longer, result in 30 or more years of financial misery later on, and the impact on the whole community by way of people being increasingly reliant on government pensions and assistance in retirement, is obvious. [6]

11.16 Representing the Institute of Actuaries, Mr John Trowbridge acknowledged there is a potential problem associated with employees being induced to make decisions that are against their best interests. `There are clearly protections needed against sharp sales practices...'. Mr. Trowbridge is of the view that key features statements by providers offer protection:

> ...one of the consumer protection issues here is to have key features statements by providers. We want to prevent institutions, fund managers of various kinds, pushing people into high expense rate and either high risk or low risk earnings rate type funds when they are better off where they are today. So the whole regime has got to push providers to be responsible and make them accountable for trying to do the best for their employees. There are clearly protections needed against sharp sales practices and so forth... [7]

11.17 The Committee discussed the U.K. experience with ISC representatives at its Canberra public hearing. Mr John Larkin told the Committee that the UK problem arose from defined benefit scheme members being enticed to leave their schemes and join personal pension plans that were sold on the basis of quite high commissions. Further, employers provided less support to the personal pension plans than they would have otherwise provided had the employees stayed in the defined benefit fund. [8]

11.18 Mr Larkin told the Committee there are some important existing or foreshadowed safeguards here that would protect against a situation, similar to that in the UK, arising in Australia:

> ...it was foreshadowed in the budget announcement on choice of fund that existing employees of defined benefit funds would be given a statement explaining the consequences of a choice to leave a defined benefit scheme. In our discussion paper released in December we foreshadowed some of the items that would be included in that disclosure statement. That would give those employees a basis for making an informed choice. [9]

11.19 Mr Larkin also advised the Committee that there is quite stringent regulation of financial advice in Australia. He listed the following safeguards:

- Securities dealers and investment advisers are licenced;
- Dealers and advisers are subject to rigorous disclosure requirements to disclose commissions and material conflicts under the Corporations Law;
- The ISC administers a code of practice, in respect of life insurance agents, that includes a requirement for agents to undertake a needs assessment before recommending particular financial products; and

- Transparent disclosure rules at present administered by the ISC and also the ASC. [10]

Relationships between employers and providers

11.20 The Committee received evidence arguing that there is potential for employees to be locked into fund choices by their employer, where the fund choice is based more on the interest of the employer rather than the employees. In particular, the practice of bundled selling was raised as a potential issue, as was the issue of undisclosed inducements and rewards.

11.21For example, a provider such as a bank might offer favourable terms and conditions on other products that it was selling to an employer, if the employer persuaded employees to switch funds to those being offered by the bank. This would not necessarily be in the best interests of the employees. Protection against this practice may however be offered under the provisions of the *Trade Practices Act 1974.*

11.22 In many cases, relationships between providers and employers are innocent and may in fact be in the interests of the employees. However, there is evidence of other situations where the best interests of employees are not the major consideration.

11.23 Westscheme provided such an example to the Committee in its submission. Westscheme submitted that there was evidence, within weeks of the Western Australian Government's choice of fund legislation, of employers being offered financial incentives to meet their choice obligations through a service provider.

11.24 The ACA and several other witnesses considered that there should be strong provisions against `deals' between employers and product providers. The ACA told the Committee that such deals work against the interests of employees, or unnecessarily restrict choice.

11.25 Accordingly, the ACA considered that the Committee should seek a clear opinion of whether the Trade Practices Act provisions relating to "third line forcing" are adequate for the protection of employees in such situations. The ACA also recommended that there be disclosure of relationships between employees and product providers where the relationship extends beyond the provision of superannuation. [11]

11.26 The Association of Superannuation Funds of Australia (ASFA) also addressed this issue. ASFA noted that where an employer has a financial relationship with a provider of financial services including superannuation, there is a possibility of a perception of bias arising if an employer nominates a fund provided by that financial provider.

11.27 ASFA however did not think that such a relationship should be disallowed. As Dr Michaela Anderson noted, `The other side to that is that you might be depriving people of something that was really good'. [12]

11.28 ASFA and a number of other groups recommended that a full disclosure of financial relationships between an employer and a financial provider be made to relevant employees offered choice of fund. [13]

11.29 The Committee asked ISC, ATO and Treasury representatives whether there was a need to regulate commission based selling more heavily, or to ban it completely.

