the voice of super

Response to the Financial System Inquiry Final Report

March 2015
The Association of Superannuation Funds of Australia (ASFA)

Contents

Introduction

The following submission is provided as part of the consultation process on the Financial System Inquiry (FSI) Final Report. The Association of Superannuation Funds of Australia's (ASFA's) submission focuses on recommendations relating to superannuation and the retirement income system. We look forward to discussing our submission further and assisting with the implementation of key recommendations.

Our submission comprises four sections:

1. an executive summary

2. an overarching discussion on the key issues raised in the report:
   - **2.1 retirement income products:** converting assets at retirement into income flows to effectively support retirement Improving clarity around the objectives of the system
   - **2.2 clarifying the objectives of the system:** developing objectives for the superannuation industry to that ensure superannuation and retirement incomes policy and the regulatory architecture are aligned
   - **2.3 price-based competition:** ensuring that there is an appropriate level of price-based competition, which allows the scale benefits of the industry to be fully realised
   - **2.4 measuring and monitoring system efficiency:** ensuring that an appropriate assessment of the level of competition can be made

3. responses to the recommendations in the Final Report that relate to superannuation

4. attachments: information supporting our responses to the various superannuation-related recommendations.

Executive summary

ASFA welcomes the Final Report of the FSI and congratulates the FSI Committee on a balanced and considered assessment of the Australian financial system. ASFA is delighted that the Committee has acknowledged the importance of the superannuation and retirement system to the Australian economy, and its critical role in enabling Australians to have a comfortable and dignified lifestyle in retirement.

The Committee has identified the importance of ensuring the efficiency of the superannuation and retirement system. ASFA believes that the efficiency of the system will be enhanced if policy and objectives are focused on the cohort of individuals who need most assistance to meet retirement objectives. Without clarity around which sector of the population the superannuation system is looking to assist, system and product design will be limited in their effectiveness to meet the greater challenge of retirement income for most Australians.

ASFA believes there are four key issues for superannuation, arising from the final FSI Report:

1. targeting the delivery of *better retirement products* for Australians
2. *setting long-term objectives* for the superannuation and retirement system
3. assessing the *competitiveness*, and therefore efficiency of the system, particularly for default members
4. *measuring and monitoring system efficiency* so that an appropriate assessment of the level of competition can be made.

Better retirement products

We know that as the system matures we will see a significant increase in the need for retired Australians to have sensible retirement-income products, which protect them from financial risks. In its November 2014 paper, *The future of Australia's super: a new framework for a better system*, ASFA identified the need for superannuation funds to offer a retirement income product to members, which would be designed to meet retirement needs such as regular income, protection against longevity and support aged care needs. ASFA supports the very practical approach that the FSI has taken to the way in which such a product could be implemented. While a cost-benefit analysis is yet to be done, our initial assessment is that the solution appears to be one which could be put in place with relatively little cost to superannuation funds and, therefore, members. Success of this initiative will depend upon:

- flexibility being given to a trustee to offer more than one comprehensive income product for retirement (CIPR) to better meet differences in needs across their membership
- appropriate regulation of these products at inception and on an ongoing basis by APRA, as the superannuation regulator and
- complementary policy settings in other areas of government, such as taxation and social security.

Setting long-term objectives

In its submission to the FSI following the release of its Interim Report, ASFA called for bipartisan agreement on the objectives of the superannuation system. ASFA fully supports the recommendation of the report that the objective of the superannuation and retirement system be set as:

> ***To provide income in retirement to substitute or supplement the Age Pension***

ASFA calls for agreement of this objective across industry and political lines as soon as possible. We note, however, that agreeing on an objective is just the first step towards actually achieving this goal. To improve our probability of success, ASFA recommends that:

- agreement is reached on tangible measures of success and progress monitored against these
- this process is co-ordinated by a cross-sectional Superannuation System Review Panel comprising industry, academics, regulators and government (see below).

Competition

ASFA agrees with the FSI Committee that the benefits of the recent reforms of Stronger Super, Future of Financial Advice (FoFA) and SuperStream are yet to fully emerge.

In the ASFA submission to the interim report, we believe we provided a balanced discussion of the state of competition in the superannuation industry, acknowledging that there are both demand and supply side complexities, and noting the ancillary benefits, such as insurance, which are often not factored into assessments of the costs of providing services. The superannuation and retirement system is complicated and ASFA agrees that a comprehensive assessment of the system is required before any judgement can be made as to its efficiency.

However, it is critical that we begin this process of assessment early, and develop a time series of data upon which to form a framework for any future review. Progress against this assessment could then be analysed on an ongoing basis, as well as at points in time, such as 2020. This will enable public policymakers to make decisions relating to the future direction of the system, well informed by evidence-based analysis.

ASFA recommends that a cross-sectional Superannuation System Review Panel is established that has wide membership, including system participants, government, academics and regulators to assess the efficiency of the system. This group must determine sensible measures of efficiency against which the system can be assessed.

