



## **AIST Submission**

Review into the governance,  
efficiency, structure and operation of  
Australia's superannuation system

**Response to Phase One  
Preliminary Report - *Clearer  
Super Choices: Matching  
Governance Solutions***

**19 February 2010**



Australian Institute of Superannuation Trustees

## Background

The 'Super System Review', announced by the Government on 29 May 2009, is a review into the governance, efficiency, operation and structure of the current superannuation system in Australia.

The Australian Institute of Superannuation Trustees (AIST) welcomes the opportunity to provide a submission in response to the Review Panel's Phase One Preliminary Report, *Clearer Super Choices: Matching Solutions*.

We look forward to being involved in the remainder of the consultation process.

## AIST

AIST is a national not-for-profit organisation whose mission is to promote and protect the interests of Australia's \$450 billion not-for-profit superannuation sector. AIST's membership includes the trustee directors and staff of industry, corporate and public-sector funds, who manage the superannuation accounts of nearly two-thirds of the Australian workforce.

As the principal advocate and peak representative body for the not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training, consulting services and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

## Emerging themes

The paper from the Review Panel, issued on 14 December 2009, stated it intended to communicate the Panel's current direction and invited feedback on trends, issues and ideas it was considering.

In this document, the Australian Institute of Superannuation Trustees (AIST), representing not-for-profit industry, public-sector, and corporate superannuation funds, offers its views following meetings of its policy committee and extensive consultation with members and others in the superannuation industry.

AIST agrees with the Panel's view that superannuation is not just another financial product, and that it does service "an overarching social policy objective".

We also agree that an appropriate balance between competition and regulation is desirable, and recognise that the Panel appears to be firmly focused on 'better' rather than 'more' regulation.

We acknowledge the need for governance structures that fit the circumstances and needs of members whose funds are governed. However, we stress that these structures are themselves a means to the same end; that is, the "overarching social policy objective", and the design of those structures needs to be firmly grounded in that objective.

## The Panel's proposed architecture

While the Panel noted the unique features of Australia's retirement incomes system, we do not accept that the proposed 'architecture' at the heart of the preliminary findings will enhance the overarching social policy objective that 25 years of building a world class superannuation system in this country has achieved.

Indeed we argue that a close reading of the proposal – accepting that it is only preliminary at this stage – suggests the proposed architecture is aimed not at the renovation of an essentially sound existing structure, requiring some refurbishment, but at seeking to pull down the construction and starting afresh.

This flies in the face of the Panel's own assessment that Australia's superannuation experiment is an overall success.

While we welcome the member focus which the Panel preliminary report says is underpinning its "choice architecture", we believe the application of the proposed model to the practical interests of the overwhelming majority of our members will be detrimental in both the short and longer term.

Even in its embryonic state, the proposed new architecture would be less cost-effective than the low-cost, not-for-profit model currently in operation. The current model successfully services both engaged and disengaged members, while ensuring that adequate information is provided.

Rather than driving efficiency and reducing costs, the proposed system, as outlined in the Panel's preliminary report, would add additional layers of cost and complexity. Moreover, it is difficult to establish how the Panel envisages the universal and choice options would operate in practice.

If, as our feedback suggests, it is the Panel's intention that the "fund with a single diversified investment strategy" is in fact a separately constituted fund, AIST funds would need to significantly restructure their operations to accommodate both their universal and choice members, incurring substantial legal, tax, marketing, and administrative costs. This would inevitably translate into higher, not lower, costs per member, an outcome that would seriously undermine the efficiency gains and cost reductions sought by the Review.

Many not-for-profit funds, most of them currently offering low-cost competitive investment choices to their members, believe the establishment of separate fund structures for each member type may make it too costly to continue to offer their members choice.

There is also concern that the model could draw 'high-balance' members – who are perhaps more likely to make a choice – away from the no-frills universal fund, thereby diluting the economy-of-scale benefits now available to the trustees and managers of the balanced fund options that most super fund members currently call home. Take the case of one large industry fund, where 10 per cent of members currently own 50 per cent of the fund's assets. If these high-balance members were to shift to a choice fund as a result of the Panel's model, the remaining assets available for the fund's universal option would be almost half of the assets currently invested in that fund's balanced option.

And what about the members who want both - say 50 per cent default and 50 per cent choice? What about members who want a temporary investment change – say to 100 per cent cash – because of their personal circumstances? That would mean two funds and two sets of fees.