11.30 Mr Larkin advised that commissions are a "traditional and quite normal method of remunerating people who distribute financial products". He sees no major problem with commissions provided they are fully disclosed in a manner that is transparent to the consumer. He reminded the Committee:

> ...in Australia we have quite strong disclosure of commissions. For example, the disclosure rules administered under the SIS regime require full disclosure of all direct and indirect commissions and adviser remuneration. Under our life insurance regime, there is commission disclosure and, indeed, benefit illustrations in respect of the impact of fees and charges on regular premium products. So there are quite stringent regulations. [14]

11.31 There are, however, limits to what regulation can achieve.

11.32 Committee members referred the officials to previous evidence about inducements such as consumers being given mobile telephones in order to induce them to switch funds. Mr Keith Chapman, Deputy Commissioner - Superannuation, ISC, confirmed this would be difficult to prevent, and would require `extremely draconian' legislation. [15]

Dispute Resolution

11.33 Several groups advised the Committee there is a clear need for an alternative dispute resolution mechanism, particularly in view of a recent Federal Court decision that removed the powers of the Superannuation Complaints Tribunal. [16]

11.34The Australian Consumers Association addressed this issue. In its submission, the ACA argued that the regulatory gap created by the Federal Court decision needs to be addressed urgently.

11.35The Association expressed the view that if a legislative solution to this problem is not possible, then an industry complaints scheme should be established "very quickly prior to the introduction of choice of fund". [17]

11.36The ACA advised that the foremost requirement of a complaints handling mechanism is that it must be compulsory for superannuation funds to participate. The ACA drew the Committee's attention to similar requirements for financial advisers' licences:

> ...it will soon be a condition of holding a financial adviser's licence that the holder becomes the member of an industry complaints handling body. [18]

11.37 A submission by National Legal Aid (NLA) also referred to the dispute resolution problem. NLA noted that one of the aims of the Superannuation (Resolution of Complaints) Act 1993 is to provide relief for individuals as a result of unfair tactics in respect of the sale of superannuation policies, but `those provisions are now constitutionally invalid.' [19]

11.38 NLA also noted that the foreshadowed Life Insurance, Conduct and Disclosure Bill 1997 still has not been introduced into Parliament. NLA said the practical result of this is, that there is an absence of regulation addressing problems within the superannuation industry.

11.39 NLA informed the Committee that the Government needs to act quickly to remedy this situation because the practical effect is that superannuation funds are now largely unaccountable. [20]

11.40 ASFA also addressed the issue of dispute resolution, advising the Committee there is a need for an early stage and low cost mechanism for resolving choice disputes involving employers.

11.41 ASFA warned that the operation of choice of superannuation fund has the potential to generate disputes between employers and employees on a range of matters both major and minor, concluding that `what is needed is a dispute resolution mechanism which is able to resolve choice disputes involving employers at an early stage and at a low cost'.

11.42 ASFA recommended the Government further investigate choice related dispute resolution in the course of establishing the ASIC and the "gateway" for dispute resolution.

Footnotes

[1] *Submission*, attachment p. 7.

[2] *Submission*, p. 4.

[3] *Submission*, p. 4.

[4] *Evidence*, p. 110.

[5] *Evidence*, p. 113.

[6] *Submission*, p. 7-8.

[7] *Evidence*, p. 233.

[8] *Evidence*, p. 432.

[9] *Evidence*, p. 432.

[10] *Evidence*, p. 432-3.

[11] *Submission*, p. 9.

[12] *Evidence*, p. 243.

[13] *Submission*, p. 16.

[14] *Evidence*, p. 437.

[15] *Evidence*, p. 437.

[16] Wilkinson, Tuohey and Wall v CARE Superannuation Pty Ltd and others.

[17] *Submission*, p. 11.

[18] *Submission*, p. 11.

[19] *Submission*, p. 2.

[20] *Submission*, p. 2.

The cracks in Chile's pension reform

by Kandell, Jonathan
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Private retirement funds have helped ignite the Chilean economy. But now the funds themselves are being hurt by overeager salespeople and overly conservative investment strategies.

On a sweltering summer day, Jacqueline Toro and Adriana Vargas -- well-dressed, 30-something professionals -- wander the unpaved streets of a development on the outskirts of Santiago where 700 mock-Alpine, prefabricated houses are being built. They peer into a construction shack where four workers are finishing their lunch break with a poker game. The men drop their cards in surprise.

