Initial submission to the Financial System Inquiry

31 March 2014

AIST Submission

AIST

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose mission is to promote and protect the interests of Australia's $600 billion not-for-profit superannuation sector – roughly one third of Australia's superannuation pool of savings.

AIST's membership includes 662 trustee directors and more than 3000 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.

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1 Executive summary

Key recommendations:

- The Government should strengthen and expand the role of the Council of Financial Regulators to ensure regulatory co-ordination and greater systemic efficiency, while recognising the distinct roles played by APRA, ASIC and the ATO.
- The Council of Financial Regulators should develop and monitor benchmarks on adequacy, sustainability and longevity to better track and assess the performance of the superannuation system in meeting its primary objective.
- APRA and the ATO's powers should include the supervision of superannuation systemic risks, including technology and interconnectedness risks.
- ASIC should have an enhanced consumer protection role with the emphasis on improving financial comprehension.
- The governance model of the not-for-profit superannuation sector should be supported as the diversity of governance structures across the industry reduces the risk of governance failure in the finance sector.

AIST acknowledges the significance and relevance of the broad terms of reference of the Financial System Inquiry. Our focus in this submission, however, is on the benefits to the financial sector of good governance, diversity, transparency and efficient regulation in superannuation.

Our submission puts these benefits in the context of managing systemic and other risks, and balancing this with the encouragement of efficiency and innovation in the financial sector.

AIST generally supports the existing financial sector regulatory framework as it applies to superannuation – and the respective roles of APRA and ASIC. However, we recognise the need to better strike a balance between efficient and effective regulation and regulation that is costly and stifles innovation.

The superannuation sector generally withstood the impact of the Global Financial Crisis, despite the extraordinary market turmoil and its subsequent effect on consumer confidence. Super funds were well-managed and governed, and the intensive oversight of APRA and ASIC ensured that funds were acutely aware, and responded appropriately, to the heightened risks of market volatility. We therefore recommend reform rather than revolutionary change or realignment.

A strengthening of regulatory arrangements is nonetheless needed to respond effectively to the significant growth in the size, complexity and composition of superannuation.

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Expanded role of Council of Financial Regulators

The growth of superannuation and the increasing level and complexity of superannuation regulation requires a higher level of coordination between regulatory bodies, and a greater focus on efficiency.

Structurally, the ATO has emerged – alongside APRA and ASIC – as a third key superannuation regulator. This follows the rapid growth of SMSFs; the ATO's role in driving the ecommerce SuperStream changes; its position as a superannuation data repository; and its increasing role in the management of superannuation accounts.

AIST believes there is a need for an overarching body to actively co-ordinate the role of the three superannuation regulators as well as other regulators in the financial sector. We therefore recommend a significant enhancement and strengthening to the existing role of the Council of Financial Regulators (CFR).

We recommend that the CFR expand its co-ordinating role to include the ATO, ACCC and AUSTRAC, and for the CFR to have superannuation responsibility that ensures overall regulatory requirements are being applied efficiently and consistently.

Benchmarks on adequacy, sustainability and longevity.

Superannuation's primary objective is to provide an adequate and sustainable retirement benefit to Australians. The growth, maturity and increasing complexity of the superannuation system has highlighted the need to have a proper focus on the key drivers of adequacy, sustainability and longevity within the super system. A focus on short-term policy change needs to be replaced by a long-term perspective.

AIST believes that in order to better assess the success of the super industry and whether it is delivering on its primary objective, we need a nationally accepted benchmark of what is an "adequate" retirement, together with a benchmark on sustainability and a greater understanding of longevity risk.

AIST recommends that the CFR should be given a mandate to develop broad, overarching superannuation policy, and make recommendations to government on these threshold questions. This would include the development of a nationally-accepted benchmark of what is an "adequate" retirement (an adequacy benchmark), a sustainability benchmark and a longevity index.

AIST also recommends that the CFR play a role of testing superannuation policy changes against these benchmarks, as well as weighing up the cost of implementing change against benefits to the Australian people. The challenges and opportunities of rapidly emerging new technologies, the impact of liquidity requirements and removing obstacles to the development of post-retirement products should be on the CFR's agenda.

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A governance structure that works

A strong regulatory structure must underpin the superannuation system. AIST emphasizes that the high duty of care for trustees of super funds is also a major source of the strength of superannuation. The equal representation model of not-for-profit funds in particular has proven to be highly functional, effective and adaptive.

The representative model brings diversity to the governance of super funds, protects members from the pursuit of interests outside of members/ best interests, and provides diversity to the system that mitigates the risk of governance failure across the broader finance sector.

Improved consumer protection

AIST also sees a role for ASIC in providing greater consumer protection for superannuation members. Greater consumer-friendly transparency and disclosure, removal of barriers to ecommerce, and removal of unnecessary red-tape is recommended.

The lack of alignment between fees charged and the services delivered, at both an institutional and member level, continue to result in distortions and higher than necessary fees, especially for investments. AIST recommends that ASIC promote more efficient and cost-effective fee structures that are in members' best interests.

Expanded role of APRA to monitor related-party risks

AIST is concerned that the interconnectedness of providers through related-party arrangements creates systemic risk, and that management of this risk is not sufficiently regulated.

We recommend that APRA's risk assessment system, PAIRS, be expanded to consider areas of systemic risk, such as interconnectedness and sustainability of service providers (including fund managers, Managed Investment Schemes, insurers, custodians and administrators).

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2 Recommendations

While the Financial System Inquiry's terms of reference are broad, and could cover many topics of interest and worth, AIST has focussed on:

- Promoting diversity and best practice in governance models within superannuation.
- Ensuring there is transparency and equity in the Adequacy, Sustainability, and managing Longevity risks within the superannuation system.
- A safe and secure superannuation system, based on a best practice regulatory program.

The recommendations made in this submission are consolidated below.

2.1 The regulation of superannuation

AIST supports the overall regulatory framework for the superannuation system. Our observations and recommendations for change are about improving regulatory efficiency and coordination, rather than wholesale change.

AIST recommends that role of the Council of Financial Regulators (CFR) be enhanced with responsibility to ensure regulatory co-ordination and systemic efficiency.

2.2 Adequacy, sustainability and longevity measures

AIST recommends that:

- *The CFR has an expanded role to examine Adequacy, Sustainability, and Longevity measures in order to assess the effectiveness of our superannuation system in meeting its primary objective.*
- *Consideration of aged care, health care, and active community participation should be included within superannuation policy. This is in line with World Bank recommendations.*

2.3 Diversity and governance

AIST recommends that the governance model of the not-for-profit superannuation sector be supported by the Inquiry as the diversity of governance structures across the industry ensures a diversity of approaches to the management of compulsory retirement savings in an area underpinned by strong regulation.

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2.4 Systemic risk in the superannuation system

AIST recommends that APRA's powers should include supervision of superannuation systemic risk, rather than creating an additional macro-prudential regulator. AIST also notes that 'Systemic risk' is a possibility across the superannuation system and that the ATO should have similar powers in respect of SMSFs. This possibility arises from the interconnectedness of the entities that funds outsource to, such as administrators and custodians.

AIST recommends that the Probability and Impact Rating System established by APRA be reviewed to include, for example, the degree of interconnectedness of the superannuation system and its components.

2.5 Ensuring the system delivers

Regulatory and transparency recommendations:

- *AIST continues to support a strong regulatory regime in the consumer protection space.*
- *To better protect individual Australians, disclosure of superannuation products and services must be on a level playing field (e.g. Non MySuper products must fully disclose fees and related party interests).*
- *Any proposed disclosure requirements must be consumer tested to ensure we are not only 'telling' members, but they are actually 'informed' by the disclosure.*
- *A methodology for tracking consumer's understanding of financial concepts should be developed.*
- *AIST recommends that the Government's Cost Recovery Guidelines should be applied to Financial Industry Levies.*

Technology recommendations

- *All barriers to ecommerce should be removed.*
- *Compliance barriers to innovation and improved customer service should be identified and removed, where this is in members' best interests.*
- *There should be consumer testing of financial products disclosure requirements undertaken at the design and regulatory stage, and again following implementation.*
- *The superannuation industry, in consultation with government and consumer groups, should develop best practice guiding and binding principles on providing information to consumers, including most effective use of new technologies.*
- *The Council of Financial Regulators recommended by AIST should have specific statutory responsibility to improve coordination, reduce overlap (and hence unnecessary red-tape) between regulatory agencies in areas of reporting, supervisory and product responsibilities and providing consumer protections.*
- *Liquidity requirements for superannuation products should be reviewed by the government (having regard to their long-term objectives).*

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Fee and cost recommendations:

- *Asset-based fees phased out and replaced with dollar-based fees charged on a fee-for-service basis;*
- *Payments to related parties should be disclosed;*
- *Carve-outs of conflicted remuneration should be eventually phased out;*
- *Gross interest margins should be disclosed to superannuation fund members, where money is deposited with related parties; and*

Shelf-space fees and profit sharing arrangements should be passed through to members to ensure that they benefit from these arrangements in full.