The Panel's thinking behind the 'single investment strategy' is to reduce cross-subsidisation and facilitate more precise allocation of costs to members. If only a small proportion of members choose an investment option other than default, why should the default members subsidise the choice members? But in an attempt to shift the cost of administration to those who use it most, and protect those who use it least, the Panel has proposed a rough model which will, perversely, result in the opposite effect.

We acknowledge that there are varying degrees of cross-subsidisation within many funds. But we argue this is inevitable, as it is with other pooled vehicles where it is impractical to fully unbundle costs. However, many super funds reduce cross-subsidisation by charging fees for specific activities such as switching. The real issue is striking the balance between efficiency and simplicity against the user-pays principle.

## **Member engagement and the universal fund**

Clearly the panel's notional 'universal' category is of prime importance to our members, as approximately 80 per cent of members of AIST-linked superannuation funds belong at present to 'balanced' or 'default' funds.

We are concerned that the Report states that universal members “must be in a fund with a single diversified investment strategy”. Many of our member funds currently cover members who would be considered ‘universal’ as well as members who would fit into ‘choice’. The Report also states that “organisations would be able to offer either (or both) universal and choice products to members, but the requirements pertinent to each of the types of product would need to be met.”

We are also concerned that the proposed model will undermine the accountability of superannuation funds and trustees by removing the level of responsibility trustees have for members who have made a choice. We do not accept that trustees should have less responsibility for members who have made a choice versus those they have placed in a passively invested, defensive option. Nor do we accept that those currently in a balanced or default fund are necessarily disengaged. How will funds determine the level of engagement? And where is the evidence to suggest that all those currently in a balanced or default fund are necessarily disengaged, or that those who make a choice are informed and understand the markets?

From a process perspective, determining whether an individual has in fact made a choice can be very difficult and it is unlikely this information can be ascertained without direct consultation with the member concerned. Given the levels of disengagement within the superannuation system, which the Panel acknowledges, the task of establishing the information necessary to lay the foundations for an entirely new superannuation construction would be considerable.

Most funds represented by AIST have offered all their members investment choice for a significant number of years, typically providing publicity material and guidance in brochures, on websites and in annual statements on how to exercise choice. Yet despite this consistent flow of educative information, approximately eight out of every 10 fund members remain in the default or balanced option. Have they chosen to do so? We do not believe it should be assumed they are simply disengaged and would be better off with a stripped down default fund as envisaged in the preliminary findings.

The Panel also proposes to couple this universal option with a ‘lifecycle’ investment overlay, which is itself an intensely contentious proposition for members, who it is claimed, have made no (or at best a feeble) choice to participate. AIST, along with other representative organisations in the superannuation marketplace, has examined various lifecycle investing models, and believes the jury is still out on their efficacy and whether they deliver superior returns over the long term.

In addition, the AIST believes that the existing system allows for trustees to focus not simply on costs, but also on returns for the default options. The Panel’s Preliminary Report discusses the issue of costs but gives scant attention to the question of returns. At present, the sole purpose test is directed at trustees achieving the best possible returns for a member for their retirement. Unless it is envisaged that the universal option will wither away as better informed members opt for an alternative choice, it is unclear what role is envisaged for trustees in seeking to achieve superior returns while simultaneously ensuring their funds control costs.

## Disconnected

The nexus between the 'disconnected' and 'universal' categories will incorporate the challenges of lost members. However, in terms of 'governance philosophy', we assume the Panel's view is that disconnected members would be covered by the protections implicit in a traditional, active trusteeship model, and we endorse that view.

However we do not agree with the panel's view that disconnected members should be provided with a 'conservative' investment strategy. This might be appropriate if the outcomes from the Review led to a dramatic improvement in the movement of disconnected members to other categories, so that the actual time spent on average in the disconnected sector was quite short. However, if, as at present, large numbers of members remain disconnected for extended periods, we would see investment strategies more in keeping with the universal category as appropriate.

The not-for-profit sector already provides a low cost and high performing option – AUSfund – whose single investment strategy is effectively a low-cost balanced option. While AIST recognises that lost super is a \$16 billion problem requiring rectification, we do not believe that a model should be developed with the view to this problem continuing or that the government and the industry should throw in the towel in better educating superannuation fund members.

Instead we believe better tracking of superannuation payments, with far greater focus on mandating appropriate identifiers such as the existing tax file number or a similar identifier throughout the whole superannuation cycle, will go far further in eliminating the primary cause of disconnection.

Considering there are 34 million superannuation accounts in Australia for a working and post-retirement age cohort of some 12 million, it is the view of AIST that focusing on other potential efficiencies across the system should be a priority.