The two women are not looking to purchase one of the $20,000 homes. They are pension fund salespeople, foot soldiers for a sophisticated savings-and-investment system that has helped make Chile the model of economic reform in Latin America, and they are peddling retirement policies to the four laborers. Along with nearly 20,000 colleagues, they have turned the privately run pension fund system into an economic powerhouse. But now their overzealousness is eating into the funds' profits -- and thus the retirement security of people like the workers they are courting.

Since abandoning its bankrupt, state-run social security system 16 years ago, Chile has enrolled virtually its entire working population in 15 private pension fund management compahies, known as administradoras de fondos de pensiones. The AFPs collect 10 percent of an employee's gross monthly salary and invest the money mainly in domestic bonds and stocks, promising to return to the contributors enough of an income to subsist in retirement. Though participation in the system is mandatory except for the self-employed, workers can choose which fund to enroll in. The funds are paid a management fee of about 2.2 percent of salary as opposed to assets -- extremely high by U.S. standards but in line with the going rate elsewhere in Latin America -- and collect a further 0.8 percent for mandatory life and disability insurance.

It's hard to overstate the impact of these funds on the nation's economy. They have helped finance the privatization of Chilean industry and virtually created the domestic corporate-bond market. Their assets under management -- $30 billion atthe end of last year -- are equivalent to 41 percent of Chile's gross domestic product, and by 2000 that figure is expected to jump to fully half the GDP.

The APPs have such a dominant role in the Santiago stock exchange -- they own more than 10 percent of all Chilean equities and are responsible forabout one quarter of all transactions on the exchange -- that analysts track their investments as a guide to where the market is headed: "They are the only true domestic institutional investors in Latin America," says Jacinto Diaz, chief executive of Cia. de Telecomunicaciones de Chile, the country's largest telecommunications company, which has sold several hundred million dollars in bonds to the APPs over che years. Meanwhile, unburdened by social security costs, the government has been able to funnel money into infrastructure and education.

Thus it's no surprise that AFPs have aroused a great deal of interest abroad. Most of that attention has focused on their role in boosting the economy and their potential to serve as a model for privatizing Social Security in the U.S.

But the Chilean system is beginning to display some serious, if still little-remarked, flaws. Administrative

costs, particularly those linked to the 18,561 salespeople like Toro and Vargas and the client turnover they encourage, are climbing so steeply that seven of the 15 AFPs are reporting net losses. Meanwhile, returns on the assets under management have declined dramatically since 1994, the result of restrictive laws, changing economic conditions and a basic herd mentality. All of these problems spark questions as to whether Chilean workers will indeed become the first blue-collar generation in Latin America to spend its golden years with something approaching economic dignity.

Why switch?

This is not to suggest that the Chilean private pension fund system is verging on failure. Fund managers are making some efforts to cut their costs and diversify their portfolios to generate greater returns, and they hope the government will help by changing the laws affecting asset allocation and participant turnover.

The efforts of Toro and Vargas encapsulate some of the problems facing the AFPs. Their employer, Habitat, is on(of the largest management companies, with more than 1 million members and $4.6 billion-plus in assets, and is regarded as typical of the industry.

At the Santiago construction site, Toro turns her charm on Ivan Barriga, a stocky, 30-year-old laborer who recently switched his affiliation from Habitat to another fund. She pulls out a chart showing that Habitat charges a lower fee than Barriga's new APP and has had a better return on assets. But the Construction worker claims he is satisfied with his choice.

"Even though you're losing money?" asks Toro, her hands on her hips and her head cocked to the side.

"So what do you stand to gain if I switch to Habitat?" retorts Barriga. The unstated answer is, of course, more money. Although some salespeople get a minimal base salary, the big bucks come from commissions based on the number of contributors signed up -- including clients snatched away from other AFPs.

Contributors can change pension funds every six months without incurring penalties. Sometimes it's to take advantage of lower management fees or to seek higher returns. (Although complicated government regulations regarding "excess profits" ensure that all AFPs produce roughly the same return each year, even a slight difference in income can, of course, add up over a working lifetime.) More often, however, people switch fund companies based on the same motivation that powers automobile and cigarette marketing throughout the world: sex appeal.

"Lots of pretty saleswomen come by this factory;" says Marco Guzman, personnel manager at Watt's, a food and juice manufacturer located south of Santiago. "Some of them can't answer even basic questions about the AFP system, so I'll tell them to come back when they demonstrate they know their business."

