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The future of superannuation in Australia: The Super System Review Peggy Haines Freehills Melbourne Australia www.freehills.com.au

An important review of the entire superannuation system is presently taking place in Australia and this paper will provide you with some high level information as to what is happening. I am acting as a part-time consultant to the federal Treasury in the conduct of the review.

1 A little about the Australian superannuation system

For those of you who aren't familiar with the Australian superannuation system, I thought that it might be helpful to provide some background as to its design and functioning.

In Australia, retirement benefits are provided by means of 'superannuation funds' (another name for what is known as a 'retirement plan' or 'pension fund' in other parts of the world). In the past, most large companies in Australia have maintained a company-sponsored superannuation fund for their employees. However, in recent years as the complexity of superannuation and its regulation has increased, the trend has been for company-sponsored superannuation funds to be 'merged' into a superannuation master fund (a type of fund often offered by a bank or insurer) to which many unrelated employers contribute.

Superannuation funds must be structured as trusts and the fund trustee is solely responsible for their operation. In Australia, employers play a less significant role in operating retirement funds than in some other countries such as the US or the UK. The primary legislation governing superannuation funds in Australia is the *Superannuation Industry (Supervision) Act 1993 (SIS Act)*.

Because of constitutional requirements, superannuation fund trustees are required to be companies in most all instances and, accordingly, the work of the trustee is guided by a board of directors.

Superannuation funds generally provide benefits upon a member retiring after reaching a prescribed age, resigning from service with the employer, dying, becoming totally and temporarily disabled or becoming totally and permanently disabled. Death and disablement benefits are usually externally insured.

Earnings of superannuation funds are taxed at concessional rates as are employer contributions. Benefits also receive concessional tax treatment depending on the member's age. Contributions are generally required to be 'preserved' in the superannuation fund so that benefits cannot be paid in cash to the member until, among other things, the member retires from all gainful employment after age 55, dies or becomes disabled. The preservation age is slowly being increased so that for persons born after 1 July 1964, preservation applies until they reach age 60 (instead of age 55 for those born before 1 July 1960).

Since 1992, there has been a requirement under the *Superannuation Guarantee (Administration) Act 1992 (SG Act)* that all employers must contribute a percentage of the salary of each of its eligible employees to a superannuation fund. Under The SG Act, the percentage that must be contributed has increased from 3% (at the SG Act's inception) to 9% (from 1 July 2002). The 9% contribution is not scheduled to increase any further although there have been political calls for it to do so. If an employer fails to make the prescribed level of superannuation contributions, the employer must pay a superannuation 'charge' to the Australian Tax Office which is equivalent to what should have been paid to the fund but the 'charge' is not deductible by the employer. Penalties and interest also apply.

Since 1 July 2005, the SG Act has also required that employees be given a 'choice of fund'. This generally means that employees can choose a fund (other than the employer's nominated fund) and direct their employer to make the compulsory SG Act contributions to the nominated fund. However, few employees have actually taken advantage of this facility and tend to remain in the 'default' fund nominated by their employer or set out in a relevant industrial instrument.

There has been a steady decline in the number of 'defined benefit' funds as employers have been reluctant to bear the investment risk, especially after the global market downturns in 1999-2002 and 2007-2009. As a result, virtually all new employees are made members of defined contribution funds. Most employees receive benefits as a lump sum but there have been recent initiatives by the Government to make it more attractive for employees to take their superannuation benefit in instalments or as a life-time pension.

The mandatory employer contribution under the SG Act has resulted in an continual, ever-expanding pool of money being invested by the private sector. Not surprisingly, there has also been a corresponding increase in regulatory focus on superannuation to make sure that the superannuation system remains safe. Since 1 July 2006, all superannuation fund trustees have been required to have a licence from the Australian Prudential Regulatory Authority in order to continue to operate a superannuation fund. Many superannuation fund trustees were also required to obtain an Australian Financial Services Licence from the Australian Securities and Investments Commission on or before 11 March 2004. The requirements to obtain these two licences has contributed significantly to the demise of employer-sponsored corporate funds.

2 Establishment and scope of the Review

On 29 May 2009, Senator Nick Sherry announced a comprehensive review of Australia's superannuation system: the Super System Review (**Review**). By the end of December 2009, total estimated assets in the superannuation system stood at \$1.23 trillion.¹

Even though the system weathered the global financial crisis relatively well and there were no systemic problems or failures, given the amount of assets involved in the superannuation system and the compulsory nature of employer superannuation

¹

APRA December 2009 Quarterly Superannuation Performance publication, http://www.apra.gov.au/media-releases/10_05.cfm

contributions, the Government understands that confidence in the system is critically important and wants to ensure that the superannuation system operates efficiently and delivers for the Australian people.

