SUBMISSION

by

THE LAW INSTITUTE OF VICTORIA

to

THE PRODUCTIVITY COMMISSION

on

REVIEW OF *SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993* AND CERTAIN OTHER SUPERANNUATION LEGISLATION

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1. SUBMISSIONS

This submission is made by the **LAW INSTITUTE OF VICTORIA** ("**the Law Institute**"), a division of VICTORIAN LAWYERS RPA LTD (ACN 075 475 731).

The submissions have also been discussed by the Superannuation Committee of the Commercial Law Section of the Law Institute of Victoria ("Superannuation Committee") and have been agreed in principle by that Committee.

The submission is made in response to the Productivity Commission's Draft Report of September 2001.

The Law Institute's submissions are as follows:

Submission 1

If Draft Recommendation 4.1 is to be retained in the final report, it should be made applicable only to trustees of funds that APRA considers to be problem funds, namely funds of <$5 m. which are not approved trustees.

Submission 2

If Draft Recommendation 4.2 is to be retained in the final report, it should provide that, in the case of not-for-profit trustees which outsource the administration of the funds to an administrator, the obligation to maintain the required level of eligible assets and liquid assets can be passed on to the administrator.

Reasons for these submissions are given below.

In addition, the Superannuation Committee wishes to record its agreement with the Commission's draft recommendations and draft findings referred to in section 6 of this Submission.

2. SPECIAL CONSIDERATIONS RELATING TO NOT-FOR-PROFIT TRUSTEES

The issues addressed in this submission will be common to a number of other not-for-profit superannuation trustees.

Before addressing the problems raised by the Draft Recommendations, it may be helpful to describe the structure of the superannuation funds that are sponsored by the Law Institute. From these descriptions it will be noted that funds such as those sponsored by the Law Institute are in a special category that has not been identified as such in the Draft Report, and on whose trustees it would be quite inappropriate to impose new regulatory requirements that are designed to discipline smaller commercial funds.

3. THE LAW INSTITUTE AND ITS SUPERANNUATION FUNDS

The Law Institute is an incorporated body that represents Victoria's solicitors as a professional association. In addition to exercising statutory functions in the regulation of the profession, the Law Institute provides services to members, puts their views in public debate and on issues of legal reform, promotes the services of solicitors to the public and educates the public about the law and the legal profession.

As part of its service to the legal profession, the Law Institute sponsors two superannuation funds:

❖ VSSF

In 1960 the Law Institute established the Victorian Solicitors' Superannuation Fund ("**VSSF**") as a fund to provide superannuation for self-employed solicitors.

VSSF is a public offer fund. At 30 June 2001 VSSF had 323 members and funds under management of $28.1 million.

The trustee of VSSF is Victorian Solicitors' Superannuation Pty Ltd, a single-purpose company established for the purpose of being a superannuation trustee. Share capital of the trustee is $14 consisting of 7 shares held by the Law Institute or its nominees.

The board of directors of the trustee company is appointed by the Law Institute. All Directors are senior lawyers with experience in superannuation.

❖ LISS

The Law Institute established the Legal Industry Superannuation Scheme ("**LISS**") in 1989 to provide superannuation for solicitors and law office staff. LISS is not currently a public offer fund, but contemplates becoming one, and probably amalgamating with VSSF. At 30 June last LISS had 14,843 members and funds under management of $142.75 million.

The trustee of LISS is L.I.S. Pty Ltd, a single-purpose company. Share capital of the trustee is $2, consisting of 2 shares held by nominees on behalf of the Law Institute.

The board of directors of LISS consists of:

- 4 members nominated by the Law Institute of Victoria;
- 4 members nominated by Australian Services Union;
- 1 independent chairman appointed by the board.

Victorian Solicitors' Superannuation Pty Ltd and L.I.S. Pty Ltd:

- are not designed to make a profit - their purpose is to provide a service to the legal profession and a vehicle in which lawyers and their staff can accumulate their retirement savings in a more cost-effective environment than is available from master trusts or other retail funds;
- have no net real assets;
- have never paid a dividend on their shares, and are not intended to;
- pass on all operational savings in the running of the funds to the fund members, not to shareholders;
- unlike most retail funds, do not pay no commissions or other incentive benefits to financial planners or other agents at the expense of the members of the fund;
- have no employees.