* Although most AFP salespeople are -- not surprisingly -- young women, the tactic can Work for both sexes. Conrado Millar, a 38-year-old star salesman for Habitat and self-described "homely guy with a beard," courts contributors mainly among the female secretaries and clerks at government offices.

Trouble is, these salespeople may be too good at their jobs. Last year they persuaded an asfounding 1.6 million of the 5. million Chileans enrolled in AFPs to switch pension funds. This tug-of-war for participants is costing the AFPs a small fortune in processing- up from 9 percent of total expenditures in 1989 to 38 percent by 1996. "That's unsustainable," says Habitat chairman German Molina.

Much of this work is pure waste. At Habitat 30 to 40 percent of transferring contributors are rejected, according to Enrique Rusch, the fund's manager of back-office operations. "A lot of cases involve people who are already signed up with Habitat, 0nly they didn't realize it because they have switched AFPs so many times that they've lost track of where they are enrolled," he explains. Funds also must reject contributors who change AFPs more often than allowed by law. And at the beginning of the current transfer mania, Rusch notes, "some salespeople were literally signing up the dead -- from the cemeteries."

many fund managers are convinced that the problem of overselling can be solved only by changing the law. And after years of lobbying, they are confident the Chilean Congress will pass legislation before year-end limiting contributors to only one fund switch a year and, to reward loyalty, lowering the management fee the longer a contributor remains with an AFP.

To Ivan Barriga, the construction worker, any such changes are basically irrelevant. Over the past 12

years, he has accumulated a pension nest egg of about $3,000; switching funds a half dozen times in the process. But he figures he will need about 12 times that amount to net a pension paying the equivalent of his current $300 monthly salary. "By then I'd be about 65 years old," he says. "Nobody in my family lives that long."

In the construction-site office a couple hundred yards away, Victor Lillo, a 37-year-old foreman, seems a lot more upbeat. He has switched AFPs only once and thinks that limiting such transfers would be a good thing if it contributes to the system's financial health. Thanks to a series of promotions, his monthly salary has jumped by 60 percent, to $550, in the past two years, and he expects his income -- and pension contributions -- to continue climbing in the years ahead. On average, the 140,000 Chileans who have reached retirement age under the AFP system are receding about 40 percent higher pensions than the 860,000 retirees living under the old social security system.

Lillo and his fellow participants may not be able to get the kind of pensions they expect, however, if the funds' returns don't improve. From 1981 through 1994 the AFPs averaged a brisk 14 percent annual compound return on their investments (see chart). But in 1995 that turned into a 2.5 percent loss, and re--turns rebounded only slightly, to a gain of 4.6 percent, last year. True, there were also plenty of drops to the single digits during the 1981-'94 run, but for a variety of reasons experts don't expect the big numbers of the past to return. A recent research report by Salomon Brothers assumes returns of just 5 percent or so for the foreseeable future.

Because the replacement of social security by private pension funds was considered such a radical policy-- there were no existing models anywhere in the world back in 1981 -- the AFPs have always been restricted to low-risk investments. At first they could place their contributors' money only in Chilean government notes. Chilean stocks were allowed in 1986, and foreign securities were finally added in 1990. But the government continues to limit AFP investment in foreign instruments to 9 percent of the total portfolio, with no more than half of that in stocks.

Until recently, the domestic bias wasn't much of a problem.

It was almost impossible not to rack up good returns From Chilean securities: Share prices kept soaring, and real interest rates on government bonds were higher than in any OECD country. Besides, "there was a generalized feeling in this country that it was somehow immoral to invest in foreign instruments if there were so many capital needs here in Chile," recalls Eugenic Valck, Habitat's investment manager.

The result of sticking so heavily with domestic investments, however, was that the AFPs entirely missed out on Wall Street's bull run. Meanwhile, the local stock market has turned in a mediocre performance over the past two years, as the relatively small number of Chilean stocks became oversubscribed. "Now nobody doubts that foreign equities are a good idea," says Valck.

Ira fund nevertheless does hit a home run, despite all the restrictions, government regulations require that "excess profits" -- returns of 2 percent or more above the industry average for the past 12 months -- must be put in the reserves the funds are required to maintain in order to be sure they can pay out their pensions. The intent is to make sure there is enough cash to pay pensions. But the result, as Valck points out, "is that AFPs can't distance themselves [significantly] from each other in their asset management performance."

So--as the funds themselves concede -- they tend to invest in packs. "We're always looking at the other AFPs. We don't want to hold, say, more than 10 percent more in a company's shares than they do," explains Santiago Edwards, until recently investment manager for Provida, the largest of the funds, with $5.6 billion in assets.