2.6 Consideration of post-retirement solutions

AIST recommends:

- *A review of the Superannuation Industry (Supervision) Regulations 1994 rules relating to income streams that restrict product innovation. Regulations should be drafted in an enabling fashion rather than having specific features listed, thus enabling product design innovations. AIST specifically supports amendments to Regulations 1.05 and 1.06 to facilitate products such as variable annuities (to assist the pooling/guarantee of longevity risk), income stream packages (including deferred annuities at an advanced age), and with-profit annuities (investment/longevity profits and losses are shared.*
- *Amending taxation legislation so that if a deferred lifetime annuity is taken out in drawdown phase, it is viewed as a pension and therefore exempt from income tax. This deferral of retirement income would result in a small increase in the Age Pension if the pensioner is eligible for an Age Pension. However, this can occur in any event with retirees having the option to take a smaller income stream, provided they comply with the minimum drawdown rules. Any legislative change would need to ensure that the tax free status applies only to genuine non-commutable retirement deferred lifetime annuities purchased with superannuation money.*
- *With respect to the deferral period of a deferred lifetime annuity, reviewing the rules around minimum surrender values, minimum drawdown rules, social security and aged care tests to ensure that the products can be developed and exist on an equal playing field with existing products.*
- *Development of a default ("MySuper") post-retirement product.*

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3 The regulation of superannuation

As has been widely observed, Australia weathered the Global Financial Crisis well with all major financial institutions and structures emerging intact. In particular, the superannuation system maintained member confidence despite the temporary but significant reduction in the value of member funds under management.

There was no significant movement of member funds in the not-for-profit sector away from the trustees default investment option where most members' balances are held. Similarly, at that time and all other times, the ability of not-for-profit member super funds to function effectively, competitively and in the best interests on members has not been diminished.

A generally well-functioning regulatory structure has been a key factor in the stability of the superannuation system.

3.1 The increasing regulation of superannuation

Currently, primary regulatory responsibility for superannuation is split between three regulators. The Australian Securities and Investments Commission (ASIC) is responsible for consumer/investor protection (including disclosure) for all superannuation funds, the Australian Taxation Office (ATO) supervises the compliance with retirement income standards of self-managed superannuation funds (funds with less than five members all of whom must be trustees), and the Australian Prudential Regulation Authority (APRA) prudentially supervises the balance of other large and small superannuation funds, except for constitutionally exempt public sector schemes.

While there has not been any significant change to the statutory structure of superannuation regulators since the creation of ASIC and APRA in 1998, there has been significant convergence and a broadening of regulatory requirements in recent years, both between regulators and between the superannuation sector and other parts of the financial system.

Superannuation funds are subject to a heavy regulatory burden commensurate with their status as custodians for compulsory retirements saving that must be preserved until retirement. While increasing regulatory and compliance burdens have been a factor in the dramatic reduction in the number of large APRA –regulated super funds over the past 15 years, the question has to be asked if the increased regulation was applied in the most efficient manner.

The MySuper elements of the Stronger Super changes for instance were introduced in four separate tranches of legislation over the period of a year, with later bills amending the provisions made earlier. There were additionally another dozen pieces of other legislation relating to other parts of Stronger Super. It became increasingly difficult for anyone – including sponsors of the legislation – to fully comprehend and understand the interrelationship of all parts of the reform package.

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AIST submits that the key issue is the level of coordination and regulatory efficiency rather than the level of regulation, and this needs to be addressed accordingly. This should include consideration of how regulators have used their powers, and whether or not outcomes have met government policy objectives. A specific recommendation about this is made below.

3.2 The twin peaks model

The increasing regulation and complexity of superannuation has led to calls from some quarters for a mega-regulatory to replace the role of APRA and ASIC. AIST does not believe that moving from the current twin peaks model to a mega-regulator model or to a lead regulator model would lead to a significant reduction of the regulatory burden.

Moreover, AIST is concerned that the overall focus on consumer protection might be reduced within a mega-regulator as prudential regulation may dominate. APRA and ASIC have distinct and recognisable cultures, and there is transition risk in bringing them together.

AIST has similar concerns about proposals for the absorption of APRA into the RBA. As outlined in our chapter on Diversity and Governance, a central bank whose primary role is in relation to the banking system is unlikely to be able to effectively regulate superannuation. As a secondary responsibility, prudential supervision would be likely to receive less attention, less resources and less consideration in decision-making. The superannuation system has a fundamentally different structure, and markedly different risk characteristics.

The twin peaks model has the advantage of two specialist bodies with very clearly defined roles. That APRA generally responded quickly and decisively during the GFC was in some part due to its relatively small size, ability to respond and intervene where it was necessary.

As super funds are "customers" of both regulators, and regulators are aware that the effectiveness and efficiency of their operations are observed and commented on by their customers, there is some competition between regulators. This dynamic tension is limited and controlled; it is healthy competition that keeps the bureaucracy in check, and adds to the efficiency of the financial system.

Until the implementation of Stronger Super changes, the division between APRA and ASIC on functional lines was generally clear and understood by the superannuation industry.

We note that within the far larger bureaucracy of the ATO, until recent years it was often difficult for super fund consumers to access the right personnel and understand the allocation of responsibilities within the ATO. It also appeared as if superannuation was very much a secondary concern to the collection of taxation. Over the past few years, with the growth of the SMSF sector and the introduction of Standard Business Reporting, SuperStream and increased data collection, the ATO appears to have given superannuation a higher priority, and has improved accessibility and relationships with super fund clients.

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3.3 Emerging regulatory overlap and duplication

During the GFC and its aftermath, both APRA and ASIC separately monitored fund and member behaviour and trends in transactions. While this may have resulted in some duplication of effort, more importantly it was scrutiny that was proportionate to the potential threat posed by the adverse market conditions.

Recently however, there has been increased possibility for regulatory overlap and duplication. The implementation of Stronger Super has resulted in APRA, ASIC and the ATO being given additional powers. This has meant that there has been further blurring in the boundaries between regulators.

For example, the implementation of MySuper has required APRA to become a product regulator. MySuper is the mandated default investment option, and has higher levels of trustee obligations and member protections. APRA is now responsible for the prudential regulation of this product as well as overall prudential regulation of super funds. Throughout the design and implementation process this has raised issues about the boundaries between APRA and ASIC, and has required continual monitoring and coordination to appropriately delineate regulatory responsibilities.

These issues have also been evident in relation to reporting requirements, where the disclosure of super fund information (regulated by ASIC) has to be based on the information (methodologies) reported to APRA.

This requires continual monitoring and inter-regulatory coordination to appropriately delineate regulatory responsibilities. However, the size, complexity and continual changes in the finance sector mean that simply improving these bilateral arrangements between ASIC and APRA may not be sufficient.

3.4 Recognising the ATO as the "third peak"

Another noteworthy development has been the emergence of the ATO as the "third peak". The matching of the following data, held and analysed by the ATO, is significant for the operation of the financial system:

- The growth in the number and value of SMSFs;
- The implementation of SuperStream;
- The administration of lost and unclaimed superannuation; and
- Their greatly increased superannuation data collection.

In particular, the role of the ATO in the prudential regulation of entities holding around one-third of the assets in the superannuation system justifies the ATO's characterisation as one of the three peaks.

There is however no straightforward way of comparing the quality and adequacy of the prudential supervision provided to SMSFs by the ATO with that provided to large super funds by APRA. The different size, relationship to beneficiaries and approaches to supervision make this very difficult. In addition, the possibility of systemic risk associated with SMSFs is often not recognised, let alone addressed. That widespread lack of recognition is of itself a failing of the system.

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AIST is not calling for the supervision of SMSFs by APRA. This would also involve great transition risk. It also would not acknowledge the high level of skills and experience within the ATO in relation to SMSFs and the value of using other ATO tax data in relation to members of SMSFs. Rather AIST's preferred approach is to call for greater and more formal coordination between regulatory bodies, and for there to be a requirement for them to consider efficiency as well as prudential oversight.

3.5 Reducing regulatory overlap and duplication

The Australian superannuation system has matured to the point where there is a need for a body to take responsibility for broad, overarching superannuation policy. In order to provide proper focus on key drivers in developing a framework for superannuation's sustainability, adequacy and efficiency, AIST recommends that the government in consultation with the Council of Financial Regulators (CFR), regulators, the finance sector and the wider community address some threshold questions.