Both funds are administered by the Law Institute under an administration service agreement. LIV receives a fee for its administrative services. In the past the fees received have not covered the Institute's costs, so that the funds have been subsidised by the Law Institute.

Over the 40 years that the Law Institute has been administering superannuation for the legal profession, the funds have been administered responsibly and efficiently.

4. DRAFT RECOMMENDATION 4.1 NET TANGIBLE ASSET REQUIREMENTS FOR APPROVED TRUSTEES

4.1. The current requirements

At present SIS sec.26 requires that an approved trustee must:

- have $5 m. of net tangible assets ("**NTA**"), or
- have an "approved guarantee" for $5 m., or
- have a combination of NTA and approved guarantee totalling $5 m., or
- agree to comply with requirements relating to the custody of the assets (in which case the custodian will be required to meet the $5 m. NTA or approved guarantee requirement) - SIS sec. 26(1)(b)(iia).

4.2. Draft Recommendation 4.1

The Draft Recommendation provides:

> *The net tangible asset requirements for approved trustees should be strengthened through legislative amendment. All approved trustees should be required to have a specified minimum amount of net tangible assets (or approved guarantee or combination thereof) regardless of their custodial arrangement. Approved trustees who use custodians should not be required to have more than the specified minimum amount.*

The draft recommendation proposes that, where there is no independent custodian, the approved trustee would need $5 m. NTA (or equivalent form), whereas, if an independent custodian is used, that figure would be reduced to $2 m. However that proposal is modified in the following terms:

> *There may also be a need to set the requirement for the former group at a level higher than $5 million, given that inflation has reduced the real value of the $5 million by about 20 per cent.* [Draft Report p.45]

4.3. The effect of Draft Recommendation 4.1 on not-for-profit trustees

In relation to not-for-profit trustee companies such as the trustees of LISS and VSSF, any requirements that they should hold minimal amounts of net assets in their own right (as distinct from assets held on trust for the members of the superannuation fund) would be entirely contrary to the principle on which they operate. They have no need of capital. They are not set up to make corporate profits. They have virtually no assets. There is no corporate sponsor or commercial financial services provider who would contribute capital to fund a minimal capital requirement or an approved guarantee if such a requirement were now to be imposed on them.

At present VSSF, even though it is an approved trustee, is exempted from the $5 m. NTA requirement by SIS sec. 26(1)(b)(iia), because VSSF has appointed an independent custodian which meets the NTA requirements. However, the basic effect of Draft Recommendation 4.1 would be to delete sec. 26(1)(b)(iia), so as to remove the VSSF trustee's present exemption from a capital adequacy requirement.

Under Draft Recommendation 4.1, an alternative to the requirement of a specified value of NTA would be for the trustee to provide an approved guarantee for $5 m., or $2 m., or whatever figure is finally arrived at. However, a not-for-profit trustee is not in a financial position to meet the cost of such a guarantee, nor does it have any assets of its own that could be charged as collateral to support such a guarantee.

In the case of VSSF and LISS, it would not be appropriate to charge the Institute's assets in order to provide the trustees with approved guarantees.

In the result, therefore, if Draft Recommendation 4.1 were to be carried into effect in legislation, VSSF Pty Ltd could no longer act as an approved trustee of VSSF or LISS, and LIS Pty Ltd could not become an approved trustee.

4.4. Draft Recommendation 4.1 does not serve any purpose in relation to not-for-profit trustees

As the justification for Draft Recommendation 4.1, the Commission's draft report says:

> *The case for a change in the NTA requirement rests on two premises.*

Each of those premises is addressed below.

- **First Premise:** ***There is a direct link between such requirements and the likelihood of prudent management. Without such a requirement the risks associated with deficient trusteeship would be higher.***
  [Draft Report p.43]

Response to the First Premise:

❖ **Capital held by the trustee of a retail fund may or may not promote prudent management**

In the case of retail funds, where the board of the trustee is appointed by and represents the shareholders, the fact that the trustee holds shareholders' capital that is put at risk may or may not lead to more prudent management than might otherwise be the case. It could in fact cause desperate or unscrupulous directors of the trustee to take greater risks in order to try to preserve their capital.