Typical dinosaur Habitat's portfolio is thus pretty representative of the breed: 40 percent in Chilean central bank notes, 17 percent in Chilean mortgage bonds, 5 percent in Chilean corporate bonds, 5 percent in Chilean bank certificates of deposit, 29 percent in Chilean stocks, 3.5 percent in Chilean mutual funds and 0.5 percent in foreign securities, divided roughly evenly between stocks and bonds (see chart). As Ricardo Fernandez, an analyst for ING Barings in Santiago, describes the fund, "Habitat is your typical AFP dinosaur -- big, monstrous, plodding." Given all these constraints, the daily meetings of traders and analysts in Habitat's investment department have all the excitement of bingo night at a Midwestern church.

Even worse, the people at those meetings don't actually decide to buy or sell any holding. That must await the monthly meeting of the board of directors. (If action is really urgent, however, a special board meeting can be convened quickly or directors can be polled by phone.) And of course, before any momentous decisions are made, Valck notes, "we constantly check the monthly logs of the other AFPs

to find out where their investments are going." Not surprisingly, Habitat's total turnover during a recent month came to only $75 million -equivalent to a meager 1.6 percent of the portfolio. "We take a long-term perspective," Valck says.

This slow pace leaves a lot of time for what Valck calls "trade simulations." An analyst or trader is given a hypothetical portfolio of companies in a particular industry and told to simulate buying and selling their stocks. At the end of the month, quarter and year, the results are compared with the overall market performance. The idea, says Valck, is to prepare his young analysts and traders for the new era of consistently lower profits on the Chilean stock market and more investments abroad.

Industry analysts think AFP portfolio managers will need all the practice they can get. Unaccustomed to volatile stock prices, "they barely know how to study this market, let alone Wall Street," says Susan McKenna, who follows the private pension funds for Santiago brokerage Celfin.

Now that the AFPs are allowed to invest in foreign stocks, U.S. mutual fund managers and investment bankers are flooding into Santiago, hoping to pick up a piece of AFP business. But any large-scale shift into foreign equities is likely to take place only slowly. AFPs are reluctant to sharply reduce their positions on the Chilean stock market for fear of causing the prices of shares they own to tumble.

Another idea for improving asset allocation is to fine-tune. "We'd like to eventually be allowed to offer two portfolios -one with a higher percentage of stocks for younger members willing to take more risks and another with a more conservative mix for older members," says Leonardo Jorquera, marketing director at Provida. The AFPs have pushed this concept, but it's unlikely to be enacted by Congress this year.

The AFPs are also looking abroad for growth in their customer base. After 16 years of frenzied recruitment, they have already signed up about 95 percent of Chilean employees. So, as the private pension mantra spreads throughout Latin America, the Chileans are aiming to become partners in foreign pension ventures.

They have gotten off to a rocky start. Habitat invested a total of nearly $3.5 million in two Peruvian and Argentinean fund companies over the past four years but ultimately sold out both stakes because returns never equaled expectations. In both cases, Habitat says, the new private funds faced structural obstacles, such as unfair competition from the old social security system (a problem the government of Peru has acknowledged).

Now Habitat has joined forces to create a private pension fund management company in Mexico, which this year began privatizing its retirement system, using Chile as a model (Institutional Investor, February 1997). Despite its shaky track record in Peru and Argentina, Habitat figures that the Mexican market of 93 million people is too big to skip.

Of the total $75 million investment in the Mexican fund, Mexico's Banca Serfin is providing 51 percent, Citicorp 40 percent and Habitat 9 percent -- plus "the technical knowhow," says Fernando de Solminihac, Habitat's chief executive. That involves organizing and training the sales force, providing the software to keep track of transactions and creating a reliable identification system for contributors. Last year Citicorp also bought a 33.9 percent interest in Habitat for approximately $80 million.

Barings' Fernandez is somewhat optimistic that this move to Mexico could help solve some of Habitat's problems. "Maybe now that they have hooked up with Citicorp, they will show a bit more flexibility and savvy in their investments," he says.

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MEMBER BENEFIT PROTECTION

LOST MEMBERS

(1) WHY PROTECT LOST MEMBERS?