The CFR coordinates finance sector regulators. It is non-statutory and has no legal functions or powers separate from those of its individual member agencies. It operates as a high-level forum for cooperation and collaboration among its four members; the RBA, APRA, ASIC and Treasury.

The role of the CFR is to contribute to the efficiency and effectiveness of financial regulation and to promote stability in the Australian financial system. This is achieved by the members sharing information and views on financial sector conditions and risks, discussing regulatory reforms and, if necessary, coordinating responses to potential threats to financial stability. Among other things, the CFR provides close consultation between agencies to avoid overlaps and gaps in regulatory coverage.

The CFR therefore provides the appropriate basis for stronger, more broadly-based and streamlined coordination between financial regulators.

AIST recommends that the Council of Financial Regulators be given responsibility to ensure regulatory co-ordination and systemic efficiency.

In addition, AIST submits that the CFR should:

- Be expanded by adding the ATO, Australian Competition and Consumer Commission (ACCC) and the Australian Transaction Reports and Analysis Centre (AUSTRAC) to its membership;
- Promote the right balance between regulatory compliance, regulatory and systemic efficiency, and innovation in the financial system (including through a framework that can be used to measure outcomes);
- There is adequate information exchange between regulators;
- Provide operational level guidance to regulators, as well as being a high-level forum;
- Oversight of superannuation as detailed below;
- Develop a framework for finance sector efficiency (incorporating the superannuation framework proposed below).

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It may be necessary to review and possibly amend the powers of each of the existing regulatory bodies to ensure that they are in alignment with the CPR (e.g., in relation to pursuing systemic efficiency).

AIST recommends that the Council of Financial Regulators have specific statutory responsibility to ensure that:

- Areas of duplication and overlap are identified and resolved;
- No regulatory matters are overlooked, and that emerging issues are identified;
- There is appropriate consistency of requirements, terminology and guidance;
- Regulatory requirements are being applied efficiently, in the best interests of members and in accordance with government policy objectives;
- Recommendations are made to government for the reduction of unnecessary regulation and red-tape;
- There is consistent communications with the super industry;
- Competition between regulators is kept in appropriate check;
- Cross-regulator efficiencies can be identified and implemented; and
- They develop a framework for the sustainability, adequacy and efficiency of the superannuation system (this proposal is further developed in the section on systemic risk).

AIST recommends that the focus of the superannuation body would be operational, but would also provide regulatory guidance to the Council of Financial Regulators, Treasury and the Government on ensuring regulatory clarity and policy guidance.

This proposal would mean that the existing separation of consumer protection and prudential supervision would remain in the existing agencies, with their existing statutory powers and responsibilities, but with further accountabilities for co-ordination and efficiency.

3.6 Recommendations

AIST supports the overall regulatory framework for the superannuation system. Our observations and recommendations for change are about improving regulatory efficiency and coordination, rather than wholesale change.

AIST recommends that role of the Council of Financial Regulators be enhanced with responsibility to ensure regulatory co-ordination and systemic efficiency.

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4 Adequacy, sustainability and longevity measures

When the Wallis Report was published in 1997, superannuation assets stood at $321 billion, representing 47.7% of GDP[1]. Superannuation assets now stand at just over $1.8 trillion[2], having passed 100% of GDP. Superannuation holds 21% of the assets of Australia's financial institutions[3].

While Australia's superannuation system is envied globally, AIST strongly believes that (as with any system) it could be improved further.

Dr Martin Parkinson, Secretary to the Treasury commented[4]:

> *It is worth noting that, while the pressures on our fiscal sustainability are serious, Australia remains much better placed compared to many other OECD countries.… The question remains, however, whether the current framework for our superannuation system will be sustainable into the future. While changes to the superannuation guarantee have been important for improving adequacy, they will clearly come at the cost of forgone revenue. … With the Commonwealth budget coming under increasing pressure over the next few decades, the fiscal sustainability of all policies, including superannuation, will demand greater public scrutiny. This scrutiny will be even more important to the extent that existing concessions are seen to favour some at the expense of the majority.*

In support of Dr Parkinson's comments that Australia is currently in a good place in terms of sustainability, AIST notes that Australia's current public expenditure on old age and survivor benefits is one of the lowest of OECD countries[5].

However, the growth, maturity and increasing complexity of the superannuation system has highlighted the need to have a proper focus on key drivers of adequacy, sustainability and longevity within the super system.

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[1] APRA, Insight issue 2 2007, *Celebrating 10 years of superannuation data collection 1996-2006* http://www.apra.gov.au/Insight/Documents/Insight_2_2007_web.pdf

[2] APRA, Statistics Quarterly Superannuation Performance (Interim edition), December 2013 (issued 20 February 2014) http://www.apra.gov.au/Super/Publications/Documents/December%202013%20Quarterly%20Superannuation%20Performance.pdf

[3] RBA, B1 Assets of Financial Institutions, October 2012 (data at 30 June 2012).

[4] Parkinson, M. 2012. *Future challenges: Australia's superannuation system*. [e-book] Sydney: Association of Superannuation Funds Conference, 28 November 2012. http://tinyurl.com/n2nhvy [Accessed: 31 Mar 2014]

[5] OECD, Pensions at a Glance 2013 OECD and G 20 indicators, http://www.oecd.org/pensions/public-pensions/OECDPensionsAtAGlance2013.pdf (at page 171)

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While the sole purpose of superannuation is to accumulate funds during working years to provide an income in retirement, this statement leaves the policy purpose of superannuation unresolved. At an individual level, is the role of superannuation to ultimately replace the age pension, or should it continue to supplement it for some or many Australians? How many and to what extent? These questions need to be addressed so that we can assess the success or failure of the system.

At an economy level, while the role of superannuation in enhancing financial stability and economic growth, and in building Australia's future is a leading national debate, there is no recognition of this role in the structural arrangements of the superannuation system, and it remains subordinate to the sole purpose test. While this may be appropriate, the relationship between individual and system-wide objectives nonetheless needs to be debated and resolved at a policy level.

AIST therefore recommends that CFR should be given a mandate to develop broad, overarching superannuation policy, and make recommendations to government on these threshold issues. Ideally, these recommendations would receive bi-partisan support so as to reduce the incidence of short-term policy tinkering that has plagued our compulsory super system since its inception.

AIST believes the expanded role should include the following:

- The development of a nationally accepted definition of 'adequacy'.

AIST notes that while Australia's superannuation system is the fourth largest in the world, there is no agreed definition of 'adequacy'. Such a definition could then be used in reviewing superannuation policies. In formulating a definition of adequacy, the CFR could take into account Australia's scaled marginal tax rates, the need to define adequacy in terms of income rather than lump sums, and the three savings pillars of the system.

There are many issues which should be tied to a definition of 'adequacy, such as means testing. Defining adequacy could also assist with the examination of, for example, at what quantum of superannuation benefit is it appropriate for Australians to take income streams rather than lump sums. In the past, this has mainly been driven by taxation policies, such as the former Reasonable Benefits Limit. AIST suggests that this matter should be driven by what is an adequate benefit rather than as a tax issue.

- An examination of how 'sustainability' of the superannuation system can be tracked.

AIST notes that there are various benchmarks for comparing the sustainability of our system compared with other systems[6]. However, while there are methodologies for assessing the Age Pension against the

[6] Australian Centre for Financial Studies and Mercer, Melbourne Mercer Global Pension Index, October 2013 http://globalpensionindex.com/2013/melbourne-mercer-global-pension-index-2013-report.pdf

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Intergenerational Report, there is not such a benchmark for testing our superannuation system from within.

Such a methodology needs to take into account all sectors of the superannuation system, ranging from industry, public sector, corporate and retail funds to SMSFs. All sectors can affect the sustainability of retirement savings.

- Longevity – an examination of the policies which could help mitigate the effects of longevity risk.

Such a review could include, for example, reassessment of the Longevity Index[7], Age Pension Age, the taking of income streams rather than lump sums, barriers to annuities, reverting to using maxima on retirement income streams, means testing, promoting mature age workforce participation, and the need for a MySuper Retirement product.

AIST recommends that the CFR play a role of testing superannuation policy changes against these benchmarks, as well as weighing up the cost of implementing change against benefits to the Australian people.

More recognition of the cost pressures of aged care and health costs.

While it is well-recognised that Australia's ageing population will place pressure on our aged pension system, there is less recognition of the impact that ageing and health costs will have on individual's superannuation savings. AIST recommends that aged care, health care and active community participation be considered as part of superannuation policy. With the growing and ageing population, AIST supports comments from the World Bank[8] that greater consideration of the impact, costs and interaction of aged care, health care and active communication with superannuation is required for the ongoing success of our retirement income system. Superannuation policy making should therefore take into account these broader policy connections.