❖ **Capital held by the trustee of a not-for-profit fund will not promote prudent management**

But, whatever may be the effect of holding minimum capital in the case of retail funds, the same considerations do not apply to not-for-profit trustees of the kind considered here, because the motivation is different. The motivation of the directors of VSSF and LISS is one of service to the membership and to the profession of which they are a part. If it were not so, they would not be directors. They have no beneficial interest in the shares in the capital of the trustee company. Their concern is to safeguard and increase the retirement savings of the members. In doing this the question of whether the trustee does or does not have any capital of its own is irrelevant. Directors of such companies will normally use their best endeavours to cause the trustee to act prudently because their purpose is to maximise the benefits for the fund members.

❖ **There is already ample and more effective inducement to encourage directors to act prudently**

In the case of directors who needs a carrot or a stick to cause them to act prudently, they have a duty under the covenants in sec. 52 of SIS, and a risk of incurring personal liability (civil or criminal) for failing to act honestly or prudently. Accordingly, if SIS were to require a trustee company to establish an artificial capital base for which it has no operational need, the mere existence of that unwanted capital would be most unlikely to be conducive to more prudent management.

- **Second Premise:** ***there is evidence to suggest that the current arrangements are not working as well as they could. There have been some failures of funds managed by approved trustees and annual reviews by the Insurance and Superannuation Commission and APRA of a sample of approved trustees have shown a number of weaknesses in important prudent management activities.***
  [Draft Report p.43]

Response to Second Premise:

❖ **The trustees of public offer funds are not in need of further control**

As to the evidence of failure of public offer funds managed by approved trustees, APRA's most recent statement on the issue appears to see no problem:

> *Historically, prudential problems arising in this sector have been negligible.*
>
> (***APRA Insight 3rd Quarter 2001*** p.9)

VSSF is a public offer fund, and therefore falls in that category that does not cause APRA concern.

❖ **The trustees of funds of $5 m. or more are not in need of further control**

APRA's assessment of the class of funds that do pose a real risk is as follows:

> *Experience shows that by far the highest risk resides in those funds with less than $5 million in assets...The number of funds in the < $5 million group is in the order of 1800, with assets totalling around $2.3 billion (less than one per cent of the aggregate assets held in prudentially regulated superannuation funds). Many of these are well managed with active trustee (employer and employee representative) involvement. Nevertheless, as noted above, where problems have been detected in the superannuation sector they tend to be concentrated in this area.*
>
> (***APRA Insight 3rd Quarter 2001*** p.9-10)

It will be noted that those funds that APRA finds to be problem funds are therefore at the very bottom of the 3,000 odd funds that APRA classes as "Non Public Offer" or "mid-sized". It is utterly inappropriate to characterise not-for-profit funds such as VSSF ($28.1 m.) and LISS ($142.75 m.) as being subject to the same deficiencies as

are found to exist in the quite different category of APRA's <$5 m. problem funds.

Accordingly, if the Commission considers that trustees of <$5 m. funds need some minimum capitalisation, it should apply that requirement to funds below that $5 m. threshold. It should certainly not apply it to funds that have approved trustees.

4.5 Draft Recommendation 4.1 would impose unnecessary costs on fund members

Even if not-for-profit trustees were permitted to provide an approved guarantee, the cost of doing so would have to be passed on to the fund members. Thus members would have to pay the cost of servicing a guarantee which serves no purpose in the case of a not-for-profit trustee. A guarantee of $2 m. could involve members of a fund the size of VSSF in an extra $119- per member per year. This is a high cost for an unwarranted and unproductive expense, and could well make the fund unviable.

4.6. Draft Recommendation 4.1 would create a new anti-competitive restriction

The Commission is required by its terms of reference to undertake National Competition Policy review of superannuation legislation. It is required by its terms of reference to focus on those parts of the superannuation legislation that restrict competition, or impose costs or confer benefits on business. It is to take into account a number of factors, including:

> *3(a) legislation/regulation which restricts competition should be retained only if the benefits to the community as a whole outweigh the costs; and if the objectives of the legislation/regulation can be achieved only by restricting competition.*

Draft Recommendation 4.1 does not merely retain an existing restriction on competition. Contrary to Term of Reference 3(a), it would actually create a new anti-competitive restriction where there was none before. By extending the NTA requirements to cover the approved trustees who currently qualify for exemption under SIS sec. 26(1)(b)(iia), the Commission would create a new barrier to entry of new participants. Even more significantly, however, it would also render unviable trustees such as the VSSF trustee which have been providing industry superannuation effectively and competitively to the legal profession for over 40 years. To legislate so as to prohibit highly competitive trustees, such as the trustees of VSSF and LISS, from continuing to compete with banks and other financial service providers unless they hold minimum amounts of capital of which they have no need, would therefore be both beyond the Commission's Terms of Reference and entirely contrary to the competition principle which the Commission was established to promote and is required to apply.