(A) Background

(i) Statutory Rules 1995 No. 64

The Explanatory Statement (the "ES") accompanying Statutory Rules 1995 No 64 (the "Stat Rules"), which amended the *Superannuation Industry (Supervision) Regulations* (the "SISR") to introduce the Member Protection Rules ("MPR"), stated as follows: -

> *"[t]he regulations give effect to a number of the measures concerning the* ***protection of small superannuation amounts*** *announced by the Treasurer on 28 June 1994 in "Superannuation Policy - Statement of Measures". Other legislation that provides for the further implementation of the measures concerning the* ***protection of small superannuation amounts*** *includes: the Small Superannuation Accounts Bill 1995; the Superannuation Laws Amendment (Small Accounts and Other Measures) Bill 1995..."* (emphasis added).

The Attachment to the ES to the Stat Rules, under the heading "Summary", states that: -

> *"The main aim of the regulations is to: -*
>
> - *require funds to protect members with small superannuation amounts;*
> - *assist funds in protecting members by reducing disclosure requirements in resect of such members; and*
> - *require funds to protect and report the details of lost members."*

Under the heading "Background" the following statements are made: -

> *"The regulations will implement two parts of the announcement by the Treasurer dated 28 June 1994 entitled "Superannuation Policy - Statement of Measures": the "Protection of Superannuation Fund Members" and "Reduction in Disclosure Requirements for Small Amounts.*
>
> *...*
>
> *"The regulations* ***also contain consequential measures relating to lost members****. These measures are aimed at protecting lost members and ensuring that lost members are reported to a register of lost members.*
>
> ***"The main aim of the measures announced by the Treasurer is to protect superannuation fund members. Protection generally entails that an amount*** *(whether a small amount or an amount of a lost member)* ***is not eroded by administration fees and charges.***
>
> ***"This protection will allow the large number of small amounts in the superannuation system to grow to a self-sustaining level.***
>
> *"Small and lost amounts are particularly prevalent in industries which employ a high number of part time or casual workers - such as the tourism (eg. hospitality staff) and agricultural industries (eg. fruit pickers). Women in particular are likely to be holders of small or lost amounts"* (emphasis added).

(ii) The Treasurer's 28th June 1994 "Statement on Superannuation Policy"

(a) The Press Release

The Treasurer's Press Release with respect to the 28 June 1994 "Statement on Superannuation Policy" (the "Treasurer's Statement") states that the Treasurer had that day: -

> "*announced in Parliament some important measures ..... including:-*
>
> - *a comprehensive package of measures to* ***protect small superannuation accounts*** *from erosion by administrative fees and charges*" (emphasis added).

Further down the Press Release, the Treasurer goes on to say that

> "*[t]he* ***small amounts package*** *announced today will ensure that the substantial benefits of superannuation are provided to all employees receiving contributions, including those who have just begun to accumulate their superannuation savings or who have casual or part time employment.*
>
> "*Unfortunately, many such employees have found that* ***administrative fees and charges have taken more from their superannuation savings than was gained through investment earnings****. Today, I have announced an end to this problem.*
>
> *"The central element of the Government's package is to require superannuation fund trustees either to*
>
> - *redesign their charges to* ***protect small accounts*** *from fees which are greater than earnings; or*
> - *to redirect* ***small superannuation contributions*** *towards a new 'safety net" alternative payments mechanism to be established by the Taxation Office.*
>
> *"These measures will ensure that the problems are addressed comprehensively, both for existing and new* ***small superannuation accounts****.*
>
> *"In addition the Government will take a number of supplementary measures to reduce the incidence and costs of* ***small accounts****, including streamlining regulatory requirements, voluntary use of the Tax File Number to help identify and aggregate accounts, a further extension of the annual basis of assessment of the Superannuation Guarantee, and encouragement of industry initiatives such as a voluntary transfer protocol.*" (emphasis added).

Indeed, the Treasurer's Statement introduces and discusses the MPR under the heading of "Superannuation Small Amounts".

(b) The "Superannuation Policy - Statement of Measures"

The "Superannuation Policy - Statement of Measures" (the "Statement of Measures"), under the heading "Protection of Superannuation Fund Members", gives the background to the need for protection as follows: -

> "*Where the charges imposed on an account exceed the interest credited to the account, the balance falls. In the case of* ***small amounts****, it is possible for* ***charges to erode account balances to zero****. The* ***"small amounts" problem*** *refers to the* ***erosion of account balances****, where that* ***erosion is caused by administration charges*** *on the account*" (emphasis added).