4.1 Recommendations

AIST recommends that:

[7] A Longevity Index was released in 2009 but does not appear to have been updated. For details regarding the Index, see Australian Institute for Population Ageing Research, http://www.asb.unsw.edu.au/newsevents/mediaroom/media/2009/september/Pages/longevityindex.aspx

[8] Robert Holzmann, *Global Pension Systems and their Reforms: World Wide Drivers, Trends and Challenges*, Discussion Paper for the World Bank, May 2012, https://openknowledge.worldbank.org/bitstream/handle/10986/13557/689340NWP00PUB00labor0121300PUBLIC0.txt?sequence=2

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- *The FCR has an expanded role to examine Adequacy, Sustainability, and Longevity measures in order to assess the effectiveness of our superannuation system in meeting its primary objective.*
- *Consideration of aged care, health care, and active community participation should be included within superannuation policy. This is in line with World Bank recommendations.*

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5 Diversity and governance

Australia's $1.8 trillion superannuation industry is made up of several types of superannuation funds, each with different governance and ownership structures. Some funds are owned by banks, insurance companies or other financial institutions and operate as profit-making entities (retail funds), some are owned by individuals (self-managed superannuation funds) while others, in the not-for-profit sector, were created by mutual agreement between employer and employee bodies who established trusts to manage members' retirement savings. As an industry body, AIST represents the interests of the not-for-profit superannuation sector, i.e. corporate, public sector and industry funds.

The trustee ownership structure of not-for-profit funds is distinctly different from the commercial ownership structure of most retail funds. While sponsoring organisations have an ownership interest in not-for-profit funds, they are not free to sell or trade their ownership interest, as it is held in perpetuity within the trust structure. The stewardship of the assets is protected through the trust structure set out in the governing rules and supervised by law.

Another important distinction in the ownership structures of the different types of funds is that unlike the parent companies of retail funds, sponsoring organisations of not-for-profit funds are generally not in the business of superannuation (or in any related business) and their relationship with the fund is not material or profit-driven.

The governance framework of not-for-profit funds is based on an equal representation model whereby an equal number of the fund's employer and employee-sponsored directors are nominated or elected to the fund's board with the overarching protection of a two-thirds majority vote. While the two-thirds majority rule exists to protect beneficiaries and ensure that member interests are always prioritised, in practice the voting rule is seldom required as trustee directors pursue the best interests of members, usually on a consensus basis.

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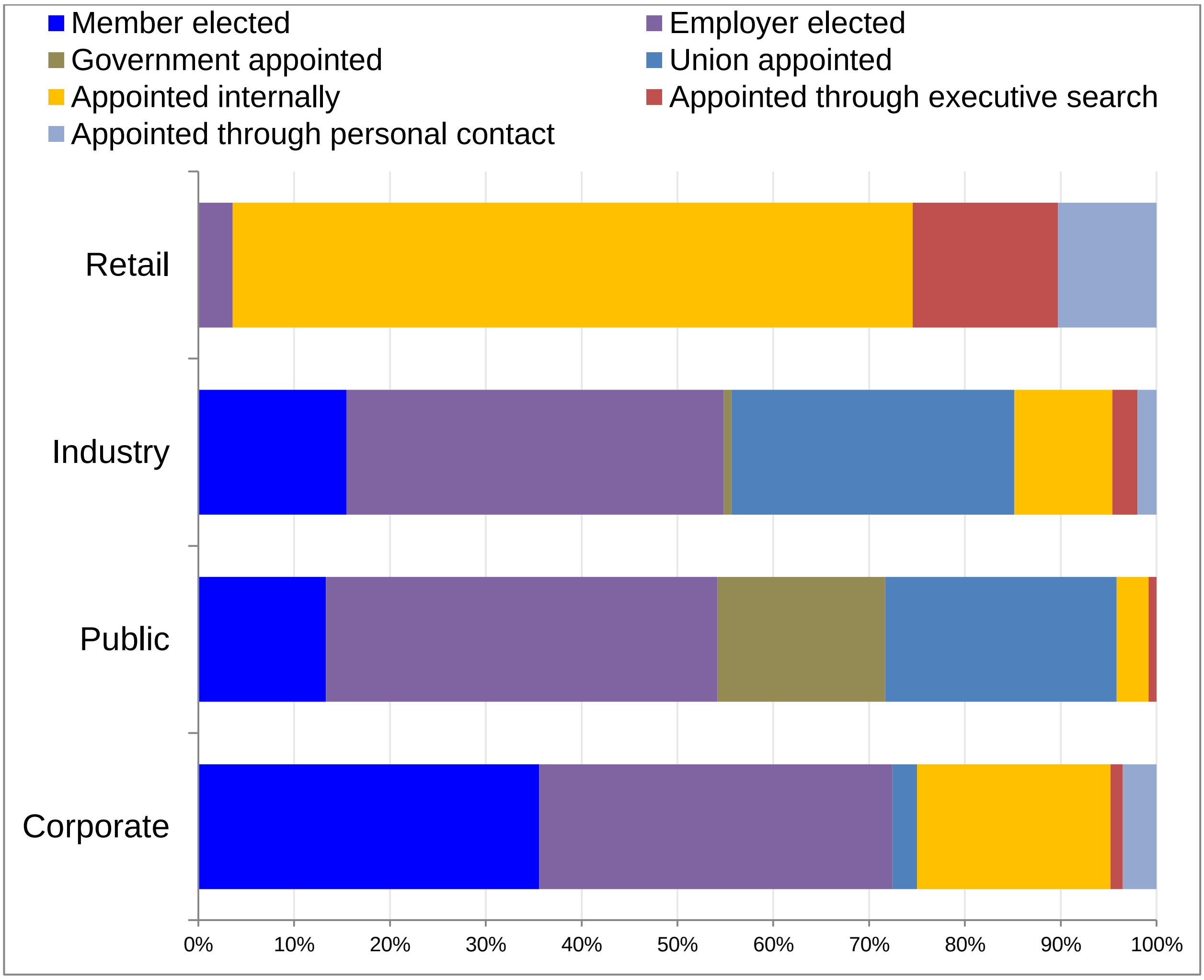
Method of board appointment across the superannuation industry



(Source: McKell Institute)

AIST submits that the governance model of not-for-profit funds has proven to be highly functional and effective, as well as highly adaptive to profoundly changing markets and commercial circumstances over time.

> *(T)he not-for-profit representative trustee model has outperformed its for-profit appointed trustee competitors on virtually every important criteria of superannuation performance over a long period. Although there may be scope for further improvement of the representative trustee model. It promotes higher levels of diversity amongst trustees, more effectively minimises conflicts of*

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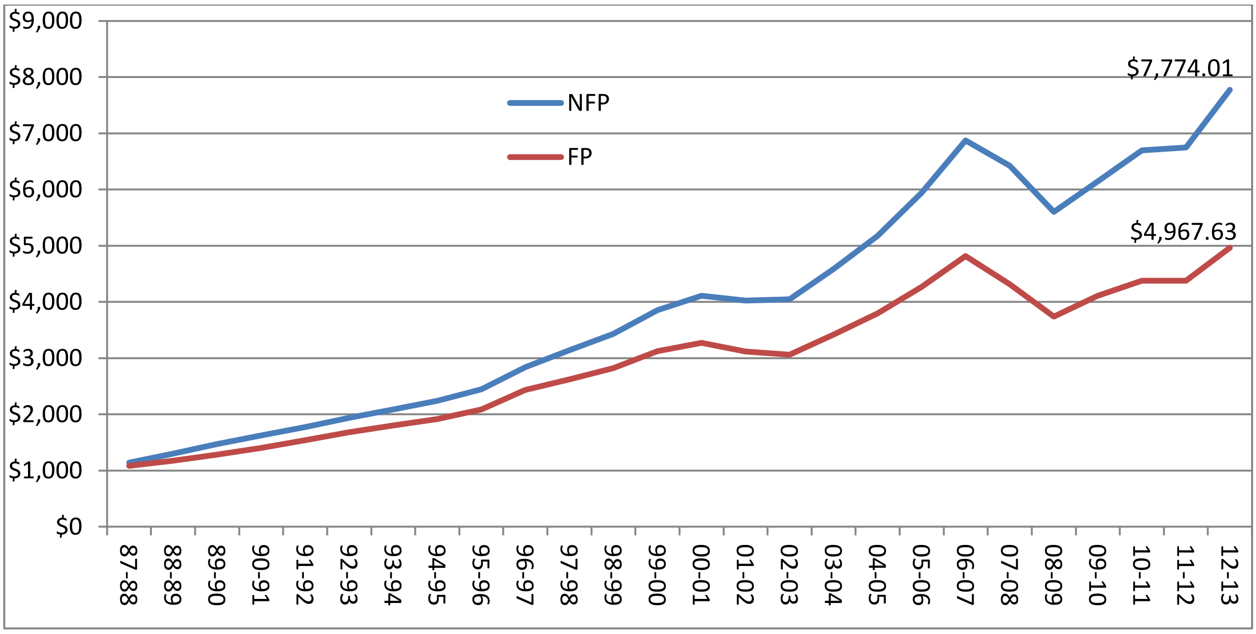
interest, and, importantly, has continually outperformed the for-profit model over the past decade, generating higher returns for fund members.[1]

The outperformance of the not-for profit (NFP) superannuation sector relative to the for-profit (FP) sector is shown in the following chart. This chart shows, for an initial investment of $1,000 in 1987 annual crediting rates compounded, balanced and default funds from 1988 to 2013.