We look forward to the Preliminary Report for Phase Two of the Review, which will canvass the Panel's views on this problem.

As discussed in previous submissions, including our Phase Three submission, we believe the inclusion of default funds within the industrial award system plays a key role in ensuring that disengaged members can default into low-cost, not-for-profit superannuation funds. Furthermore, we believe that all default funds should be commission-free low-cost vehicles governed by a Representative Trustee structure.

## Trustee role lacks clarity

The Report states that "Prudential regulation is more relevant to the 'universal' and 'choice' segments than the 'self-managed' sector, for instance. Likewise, a traditional trustee role is more relevant to the 'universal' sector than the 'choice' sector." We are concerned that these statements show a lack of clarity in relation to prudential regulation and a traditional trustee role.

In our submission to Phase Three of the Review, we argue that regulation aimed at ensuring suitable investment strategies are in place. We believe that the requirement that trustees do not invest in in-house assets, for example, should apply with equal force to the self-managed sector.

While we accept that the traditional trustee role may not play as large a part in protecting beneficiaries (because self-managed trustees are managing money for themselves only), there are important elements of the traditional trustee role that remain highly relevant to the choice sector. Unravelling the complex interaction of trust law and prudential regulation, and ensuring that these legal elements are applied to the different sectors forcefully and commensurably - if through different legal means - will be a complex and contentious process.

We note the Panel's view that individuals moving from left to right through its proposed different sectors must "signal their intention expressly and unambiguously". We would add however, that their intention must be backed by a fully informed decision. This obviously raises the issue of advice, and we strongly back the recommendations of the recent Ripoll enquiry that advisers must be required to act in their client's best interests, and to put their client's interests ahead of their own. We also believe that superannuation funds have a key role to play in offering low-cost financial advice to members about their superannuation.

## Income streams/pensions

We note that the Panel does not provide detail on how income stream/pensions might work with the proposed universal model, despite its own projections that by 2025, the ratio of accumulation to post-retirement assets will be 3:1 (from 4:1 currently). Is the panel proposing pension income streams would not be part of the universal fund? Does this mean moving money out of a universal fund into choice to obtain an income stream? How would 'transition to retirement' schemes work? Excluding income streams/pensions from the universal model also raises issues about cost-efficient investing. It would effectively reduce the investment horizon from 'whole of life' into two, or possibly three, discrete (investment) phases - accumulation (universal/choice) and decumulation phase and, in so doing, impact on funds investing in long term investments such as infrastructure and private equity.

## How a low-cost 'universal' model might work

If the Panel is determined to continue with the choice architecture, we believe the universal fund would need to include limited investment options based on a set of different risk profiles, in a similar fashion to many of the low-cost fund models that currently exist in the not-for-profit sector. Each universal fund could offer a default option, and if they want to, a limited number of options that reflect a different risk profile, say cash, cap stable, 50/50, default (70/30), high growth and shares. These limited investment options would use the same underlying assets of the default fund but the defensive/growth allocation would shift from zero to 100, with reasonable steps in between. This would mean that members who (temporarily) want to change their portfolio because of their personal circumstances would not have to change funds and the cost of switching investment options would be limited as members would not need to change all the underlying assets.

Under this scenario, members would not choose investment managers; rather, they choose a risk profile. The trustee could use a 'set-and-forget' strategy for the choice options as the investment

managers would change automatically when the managers in the default option are reviewed or changed by the trustee. This is the way not-for-profit funds manage their choice options currently and permits economies of scale on investment management costs that would not be available were the different choices segregated into separate funds.

A number of funds already apply this approach and their compliance and operational costs and operational risks are considerably lower compared to funds offering discrete investment options. It is also much easier to explain to members (less choice means less confusion and the focus is on choosing a risk profile that matches personal circumstances). In addition, those trustees that would like to adopt lifecycle options could do so within the above mentioned framework.

## Response to selected governance issues

### Listed company standard of governance

The Panel clearly recognises the impact superannuation has on the economy overall, and the risks to which the heavy reliance on defined contributions structures exposes ordinary citizens. This places trustees in a unique and demanding position in our economy and society more generally.

In our Phase One submission, we stated:

Company directors and superannuation trustees are both intermediaries standing between the ordinary citizen as investor, and a profit making venture, but each looks from the intermediating position in the opposite direction. Importantly, the two roles are distinct, but complementary. Company directors are running a business, in which their shareholders seek to derive a return. However, unlike a superannuation fund, a company does not and should not seek to deliver an integrated, diversified investment vehicle suitable for the retail investor market.