The Review has been charged with examining and analysing the governance, efficiency and operations and structure of Australia's superannuation system and to make recommendations for Government consideration as to improvements in the system which would assist in maximising the retirement incomes of Australians and improving the system's safety.

The chair of the Review is Mr Jeremy Cooper, a former Deputy Chairman of the Australian Securities and Investments Commission. There is also a panel of seven part-time members from various sectors of the industry (**Panel**).

2.1 Three phases

The Review is being conducted in three phases, which generally cover the following:

(a) *Phase One – Governance*

For purposes of the Review, 'governance' means the ideas, laws, processes and systems by which the superannuation industry, in particular superannuation funds, are operated, regulated and controlled for the benefit of members. This phase covers matters such as –

- trustee knowledge, skills and training
- trustee accountability to members
- assessing trustee and director performance
- outsourcing processes and selection of service providers such as administrators, insurers and investment managers
- design of the investment options from which members can choose and design of the default investment option for the fund.²

(b) *Phase Two – Operation and Efficiency*

'Operation and Efficiency' is the way that superannuation funds, service providers, fund members and others conduct the transactions necessary to operate the system. This phase of the Review is focussed on perhaps the most contentious aspect of the system, that is, are members paying too much in fees and expenses and are too many intermediaries taking fees without adding anything that benefits the member.

This phase is also concerned about the archaic ways in which superannuation funds still manage contributions and other transactions. Phase two covers matters such as –

- who is being paid from members' accounts and what are they adding;
- the role of commissions, ie, should commissions ever be paid in respect of services provided to superannuation fund members;
- what financial advice do members need in respect of superannuation and are they being provided with appropriate advice;
- why the super industry has not kept pace with technological developments in 'back office' transactions;
- what needs to be done so that members can more effectively compare superannuation funds; and
- is there really competition in the industry.

²

Super System Review, 'The Scope of the Review', 25 August 2009, page 6,
<http://www.supersystemreview.gov.au/content/content.aspx?doc=html/papers.htm>

(c) *Phase Three – Structure*

'Structure' refers to the shape of superannuation products and the way superannuation is provided to members across the various industry sectors, including the range of investments and other services, methods of product distribution and the outcomes different models achieve. (The Structure phase is also examining issues affecting SMSFs.)

Phase three covers matters such as –

- future of defined benefit funds;
- what types of insurance, if any, should be offered through a superannuation fund; and
- development of new retirement products and whether enough is being done to assist members in the 'de-cumulation' stage.

2.2 Consultation process

At the start of each phase, the Review has published an issues paper with a view to helping interested parties frame their submissions. There was then a period of approximately eight to ten weeks to make submissions in response to each issues paper. The deadline for final submissions was 19 February 2010 and, to date, approximately 7000 pages of submissions have been received. The Review has also made all submissions publicly available on the Review website (unless the submission was confidential) as well as all media releases.

The Panel has also held numerous meetings with a range of parties and has conducted –

- focus groups with members in capital cities and regional centres to better understand their attitudes and concerns; and
- industry roundtables on a variety of topics such as insurance, administration; advice, defined benefit funds, legal concerns and governance issues.

The Review has participated in discussions with industry experts, super fund executives, professional services firms, fund managers, investment banks, trustees, industry organisations and regulatory agencies. Chair Jeremy Cooper also undertook an international fact-finding trip to understand how other countries have been addressing some of these issues and to determine what lessons might be valuable in recommending changes to the Australian superannuation system.

There is no doubt that the Review has stimulated public debate and it is unusual if a day passes in the financial press without the Review being the topic of an article or opinion piece.

2.3 Publications and interim reports

The Panel's preliminary conclusions are being communicated to the industry throughout the Review to encourage transparency and debate and to allow feedback before final recommendations are made.³

Accordingly, the Panel has released the following papers:

1. *Scope of the Review: A Three-Phased Consultation* (25 August 2009) – a paper outlining the approach to the Review, including its timetable;
2. Issues papers on each of the three phases - Governance (25 August 2009), Operation and Efficiency (16 October 2009) and Structure (14 December 2009); and

³

<http://www.supersystemreview.gov.au/content/content.aspx?doc=html/papers.htm>

3. *A Statistical Summary of Self-Managed Super Funds* (10 December 2009) – a broad factual overview of the SMSF sector.

As at 23 March 2010, the Panel has also released the following two preliminary reports:

4. *Clearer Super Choices: Matching Governance Solutions* (14 December 2009) - a preliminary report in response to phase one of the Review.
5. *SuperStream: a proposal to bring the back office of super into the 21st century* (22 March 2010) – a preliminary report related to phase two addressing 'back office' issues affecting the superannuation system.

The Panel must make its final report to Government by 30 June 2010.

More information about the Review including all of these publications can be found on its website: <http://www.supersystemreview.gov.au>.