(Source: McKell Institute)

Another important attribute of the representative model is the diversity it brings to the boards of superannuation funds that generally have far greater occupational, gender and age diversity than corporate boards.

The governance structure of APRA regulated super funds is necessarily different to that of banks and insurance companies. Banks and insurance companies are large corporate entities with shareholders expecting profits in return for their capital investment. Super funds on the other hand have stewardship of working Australians' mandatory retirement savings, and operate under a trust structure to protect the members and beneficiaries against the pursuit of interests outside of members' best interests.

[1] Markey, R., Rafferty, M. and Angus, C. 2014. *McKell Institute and the Macquarie University Centre for Workforce Futures submission to: Australian Government Better regulation and governance, enhanced transparency and improved competition in superannuation Discussion Paper*. [pdf] Sydney: McKell Institute, Macquarie University.

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AIST submits that this difference in governance design is beneficial not only to the way the different financial services sectors operate and fulfil their respective purposes, but the diversity of approach mitigates the risk of governance failure across the broader financial services system.

Like banking and insurance, superannuation funds are highly regulated. Due to the compulsory savings foundation of our superannuation system, and the implications for government should the system fail, it is highly appropriate that strong prudential regulation exists for the industry. As mentioned elsewhere in this paper, the prudential standards making powers of APRA, the codification of fiduciary responsibilities in the superannuation legislation and the systematic regulatory reviews of individual funds ensure that the industry's practices are subject to regular, external and independent audit.

The banking and insurance industries are similarly subject to prudential standards, and where the similarities allow, the requirements are consolidated. The unique trust relationship at the heart of superannuation sets it apart from other financial services businesses such as banks and insurance companies, and this structure is appropriate for the unique objectives of our superannuation system.

The regulatory framework that now exists for super funds ensures the appropriate management of:

- Operational risks
- Investment risks
- Insurance management risks
- Outsourcing risks
- Business continuity risks
- Conflicts of interest and duty

AIST submits that good governance coupled with appropriate regulation will ensure the sustainability and effectiveness of Australia's superannuation system into the future.

5.1 Recommendations

AIST recommends that the governance model of the not-for-profit superannuation sector be supported by the Inquiry as the diversity of governance structures across the industry ensures a diversity of approaches to the management of compulsory retirement savings in an area underpinned by strong regulation.

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6 Systemic risk in superannuation

The Terms of Reference of this Inquiry include an examination of the safety of financial services, how systemic risk is managed, and the role and objectives of financial regulators.

A core element of a better retirement future is to examine the stability and safety of Australia's superannuation system. A methodology for identifying systemic risk is worthy of consideration as in Australia's predominantly defined contribution scheme members are 'wearing' the risks (e.g. investment, administration). While superannuation funds might be classified as 'users' of financial markets, the interconnectedness of that use may pose a systemic risk.

6.1 Management of systemic risk in overseas pension schemes

Regulatory bodies in both Europe and the USA have either included, or are considering whether to include, superannuation funds within their regulatory framework to manage systemic risk.

The Financial Stability Board, the International Monetary Fund and the Bank for International Settlements[2] broadly define a systemic event as:

- A disruption to the flow of financial services that is caused by an impairment of all or parts of the financial system; and
- Has the potential to have serious negative consequences for the real economy.

The key criteria used in identifying the systemic importance of markets and institutions include:

- *Size* (volume of financial services provided by the individual component of the financial system)
- *Substitutability* (extent to which other components of the system can provide the same service in the event of a failure) and
- The *interconnectedness* (linkages with other components of the system).

The International Organisation of Pension Supervisors (IOPS) applies this to superannuation systems and talks about systemic risk[3] as risk which affects all or most supervised entities. IOPS notes that it is not productive to deal with systemic risks on a fund-by-fund basis: systemic risks should be dealt with by improving the entire pension system.

[2] Financial Stability Board, International Monetary Fund, Bank for International Settlements, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations – Background Paper Report to the G-20 Finance Ministers and Central Bank Governance October 2009* , http://www.financialstabilityboard.org/8C4D1B0E-89B5-4486-89A0-6CB761AF5898/FinalDownload/DownloadId-00700D0F1BEDF741767377CCA8321F80/8C4D1B0E-89B5-4486-89A0-6CB761AF5898/publications/r_091107d.pdf

[3] http://www.iopstoolkit.org/toolkit-module3.html

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IOPS goes on to comment that in superannuation systems which are defined contribution systems, the macro-prudential focus needs to be on the interconnectedness of components of the system and market themes.

Both Europe and the USA have established bodies to regulate systemic risk within financial institutions.

AIST notes the comments of the Centre for European Policy Studies, where Mirzha de Manuel[4] states that it is important to note banks, insurers and pension funds are not the same, and their collapse poses different kinds of risks.

6.2 Systemic risk in the Australian superannuation system

The Australian superannuation system – where there is a separation of trust assets from the Trustee – means the failure of the entity acting as a trustee doesn't directly affect the members in the same way as, for example, depositors of an insolvent bank.

While seemingly there is diversity in Australia's superannuation system – including over 300 registered entities and over 500,000 self-managed super funds (SMSFs) there are many links within Australia's superannuation system which create an underpinning structure with less diversification. Donald et al[5] demonstrate this through linkages to service providers. While the following graph highlights the linkages via custodian, Donald et al note that a similar pattern can be seen when examining member benefit administrators and insurers.

[4] IP Real Estate online magazine, http://realestate.ipe.com/pensionseurope-dismisses-inclusion-of-schemes-in-too-big-to-fail-resolution/56862.article 9 September 2013

[5] Scott Donald, Bruce Arnold, Hazel Bateman, Ross Buckley, Kevin Liu, Centre for Law, Markets and Regulation, *The implications of complexity for systemic risk in the superannuation system*, Sydney August 2013 http://www.clmr.unsw.edu.au/resource/compliance/prudential-regulation/clmr-working-paper13-3-implications-complexity-systemic-risk-superannuation-system

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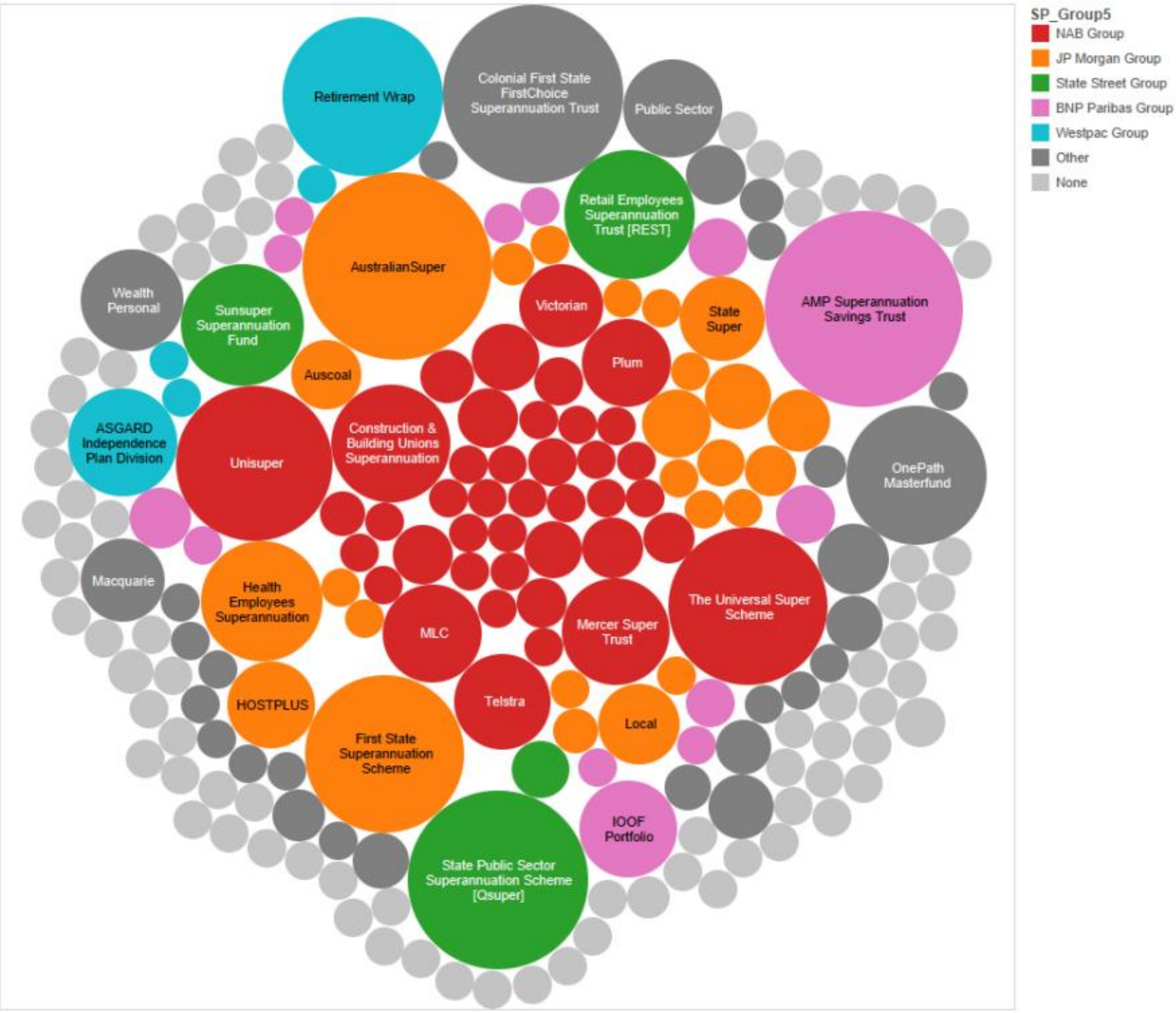
Interconnectedness of super funds by custodian as at 30 June 2012 – assets under custody