Accordingly, it is submitted that Draft Recommendation 4.1 is beyond the Commission's Terms of Reference unless it is modified to enable viable competitive superannuation providers to continue to compete. This could be achieved by not imposing an inflexible and indefensible requirement that all trustees must have minimum capitalisation of $5 m+., but, rather to limit the requirement to those cases where a genuine potential problem has been identified by APRA.

4.7. Submission 1

If Draft Recommendation 4.1 is to be retained in the final report, it should be made applicable only to trustees of funds that APRA considers to be problem funds, namely funds of <$5 m. which are not approved trustees.

5. DRAFT RECOMMENDATION 4.2 OPERATING CAPITAL REQUIREMENTS

5.1. Draft Recommendation 4.2

Draft Recommendation 4.2 is as follows:

> *The operating capital requirements for all approved trustees should be revised, through legislative amendment, so that they represent a specified proportion of an approved trustee's operating costs.*

The Draft Report describes the rationale of Draft Recommendation 4.1 as being to fund operational requirements and to cover the risk of operational failures. In the case of not-for-profit trustees such as VSSF and LISS, the whole administration function is outsourced to an administrator (in these particular cases to the Law Institute) under an administration contract.

The Draft Report says:

> *these amounts need to be reformulated so that they reflect operating expense levels and appropriate provisioning for replacing record keeping systems and deal with other contingencies. Given the importance of these prudential requirements, they should apply equally to all approved trustees which do have at least $5 million NTA and should be recognised in the legislation.* [Draft Report p.46]

5.2. Present practices need to be preserved for not-for-profit outsourced trustees

Subject to Submission 3 below, we have no problem with the concept that the amounts in question should reflect appropriate levels of expense. Our concern is that the requirement would be applied to the trustee rather than to the administrator. Draft Recommendation 4.2, if carried in its present form into the Commission's final report, and if enacted as legislation (which is what the Draft Report recommends be done), would have the effect of requiring the trustees of VSSF (and of LISS when it becomes a public offer fund) to have operating capital requirements which they do not possess and which they are not structured to be able to acquire.

Condition D1 of APRA's standard instrument of approval requires approved trustees who use an independent custodian to maintain "eligible assets" of at least $100,000 and liquid assets of at least $100,000. In the case of VSSF, however, special conditions in the instrument of approval provide that condition D.1 does not apply to the trustee. Instead, those requirements are applied to the administrator, and this is to be reflected in the contractual arrangements and is to be certified annually by an auditor. This special condition therefore recognises the reality that it is the administrator that is responsible for operations and for the correction of any failures, and that it is the administrator that must be seen to have

the resources necessary to meet untoward contingencies. If the Draft recommendation were amended to allow the same procedure to be applied to not-for-profit trustees who outsource their administration, we would not have a concern.

5.3. Draft Recommendation 4.2 would create a new anti-competitive restriction

For similar reasons to those given in paragraph 4.5 above, for legislation to impose a new restriction that would render trustees such as VSSF and LISS unable to continue to compete would be contrary to the Commission's Term of Reference 3(a).

5.4. Submission 2

If Draft Recommendation 4.2 is to be retained in the final report, it should provide that, in the case of not-for-profit trustees which outsource the administration of the funds to an administrator, the obligation to maintain the required level of eligible assets and liquid assets can be passed on to the administrator.

6. OTHER DRAFT RECOMMENDATIONS & FINDINGS

The Superannuation Committee is in agreement with the substance of the following recommendations and findings:

Draft Recommendations:

- 5.1 Simplification of age and employment requirements governing contributor status and compulsory cashing of benefits.
- 5.2 Simplification of restrictions of access to or transfer of superannuation benefits of bona fide non-resident short term employees.
- 5.3 Simplification of risk management statements.
- 6.1 No expansion of exempt public sector schemes.

Draft Findings:

- 5.1 Retention of 4 month lodgement period for annual returns.
- 6.4 APRA guidelines on its discretion in applying Criminal Code and strict liability penalties.
- 6.5 Sole purpose test is necessary.
- 6.6 Successor fund provisions are appropriate but need clarification.and safeguards against abuse.

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