We believe this “complementary but different” approach needs to be reflected in the Panel’s view that “governance of APRA-regulated super funds should be equivalent to the standard applying to a listed company.” As funds become larger, and public scrutiny on their management increases, the public – many of whom are members of AIST-linked funds – will demand that trustees need to meet equivalent standards to company directors in ethical conduct and competencies. We would support the development of separate corporate governance guidelines specifically designed for trustees.

### Codification of duties

We agree with the Panel that the ambiguity of trustee duties in respect of investment choices selected by members needs to be clarified. We also agree that the exercise of investment choice (as distinct from a reasoned decision to remain in a default fund or option) is a suitable break point at which different standards of trusteeship can be applied.

However, different standards are still standards, and we do not believe that the exercise of investment choice alone removes the need for the protections inherent in trust law. Trustees operating in the choice sector will still be managing other peoples’ money (as distinct from the self-managed sector), and trust law still provides the best protections for investors in those

circumstances. In principle, we would support the introduction of a similar structure to the 'safe harbour' requirements in the US ERISA legislation.

We note the Panel's comments in relation to creating a single set of statutory duties for trustees. We support this proposal in principle, but note that the design of this structure would require extensive industry consultation, and we would be concerned to ensure that any changes did not undermine the constitutional validity of superannuation law.

## Trustee knowledge, skills and training

We acknowledge the Panel's position on trustee knowledge, skills and training, while we note that Section 52(2)(b) of the SIS Act requires trustees to exercise the same degree of care, skill and diligence "...as an ordinary prudent person..."

In many not-for-profit funds, a representative body has a right to appoint trustees. While we agree that for trustees who do not meet the equal representation requirements, knowledge and training standards should be met prior to their commencement, in the case of nominated trustees (as opposed to elected trustees), we believe permitting trustees to obtain their mandatory qualification within a short time of joining a board would open a wider population of potential trustees, and ease the nomination process among employer and employee representative bodies.

## Performance measurement

We agree with the Panel's view that while fund performance is a strong indicator of board performance, a more sophisticated method needs to be developed for boards to be able to self-assess their internal governance.

We also strongly endorse the Panel's view on the assessment of fund performance relative to objectives, and draw attention to a more detailed proposal made in our Phase Two submission. However, we believe the two issues should be kept separate. The fund's performance, as the board's key deliverable, should be benchmarked against objectives and communicated to members. A trustee board's internal governance performance, the strength and integrity of its decision-making powers, are a matter primarily for the board's process of professional development. We agree with the Panel that this is a "matter of good governance", but we are not sure that this information would be of interest or relevance to members.

## Accountability to members

We acknowledge that the Panel does not support mandatory annual general meetings for funds. We agree that there are number of shortcomings in the current one-size-fits-all approach to disclosure, and our Phase Two submission supports some differentiation between the universal and choice sectors, but on the basis of presentation and distribution rather than content. We believe the rights to information should be equivalent for all members.

With providing reasons for trustee decisions, we believe the Panel should proceed with caution. Many decisions trustees make are purely procedural, and can be assessed as 'right' or 'wrong' according to the rules and procedures that the trustee is obliged to follow. However, other

decisions do not subscribe to this straightforward procedural paradigm. For instance, in assessing death claims, trustees may have to evaluate competing claims to a deceased member's benefit. To require trustees to provide a reason for their decision in such circumstances would almost certainly invite further disputation from the unsuccessful claimant, delaying payment, and increasing trustee costs. Aggrieved fund members have available the Superannuation Complaints Tribunal, which has operated as an effective means of representing members interests while keeping trustees focused on proper processes and adherence to the law.

## Conflicts of interest and duty

We are pleased the Panel agrees that avoidance of conflicts on its own is not a sufficient means to manage conflicts throughout the industry. However, we believe disclosure of potential conflicts is an important element in managing conflicts, as even if that disclosure is not read and understood by members, it will form vital information to be used by 'best interest' advisers in making recommendations to their clients. This would particularly be the case if the Panel pursued the position that the duty to avoid conflicts be removed or softened in the choice sector. Our view is that the trust law duty to avoid conflicts is one of the key protections afforded by trust law to beneficiaries, and hence still has a place in both the universal and choice sectors.

## Consolidation of funds

We note the Panel does not support mandatory consolidation of funds. In respect of the proposal for an 'if not, why not?' obligation, it is not clear to whom the disclosure is to be made, nor what the consequences of it are. Certainly, we do not see a mandated disclosure to members of this kind as a useful addition to trustees' current reporting obligations.