6.3 Improving supervision of systemic risk in Australia

APRA's mission requires it to establish and enforce prudential standards to ensure that financial promises made by institutions are met within a stable, efficient and competitive financial system and that they play a role in preserving the integrity of Australia's retirement income policy. The ratings of Australia's superannuation system as highlighted above – coupled with Australia comparatively faring well during the GFC – all point to a well regulated system.

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However, as Australia's superannuation system continues to evolve – and as the demands of an ageing population impact the system even more – AIST submits that the management of systemic risk within an ever more complex environment should be examined.

In a paper jointly authored by the Reserve Bank of Australia (RBA) and APRA in 2012[6], the authorities note that macro-prudential policy is subsumed within the broader financial stability framework and that this has given Australian authorities greater flexibility and helps ensure continued effectiveness of the system.

While AIST notes that there are a number of supervisory tools to identify and respond to risks in the industry or at system level, it endorses the comments by Donald et al[7] that "for the most part, APRA's supervisory activities treat individual entities in the system separately."

This comment – and AIST's support of it – raises the question whether a macro-prudential regulator is needed to provide focus to systemic risk.

The establishment of specific systemic risk regulators and advisory groups overseas is fairly recent, and their efficacy or otherwise has not yet been tested. In any event, AIST submits that the answer to the need for more regulators isn't necessarily an additional regulator – rather an addition to the focus of the existing regulatory authority.

AIST recommends additions to APRA's tool kit, including that the Probability and Impact Rating System established by APRA be reviewed to include, for example, the degree of interconnectedness of the superannuation system and its components.

AIST recommends the following additions to APRA's 'tool kit':

- Provide further guidance on the definition of 'systemic risk' within the Australian superannuation system.
- Examine how 'local disturbances' within the Australian superannuation system may, while appearing immaterial, emerge notwithstanding that individual entities satisfy prudential standards.
- Examine methods for analysing how the data APRA collects could be better used to help identify systemic risks within the Australian superannuation system.
- Determine whether the rating systems used by the Financial Stability Board could assist in identifying 'systemically important' superannuation system entities/components.

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[6] RBA and APRA, Macroprudential Analysis and Policy in the Australian Financial Stability Framework, September 2012, http://www.rba.gov.au/fin-stability/resources/2012-09-map-aus-fsf/pdf/2012-09-map-aus-fsf.pdf

[7] Scott Donald, Bruce Arnold, Hazel Bateman, Ross Buckley, Kevin Liu, Centre for Law, Markets and Regulation, *The implications of complexity for systemic risk in the superannuation system*, Sydney August 2013 http://www.clmr.unsw.edu.au/resource/compliance/prudential-regulation/clmr-working-paper13-3-implications-complexity-systemic-risk-superannuation-system

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- Identify whether the PAIRS (Probability and Impact Rating System) requires review to include items other than member numbers and funds under management, e.g. sustainability of service providers, interconnectedness of the entity, and key themes affecting a particular sector (e.g. use of alternatives, high weightings to property such as for SMSFs), and key market shifts such as movements in superannuation fund administrators and custodians.

In making these recommendations, it is not proposed that regulation by APRA be extended to service providers such as custodians and administrators.

6.4 Technology as a systemic risk

The growing importance of technology in superannuation and its integration into all facets of super funds is linked to increased risks. The section on Ensuring the System Delivers (Chapter 7) identifies issues and opportunities around the use of cloud computing and the impact of faster transactional capabilities on liquidity.

While barriers to the effective use of technologies have to be reduced in order to deliver better services for super fund members, rigorous safeguards also need to be put in place to maintain the integrity of the system. Technology failures, cyber-attacks and technology-enabled fraud can have potentially catastrophic impacts on organisations.

While APRA's risk-based approach to prudential supervision will continue to be developed, this too requires greater cross-regulator coordination and increased resourcing to best address the systemic risks. For example, the CFR should ensure that the extensive ATO's and AUSTRAC's data and technology capabilities can be more effectively utilised by APRA and other agencies.

6.5 Recommendations

AIST recommends that APRA's powers should include supervision of superannuation systemic risk, rather than creating an additional macro-prudential regulator. AIST also notes that 'Systemic risk' is a possibility across the superannuation system and that the ATO should have similar powers in respect of SMSFs. This possibility arises from the interconnectedness of the entities that funds outsource to, such as administrators and custodians.

AIST recommends that the Probability and Impact Rating System established by APRA be reviewed to include, for example, the degree of interconnectedness of the superannuation system and its components.

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7 Ensuring the system delivers

7.1 Strengthening consumer protection

The vast majority of Australians are members of defined contribution rather than defined benefit superannuation funds. Defined contribution balances in Australia stood at 79% of defined benefit scheme balances[8] at 30 June 2012.

Members in defined contribution schemes bear the risks (investment, operational, etc.). As the OECD notes[9], a combination of being in defined contribution funds and having member choice can lead to, for example, hidden commissions and insider trading. The OECD notes this is a problem exaggerated when the pension providers are commercial financial institutions.

Disclosure is a critical tool for managing this risk. AIST notes that the Australian superannuation system has worked hard on providing members with standardised and comparable information, all of which meet the *OECD Guidelines for the Protection of Rights of Members and Beneficiaries in Occupational Pension Plans*[10]. In the sections dealing with member disclosure, the Mercer Global Pension Index[11] ranks Australia with either the highest score or second highest score on each element of disclosure reviewed. Suggested improvements are outlined below.

AIST continues to support a strong regulatory regime in the consumer protection space. The Financial Stability Board (FSB) (which emerged from the Financial Stability Forum to promote international financial stability - its membership includes Australia) issued a Report examining consumer finance protection with particular focus on credit post the GFC[12]. While realising that this Report focussed on bank consumer lending arrangements, it is nonetheless of interest to note the following comments from the FSB:

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[8] Hazel Bateman (University of NSW) and Geoffrey Kingston (Macquarie University), Restoring a level playing field for defined benefits superannuation, Melbourne Money and Finance Conference 1-2 July 2013 http://www.businessandeconomics.mq.edu.au/contact_the_faculty/all_fbe_staff/Geoff_Kingston/RestoringALevelPlayingFieldForDefined_BenefitsSuperannuation_1.pdf

[9] John Ashcroft and Fiona Stewart, Managing and Supervising Risks in Defined Contribution Pension Systems, Working Paper no. 12 October 2010 International Organisation of Pension Supervisors, http://www.oecd.org/site/iops/principlesandguidelines/46126017.pdf

[10] OECD Guidelines for the Protection of Rights of Members and Beneficiaries in Occupational Pension Plans, 2003 http://www.oecd.org/pensions/private-pensions/34018295.pdf

[11] Australian Centre for Financial Studies and Mercer, Melbourne Mercer Global Pension Index, October 2013 http://globalpensionindex.com/2013/melbourne-mercer-global-pension-index-2013-report.pdf (see Attachment 3 page 71)

[12] Financial Stability Board, Consumer Finance Protection with particular focus on credit, 26 October 2011 https://www.financialstabilityboard.org/publications/r_111026a.pdf

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> *Disclosure laws in Australia may have acted as a deterrent for the marketing arms of global investment banks (many of which have extensive operations in Australia) to bring riskier products to consumers in Australia.*

While this comment refers to bank consumer lending arrangements, AIST notes and supports the concepts of a strong consumer protection regulatory regime within the Australian superannuation system.