Furthermore, at paragraph 11, under the heading "Accounts Subject to Member Protection Rule" it is stated that

> *"[a]ccounts will **only** be subject to the member protection rule if:*
>
> - *the balance of the account is less than $1000 (at balance date of the fund or on termination of the account); and*
> - *the fund is not an excluded fund under the SIS rules .....; and*
> - *the fund is an accumulation fund; and*
> - *the account receives or has received employer contributions used to avoid or reduce the SGC"* (emphasis added).

The first reference to "inactive accounts" occurs at paragraph 16, under the heading of "Key Features", one of which is that

> *"[t]he measure [protection of small accounts] is to be **supplemented** with other initiatives which will:*
>
> *- reduce the administrative costs of small accounts;*
> *- facilitate the aggregation of small accounts;*
> *- minimise the number of new small accounts created in superannuation funds;*
> *- facilitate **transfer of inactive accounts** to eligible rollover funds; and*
> *- provide an alternate mechanism for meeting SG obligation." (emphasis added).*

The second limb referred to in the ES to the Stat Rules, that of the policy of the "Reduction in Disclosure Requirements for Small Amounts", refers to the following: -

> *"Where funds agree to implement the **new member protection rules**, there would also be advantages in **not requiring them to incur the transactions costs involved in transferring such amounts into an ERF** on the member becoming inactive or "lost"* (emphasis added).

Further down in the same paragraph it is stated: -

> *" Superannuation funds which implement the **member protection rules announced in this Statement in respect of account balances** (including any money rolled in) **of less than $1,000** will be permitted to comply with reduced disclosure requirements for those members."* (Emphasis added).

The penultimate sentence in that paragraph is as follows: -

> *"In addition, where funds agree to **"member protect"** accounts, such accounts will not have to be transferred to an ERF on the member becoming "lost" (as defined in the SIS legislation). The extent to which other aspects of the lost member provisions of the SIS are to apply to such accounts will be determined in further consultation with interested parties.* (emphasis added)."

This is the only instance in the Treasurer's Statement which makes a reference to "lost members" in the context of protection.

(B) Issues

(i) What precisely is it that "lost members" are to be protected from?

It is apparent from the Treasurer's Statement that the MPR were designed to "protect small superannuation accounts from erosion by administrative fees and charges" - the phenomenon whereby "many employees ... found that administrative fees and charges have taken more from their superannuation savings than was gained through investment earnings." (Treasurer's Press Release). The ES to the Stat Rules explicitly states that "[t]he main aim of the measures announced by the Treasurer is to protect superannuation fund members. Protection generally entails that an amount (whether a small amount or an amount of a lost member) is not eroded by administration fees and charges." However, the Treasurer's Statement only ever refers to protecting small accounts.

The phenomenon whereby an account balance is eroded, due to the administration charges on the account, is purely and simply a function of size (or, to be more precise, a lack of it). It is for this reason that it became known as the "small amounts problem" and why other initiatives, such as transfer protocol, were developed to facilitate the consolidation of small accounts.

It was decided that account balances of $1,000 and above were of sufficient size to be self-sustaining, and that account balances below this were in need of protection against erosion by administration fees until they attained "critical mass". Accordingly, it was considered appropriate that those members with account balances in excess of $1,000 were to bear the costs of cross-subsidising those members with small accounts.

We would submit that a "lost members" with an account balance in excess of $1,000 does not, per se, need to be protected from "erosion by administrative fees and charges" any more than an equivalently sized account of a member who is not lost. There is nothing intrinsically different about the account of a "lost" member and that of a counterpart "deferred" member, which warrants protecting the former and not the later.

It is true that a substantial proportion of "lost members" also have small balances (ie under $1,000). It is also true that these members will have their benefits protected anyway by virtue of being small.

However, we fail to see the policy rationale behind the account of a "lost member", in excess of $1,000 and therefore viable, needing to be protected against erosion from administration fees.

(ii) The Member Benefit Protection Rules as Announced in the Treasurer's Statement

The Treasurer's Press Release introduces the MPR as being "[t]he central element of the Government's package .... to require superannuation fund trustees ..... to redesign their charges to protect small accounts from fees which are greater than earnings'. The Statement of Measures states explicitly that "[a]ccounts will only be subject to the member protection rule if:

- the balance of the account is less than $1000 (at balance date .....or on termination of the account); and
- the fund is not an excluded fund under the SIS rules .....; and
- the fund is an accumulation fund; and
- the account receives or has received employer contributions used to avoid or reduce the SGC".