3 Recommendations so far

3.1 Focus on the future: system in 2025

Australia's superannuation system is expected to continue to grow strongly over the coming 15 years, underpinned by mandatory SG Act contributions.⁴ Forecasting the size and structure of the superannuation system is not an easy task, given the system's dynamism and complexity. Further, the Review provides a valuable opportunity to take stock of the current system, to consider in depth how it might develop and to attempt to anticipate future weaknesses.

When the system was reconfigured in 1993 with the enactment of the SIS Act, the changes were considered revolutionary. With the benefit of hindsight, it is clear that those far-sighted policymakers came up with a system which is not only envied throughout the world but which has also protected members very well for long period of time.

Consequently, the Panel understands that it, too, may have to be revolutionary and has focussed on assessing the regulatory regime on what will be needed in 2025 not on whether the system is sufficient at present.

3.2 What the Panel has told us so far

The Panel will not have settled its recommendations until its final report is given to Government on 30 June 2010. However, the Panel's preliminary reports give us some indication of the Panel's early thinking on several significant matters.⁵

(a) *Phase one preliminary report: governance*

The Panel has made the following comments on matters of significance with respect to phase one:

- Superannuation is not just another 'financial product'. It has a social policy purpose. Accordingly, it should have special rules and, because it is based on compulsory contributions, the Government has responsibility to establish appropriate settings to achieve policy ends.
- There is no 'one-size-fits-all' solution to superannuation fund governance. There must be room for different models and for flexibility. The Panel has recommended

⁴ Se G Rothman and D Tellis, *Projecting the Distributions of Superannuation Flows and Assets*, 16th Colloquium of Superannuation Researchers, University of New South Wales, 3-4 July 2008, Conference Paper 08/1.

⁵ Super System Review, 'Clearer Super Choice: Matching Governance Solutions', 14 December 2009, page 26, <http://www.supersystemreview.gov.au/content/content.aspx?doc=html/papers.htm>

a 'choice architecture' model to cater for those members (about 80%) who make no choice (either as to fund or to investment strategy) and rely on the trustee to make appropriate decisions for them. Those dis-engaged members should be protected by a governance model that ensures that their interests are paramount and that their accounts are protected from unnecessary fees and costs. This change in 'architecture' restores the member to the centre of the system.

- The standards of governance for trustees of superannuation funds should be equivalent to the standards applying to boards of listed companies and a code of practice substantially similar to that which applies to listed companies should be developed for trustees.
- There should be a higher standard of knowledge and skills for trustee directors. Directors must be capable of setting the business, investment and operational strategies of the fund and overseeing its operation. Boards should also be subject to closer scrutiny as to the appropriate size of the board and length of tenure for directors.
- There is a need for greater focus on the mechanisms for dealing with conflicts of duty and conflicts of interest throughout the system. Disclosure to members is not enough.
- Competition is important but is not the solution as experience in Australia and overseas suggest that competition alone has not delivered 'best practice'.
- Australia's retirement incomes system puts much greater emphasis on occupational superannuation than is the case in other OECD countries. This means the members bear directly more of the investment risks in providing for their retirement than is the case overseas. This makes the safety and efficiency of the superannuation system are perhaps of greater importance to Australians than to citizens of other countries.
- Fees paid by members are too high by international standards.
- The trust vehicle should continue as the means by which superannuation is delivered to members. Trusts are flexible and provide separation of legal and beneficial ownership, which protects members' interests.
- Given the size of the system, it seems incongruous that, based on international comparisons, most superannuation funds lack the scale to achieve economies in either investments or administration. This seems to indicate that more consolidation of funds is required for cost savings to occur.

(b) *Phase two: SuperStream and the back office of superannuation*

The Panel has made the following comments on matters of significance with respect to phase two:

- SuperStream is the name that the Panel has chosen to describe its ideas about enhancing the current 'back office' of superannuation. Submissions to the Review estimate that savings of up to \$1 billion a year are achievable from reforms consistent with the SuperStream principles. Even though there is technology available to improve back office processes, to date superannuation funds have not availed themselves of these technology-based solutions.
- SuperStream will set new standards:
 - to improve the quality of data provided by employers;
 - to allow the use of tax file numbers to match members and lost superannuation accounts; and
 - to require the use of technology to improve processing efficiency including electronic funds transfers for all participants, ecommerce solutions to replace paper and elimination of redundant processes.

4 Conclusion

The Panel is doing important work and the mere process of conducting the Review has led to public debate and resulted in 'anticipatory' improvements by industry participants (eg, investment managers, insurers and administrators) that benefit members

The Review's recommendations may be accepted by the Government in part, in total or not at all. Even if all the final recommendations are adopted, there is, of course, a lengthy process (and lobbying opportunity) before legislation is promulgated.

However, the rigor that has been applied across the industry in considering the issues posed by the Review's papers has resulted in the identification and discussion of issues which have not been the subject of public discourse in recent times and has shined light in many dark corners.

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