To better protect individual Australians, disclosure of superannuation products and services must be on a level playing field (e.g. Non MySuper products must fully disclose fees and related party interests).

While MySuper for the most part delivers comparable product disclosure, AIST recommends that there be an examination of non-MySuper products to ensure that adequate disclosure is being made. This comment particularly applies to post retirement products and so called low fee non-MySuper products, and superannuation products involving related parties.

AIST strongly endorses members having a right to know what they are being charged and that includes any additional services such as financial planning advice. AIST notes that it has made a submission regarding the Exposure Draft of the FoFA amendments where AIST strongly opposes the removal of the member opt-in to advice provision as well as the reduced requirements regarding fee disclosure.

7.2 Transparency of supervisory levies

AIST recognises the need to raise financial sector levies to assist Government agencies oversight or provide certain services. However, levies are ultimately paid by individual Australians through superannuation fees and charges and therefore affect retirement savings.

To ensure that levies are being raised appropriately, AIST strongly endorses the policy objectives contained in the Australian Government's *Cost Recovery Guidelines July 2005* (CRG), namely consistency, transparency, and accountability, and the promotion of the efficient allocation of resources. These policy objectives are particularly pertinent, given both the size of the Australian superannuation sector as well as the quantum of levies arising from SuperStream.

AIST submits that currently, there is a lack of consistency, transparency and accountability in the way levies are charged.

Superannuation should be involved in a consultation process for the review of Cost Recovery Guidelines.

All sectors of the superannuation system should be paying their share of the levies, including SMSFs (which have benefitted from the new data transfer standards).

Methodologies for costs attributable to regulators other than APRA should form part of the Cost Recovery Guideline consultation process.

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AIST recommends that the Government's Cost Recovery Guidelines should be applied to Financial Industry Levies.

7.3 Impact of technology on superannuation

Appropriate use of new technologies provides the opportunity to harness innovation for the benefit of consumers, and should be subject to a consumer benefit test.

The tension between compliance and innovation, and between stability and efficiency, is positive when it is in the right balance. Unfortunately, however, the balance tends to tilt toward compliance and stability. Compliance is generally easier to define in detail, whereas the measurement of innovation can be more amorphous. The aim of compliance is often about prudent management, consumer protection and disclosure, but the outcome can be of little use to consumers.

We will use the example of Product Disclosure Statements (PDS) for superannuation products to initially make this point. A PDS is required to be "clear, simple and concise"[13]. It is also required to comply with numerous additional requirements, such as the Shorter, Simpler PDS regime[14]. This is a good thing when it results in consumers being able to better understand products and compare them with others in a consistent manner.

However, in many cases, PDSs are impenetrable to many consumers and a barrier to their understanding. This is because the specific checklist of requirements generally trumps the more general requirement to be clear, simple and concise.

They are also difficult to use and explore. PDSs are generally provided to consumers in printed form, or in PDF format on websites or attached to emails. It is unusual for a PDS to include tools to facilitate use and understanding of the document, including finding the answer to the specific question asked by the consumer.

While the internet will be the medium primarily used by most new disclosure requirements, PDS presentation has remained determinedly "twentieth-century".

The issue of better disclosure has continued to be at the forefront during the implementation of Stronger Super reforms, especially in the design of MySuper and associated disclosures. It was an explicit criterion from the outset of the process. Significant progress has been made, although the results provide examples of both good and less positive outcomes.

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[13] Section 1013C(3), *Corporations Act 2001.*

[14] Requirements for superannuation funds are prescribed in Schedule 10D of the *Corporations Regulations 2001*.

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Increased use of new technologies provides an opportunity to improve the balance between compliance and innovation. It will also be the medium by which most new disclosures will be made. It is a positive development that there has been, and will continue to be during the current design phase, use of online solutions to improve and extend disclosure.

The requirement to be able to compare MySuper and other superannuation products on an online product dashboard is a step forward, although the template is still a work in progress. With it, as with all disclosure requirements, the question has to be "how will this help the consumer understand and compare product offerings?" In that case, the answer is relatively clear: consumers are able to see how the product has performed, how it expects to perform, and how its performance stacks up against the super fund's targets.

If that question is asked of the portfolio holdings disclosure requirement, the answer is far less clear. Is the purpose of this disclosure to help consumers understand where their super is invested, or where their fund invests, or is it about aiding research into where the super invests overall, or is it about identifying unethical investment? Will consumers use this information, will they understand it, and how will it benefit them? After all, it is members who are paying for the data to be disclosed.

There can be positive answers to these questions but these are issues that need to be addressed and clearly answered at the contemplation and design stage, and not only during implementation or as an afterthought.

AIST recommends there should be a consumer testing of financial products disclosure requirements undertaken at the design and regulatory stage, and again following implementation.

That is, at the design and regulatory stage there should be a process akin to a regulatory impact statement where government and regulators are required to demonstrate consumer benefit and comprehension. Then, following implementation there should be an ongoing requirement on product providers, monitored by regulators, to also demonstrate consumer comprehension.

But the examples of the online product dashboard and portfolio holdings disclosure are just the start of an accelerating trend to increasing online disclosure. There will be increasing examples where consumers are able to tap into super fund and industry data, as technologies make this more and more possible and make data increasingly able to be manipulated.

APRA is in the process of designing a data dissemination tool. This tool will be used to assist consumers interrogate information about the products they have, compare them with other products, and (presumably) provide rankings of products and an assessment of industry performance overall. The tool will draw upon the 4,000 data items now reported to APRA by super funds on a quarterly and annual basis. These items cover assets, performance, fees and charges and risk. The design of this tool would also benefit from consumer testing at an early stage.

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7.3.1 Reporting and disclosure co-ordination between agencies

The data dissemination tool also provides an example of where the introduction of new requirements needs to be co-ordinated between government agencies from the outset, and during the modification and expansion of these capabilities.

APRA is not the only government regulator collecting superannuation information that may be disclosed to consumers. The ATO, ASIC and Australian Bureau of Statistics are amongst the other agencies collecting superannuation information.

For example, the ATO is now collecting more information about superannuation accounts through enhanced Member Contribution Statement reporting. Most information about members' accounts, other than insurance, is now regularly reported to the ATO.

This may enable the ATO to produce a more comprehensive overview of super funds and fund member behaviour, although this has yet to be announced or perhaps even contemplated by the ATO. However, it does mean that it will be possible for the ATO and APRA to share and match data. It should also mean that the government is able to reduce the reporting burden on funds by reducing and streamlining reporting obligations.

This is a subset of the issues with coordination between agencies that should be addressed in a holistic approach.

As a consequence of the changes to both APRA and ATO reporting, super funds now report many times more data than ever before. While section 29QC of the SIS Act requires that the information that is provided to APRA which is calculated a specific way should be the same that is provided to others (including ASIC or the ATO) there is more that can and should be done on the effective co-ordination and use of superannuation data.

AIST believes it is important that the government gives a formal commitment to removing regulatory obstacles in the super system by improving coordination and reducing overlap between regulatory agencies. These can occur in reporting, supervisory and product responsibilities and providing consumer protections. The agencies generally respond that they meet regularly but this runs the risk of focusing on the ad hoc and not tending to address areas of deeper efficiencies.

AIST has recommended superannuation oversight for the Council of Financial Regulators elsewhere in this submission. While its members should be from the financial regulators, this body must involve super industry stakeholders and consumers in its consultations and communications.

AIST submits that this recommendation is relevant regardless of any change to regulatory structure arising out of the Inquiry. Regardless of any rearrangement of superannuation roles and responsibilities by government, there will be necessarily be roles and responsibilities that straddle more than one area of government.

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7.3.2 Super funds and better disclosure

Responsibility for better disclosure, best practice utilisation of new technologies and removal of barriers to innovation must not rest entirely with the government and regulators. It is an industry responsibility and a joint responsibility.

The implementation of cloud computing provides a good example of the value of taking a broad view. Cloud computing increases the effectiveness of shared resources to achieve economies of scale over a network. It can deliver reduced IT cost, scalability and increased data flexibility and efficiency. Cloud computing is likely to deliver great benefits to both super funds and their members.

The entirely reasonable response of APRA was to write to fund trustees advising them of their prudential concerns about use of cloud computing and to remind them about their risk management obligations[15]. This has since been followed up with additional guidance about managing data and IT security risks.