Clearly, the MPR as announced were only to apply to small accounts. No mention was made of protecting the accounts of "lost members".

(iii) "Lost members"

The Statement of Measures, under the heading "Reduction in Disclosure Requirements for Small Amounts", states that "[w]here funds agree to implement the new member protection rules, there would also be advantages in not requiring them to incur the transactions costs involved in transferring such amounts into an ERF on the member becoming inactive or "lost"". It is the penultimate sentence in that paragraph which states "[i]n addition, where funds agree to "member protect" accounts, such accounts will not have to be transferred to an ERF on the member becoming "lost" (as defined in the SIS legislation). The extent to which other aspects of the lost member provisions of the SIS are to apply to such accounts will be determined in further consultation with interested parties."

We would submit that the reference to funds agreeing to "member protect" accounts and, accordingly, not having to transfer the accounts of "lost" members to an ERF, means funds agreeing to protect small balances.

At no point in the Treasurer's Statement does a reference to protection explicitly refer to protecting lost members. Indeed, as every reference is to protection is made in the context of small balances, the Treasurer clearly contemplated that protection was a manifestation of the small amounts problem - that it meant the protection of small amounts from erosion by administration fees which are in excess of investment earnings.

Accordingly, we would submit that there is no need to protect "lost members" against erosion.

(2) THE DEFINITION OF "LOST MEMBERS" FOR REPORTING PURPOSES

As discussed in previous correspondence with respect to this matter, we would welcome further consideration of some of the methods suggested previously by the ISC of accommodating our concerns, particularly the possibility of removing the need an inactive member to indicate by means of a positive act that they wish to remain a member of the fund and extending the time period to determine "inactivity" from 2 years to 5 years.

The majority of members of industry funds are aware that they can leave their money in the fund until retirement, and most account balances are preserved, so the "inactive test" as currently defined is not a valid indication that a member is lost. It does seem unfair that other members of a fund, particularly those with a relatively small account balance (but with a current address) should be subsidising a member with a larger account balance (but without a current address) simply because the later has failed to advise a change of address.

The costs associated with the verifying that an inactive member wishes to continue to be a member of the fund, for the relatively large proportion of inactive members in the funds we administer, would make such an exercise prohibitive. From past experience, we do not believe that such measures would elicit a good response rate - there would be a significant number of members who would simply fail to respond to such a request.

One outworking of the regulations is that, upon confirmation of wishing to remain a member is received, the member may be "permanently excluded" from being lost and, as such, even if subsequent mail to that member were to be returned, it is open to the Trustee to treat that member as not being lost, despite the fact that they patently are now uncontactable.

Whilst we understand that there is concern that some members who are in fact lost may not be identified as such, we would submit that an balance needs to be struck between the expense which would otherwise be incurred and the underlying policy considerations, especially whether such members would be disadvantaged.

The reporting of lost members could be confined to those members whom the Trustees have reasonable grounds to believe are actually lost and not those who are merely inactive. We would suggest that any such change to the reporting provisions should be restricted to those funds which incur the expense of writing to a member's home address and not to those funds where the correspondence is passed through an employer or agent.

If the reporting of inactive members as lost is to remain unchanged then extending the inactive period from two years to five years would be welcomed, however, this doesn't address the fundamental concerns outlined above.

(3) THE PROHIBITION ON RECOUPING ADMINISTRATION CHARGES FROM A "LOST" MEMBER WHO IS SUBSEQUENTLY "FOUND"

We would also ask you to consider the possibility of permitting the Trustee of a fund, upon a lost member ceasing to be a lost member, to recoup, or "not protect", the "year-to-date" administration charges.

As any member protection is not realised until the end of an exit reporting period or member reporting period, it should not be a significant issue if the Trustee were able to "not protect" the administration charges which have already accrued. Prior to the end of the reporting period the charges would not have crystallised, the member would not have been advised of them and it would not be a matter of revising figures from previous periods.

One way in which members commonly cease to be lost is when they apply for a benefit. It is difficult to justify why these members should be protected from the beginning of that member reporting period until such time.

Similarly, it is also difficult to justify why any member who resumes contact part-way through a member reporting period should be protected from the beginning of that period.

It should be noted that we are not requesting that Trustees have the ability to "claw-back" administration charges from previous reporting periods, as these will have already been realised and reported to members. However, we would consider it reasonable if the Trustees were able to recover from the member their year-to-date administration charges.

Fiona Galbraith
Compliance Manager

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