However, because APRA does not have a mandate to promote the efficiency of the system, it has not been promoting the desirability of the superannuation system being innovative and efficient in addition to it being prudently managed.

AIST recommends that the superannuation industry, in consultation with government and consumer groups, develop best practice guiding and binding principles on providing information to consumers, including most effective use of new technologies.

7.3.3 Impact of technology on liquidity

Since 2005, most superannuation fund members have been able to choose their super fund, and to move their super benefit as they see fit. Additionally, most super fund members are also able to choose from a menu of investment options within their super fund.

Although the majority of members of not-for-profit super funds are in a default MySuper option having not made any choice, and even members in other investment options only have very low level of switching activity, super funds are aware that they may have to fund switches to another investment option or another fund – and are required by law to do so.

Despite the requirement for fund trustees to optimise long-term retirement savings, the choice rules mean that super funds have to invest on a more short term basis than they would otherwise. All super fund members may therefore be receiving lower long-term returns as a result of this.

[15] Sim, P. 2010. *Outsourcing and offshoring: Specific considerations when using cloud computing services*. [letter] Letter to All Trustees, APRA Regulated Superannuation Funds. Sent 15th November 2010. Available at http://tinyurl.com/lry3aty

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Superannuation funds' experience of the Global Financial Crisis was that they were able to continue to operate throughout, making benefit payments and making investment switches in response to member requests. Developments since then may mean that this is not the experience in any future financial crisis.

The level of member activity in response to the GFC was relatively low. Normally, members who make an investment switch annually is low[16]. Feedback from trustees indicates that the number of members who switched funds increased markedly during the 2008/2009 financial year. While this was significant increase, it is still low in absolute terms, and did not result in super funds having to restrict switches or payments.

There are many likely reasons for this relatively low level of activity. Members may have been confident about their super fund’s ability to "weather the storm". They may have thought it too difficult to move their money, or thought their balances were too small to worry about. Alternatively, given the twice-yearly mail-out of member statements, they may have only have realised the negative impact of the GFC on their account balance many months after the event.

The experience of a future GFC is likely to be very different. There is now much higher use of the internet by Australians than there was almost six years ago during the GFC: people routinely use the internet for everyday banking, consumer transactions, and to obtain any information they wish. This is often done using smart phones and with apps that greatly simplify use of the internet.

The superannuation industry has been part of this transformation. Most funds have websites and provide members with account information. These sites have become increasingly interactive and easy to use, and are increasingly being supplemented by smart apps.

Most significant, however, is the impact of SuperStream, with various aspects all combining to make transactions faster and more efficient.

The ATO is now collecting more information about superannuation accounts through enhanced Member Contribution Statement reporting, and using this information to populate its SuperSeeker website. Not only does SuperSeeker show fund members all their super holdings, including many of the accounts reported as "lost", it also encourages the consolidation of accounts.

SuperStream also comes with a three-day transaction processing rule. Once a super fund receives an application for a rollover of a benefit to another super fund with all of the requisite information, it must process the rollover within three working days, as must the super fund that receives the rollover. Prior to this rule (1 July 2013 for rollovers and from 1 July 2014 for contributions), a super fund had 30 days to

[16] Evans, J., Foster, D. and Tan, K. 2006. *Drivers of Investment Choice: Some Evidence From Australian Superannuation Participants*. [report] Sydney: Actuarial Studies Unit, School of Banking and Finance, University of New South Wales, p. 7.

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process the application. The ability to process transactions faster and using common requirements will remove administrative difficulties as a roadblock to commencing transactions.

The combination of all of these factors may mean that fund members are more willing and able to move their superannuation balances during a future financial crisis - even though it may not be in their best interests to do so and may force super funds to invest on a more short-term basis.

The contradiction between requiring increasingly higher levels of liquidity as member awareness and transactional speed increases, and investing on a long term basis remains unresolved. This also impacts on the capacity of super funds to invest in funding Australia's future through infrastructure.

AIST supports both long-term investing by super funds and funding for Australia's growth, and recommends that liquidity requirements for superannuation products should be reviewed by the government.

7.3.4 Impact of technology on ensuring the system delivers

There are a significant number of large, high-level issues whose implementation would lead to improvements across the system as a whole, both for the benefit of members and the health of the system.

While these issues may be at a lower level than those being considered by the Inquiry, they illustrate the regulatory barriers to innovation and the implementation of new technologies.

Other worthwhile initiatives to enhance the efficiency of the system through the improved use of technology include:

- Resolution of lost and unclaimed super
- Online employee registration for super and income tax
- SMSF account validation

7.4 Fees and costs

Fees and costs for superannuation in Australia are relatively high compared to the rest of the world, based upon OECD data, with a variety of rents extracted at different points. AIST's modelling shows that even apparently low fees of 2% per annum would still result in a reduction of over 50% in investment value over a 43 year term, compared to a scenario where no fees were charged.

AIST recommends that fees charged as a percentage of assets be phased out and replaced with dollar-based fees charged on a fee-for-service basis. Payments to related parties should be disclosed, and carve-outs of conflicted remuneration should be eventually phased out. Gross interest margins should be disclosed to superannuation fund members, where money is deposited with related parties.

Shelf-space fees and profit sharing arrangements should be passed through to members to ensure that they benefit from these arrangements in full.

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7.5 Recommendations

Regulatory and transparency recommendations:

- *AIST continues to support a strong regulatory regime in the consumer protection space.*
- *To better protect individual Australians, disclosure of superannuation products and services must be on a level playing field (e.g. Non MySuper products must fully disclose fees and related party interests).*
- *Any proposed disclosure requirements must be consumer tested to ensure we are not only 'telling' members, but they are actually 'informed' by the disclosure.*
- *A methodology for tracking consumer's understanding of financial concepts should be developed.*
- *AIST recommends that the Government's Cost Recovery Guidelines should be applied to Financial Industry Levies.*

Technology recommendations

- *All barriers to ecommerce should be removed.*
- *Compliance barriers to innovation and improved customer service should be identified and removed, where this is in members' best interests.*
- *There should be consumer testing of financial products disclosure requirements undertaken at the design and regulatory stage, and again following implementation.*
- *The superannuation industry, in consultation with government and consumer groups, should develop best practice guiding and binding principles on providing information to consumers, including most effective use of new technologies.*
- *The Council of Financial Regulators recommended by AIST should have specific statutory responsibility to improve coordination, reduce overlap (and hence unnecessary red-tape) between regulatory agencies in areas of reporting, supervisory and product responsibilities and providing consumer protections.*
- *Liquidity requirements for superannuation products should be reviewed by the government (having regard to their long-term objectives).*

Fee and cost recommendations:

- *Asset-based fees phased out and replaced with dollar-based fees charged on a fee-for-service basis;*
- *Payments to related parties should be disclosed;*
- *Carve-outs of conflicted remuneration should be eventually phased out;*
- *Gross interest margins should be disclosed to superannuation fund members, where money is deposited with related parties; and*
- *Shelf-space fees and profit sharing arrangements should be passed through to members to ensure that they benefit from these arrangements in full.*

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8 Consideration of post-retirement solutions

AIST advocates that where appropriate, the legislative and taxation environment for retirement products and various sectors within superannuation must be on an equal playing field.

AIST supports that a review of the legislative framework for annuities so that members are incentivised to take up all or part of their retirement benefit as an annuity. In so saying this, AIST recognises that members with amounts lower than an agreed adequacy benchmark should not be penalised for taking part or all of their benefits as an annuity.

8.1 Recommendations

AIST recommends:

- *A review of the Superannuation Industry (Supervision) Regulations 1994 rules relating to income streams that restrict product innovation. Regulations should be drafted in an enabling fashion rather than having specific features listed, thus enabling product design innovations. AIST specifically supports amendments to Regulations 1.05 and 1.06 to facilitate products such as variable annuities (to assist the pooling/guarantee of longevity risk), income stream packages (including deferred annuities at an advanced age), and with-profit annuities (investment/longevity profits and losses are shared.*
- *Amending taxation legislation so that if a deferred lifetime annuity is taken out in drawdown phase, it is viewed as a pension and therefore exempt from income tax. This deferral of retirement income would result in a small increase in the Age Pension if the pensioner is eligible for an Age Pension. However, this can occur in any event with retirees having the option to take a smaller income stream, provided they comply with the minimum drawdown rules. Any legislative change would need to ensure that the tax free status applies only to genuine non-commutable retirement deferred lifetime annuities purchased with superannuation money.*
- *With respect to the deferral period of a deferred lifetime annuity, reviewing the rules around minimum surrender values, minimum drawdown rules, social security and aged care tests to ensure that the products can be developed and exist on an equal playing field with existing products.*
- *Development of a default ("MySuper") post-retirement product.*

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