How and where this group is resourced needs to be considered. It is critical that we become more effective in the way we resource research, review and assess superannuation and retirement policy. As such, it will be important that this group leverages off, and co-ordinates with, work being undertaken to review competition as well as any other periodic assessment relating to retirement income or superannuation issues.

Measuring competition and efficiency

In this submission, we outline a three-tier framework for thinking about the efficiency of the superannuation and retirement system. These are: firstly, looking at efficiency from the perspective of its impact on the overall economy; secondly, the operating efficiency of the system itself; and thirdly, from the perspective of the individual members. In our submission, we identify the key elements across this framework that may form part of any assessment of overall system efficiency.

Other next steps

It is important though, that we do not stand still while these key initiatives are undertaken.

In our submission, we support a number of the FSI recommendations, and identify those that can be implemented now. Each represents a positive step towards a better superannuation and retirement system for Australians. These include:

- *Promoting enhanced engagement* by members by providing them with a list of superannuation accounts and balances, alongside their annual taxation assessment notice.
- Requiring that *retirement income projections* against a benchmark like the ASFA Retirement Standard are included on member statements, particularly for members who need to be thinking ahead about their retirement plans.
- Promoting a more consistent approach to superannuation savings and promoting system stability through transitioning to *prohibiting direct leverage* within super funds.
- Moving towards *more robust governance* of superannuation funds through more independent directors and mandating the appointment of an independent chair.
- Exploring ways in which we can *release more data* relating to super, to improve the quality of decision making while ensuring the privacy of individuals will be protected
- Testing *innovative approaches to disclosure documents* with consumers, and enabling innovation in this area by removing legislative constraints.
- *Raising industry standards around financial advice*, to help more Australians with the important decisions they need to make around superannuation and retirement.
- Supporting *better and more efficient regulation* of the financial system through a formal process that will review how well financial system regulators are doing their job.
- Strengthening ASIC's powers to allow them to *prohibit financial products that are demonstrably not in consumers' best interests*.
- Working out ways to *rationalise old and expensive legacy products*, to reduce costs across the financial system, without diminishing benefits such as group insurance.

2.1 Retirement income products

The industry wants to help retirees by providing retirement products that generate a regular and stable income stream, provide longevity risk management and are flexible enough to deal with unexpected life events. This will help prevent retirees from over spending, and running out of income earlier than expected, or conversely from under spending, and having an unnecessarily frugal lifestyle.

However, it will be important not to 'throw the baby out with the bath water' in coming up with solutions to this challenge. Allocated pensions can be appropriate in solving part of the retirement conundrum provided that individual retirees have a disciplined drawdown approach, and the asset allocation is consistent with the period of time income will be needed. What are needed however are additional products that provide more flexibility and meet the need to protect against the risks of longevity. These may be add-ons to an allocated pension style product, or a standalone product that bundles together desirable features that might include: a regular income stream; a deferred annuity; and a deferred cash lump sum for aged care costs. As noted in the FSI Report, any impediments to the ability of providers to offer this type of flexible product must be removed, and this process should be an early priority of public policymakers.

Many, if not most, Australians find the decisions that need to be made at the point of retirement daunting. And many, if not most, do not receive comprehensive financial advice at this time. Financial products and their features are complicated. The demonstrated preference towards term deposits and blue chip shares may reflect retirees' familiarity with these products, rather than an active decision around the appropriateness of these products for their specific retirement needs.

ASFA sees Recommendation 11 of the FSI Report as an important step in providing retirees with better guidance around the types of features they should be looking for in retirement investments. Recommendation 11 requires superannuation trustees to pre-select a comprehensive income product for members' retirement. While not a default product, it will provide a benchmark for individual members, by indicating what the trustee believes is a sensible and appropriate investment strategy for retirement. Put another way, it is a useful starting point for new retirees to consider the right investment strategy to suit their individual circumstances.

While ASFA sees Recommendation 11 as an excellent initiative to help individual members meet their retirement objectives, we are concerned about *how* these comprehensive income products for retirement (CIPRs) will be approved and assessed. It is critical that these products, which will be endorsed by trustees, are appropriate for use in retirement. As such, the approval of, and ongoing oversight over, CIPR is crucial, to ensure that these products continue to meet promises made to members to meet and manage their financial risks.

The framework for authorisation of MySuper products is a useful starting point in developing the approach for CIPR. The process of obtaining a MySuper licence requires initial authorisation by APRA of the individual product(s) and the environment in which they operate. The MySuper authorisation granted to a particular superannuation fund is on the basis of the original application. However, any subsequent changes to the MySuper offers, provided they comply with the *Superannuation Industry (Supervision) Act 1993,* are not subject to APRA approval, although, of course, APRA prudentially reviews the registrable superannuation entity (RSE) licensee, its operations and the MySuper product(s) on an ongoing basis.

ASFA believes that, consistent with MySuper applications, APRA should be responsible for authorisation of CIPR offers by trustees. In particular, ASFA recommends that any CIPR offered by a trustee should be assessed for its appropriateness in meeting objectives and managing the financial risks for individual members. Trustees should determine and report on an annual basis whether the CIPR remains appropriate and suitable to meet the objectives and manage the financial risks of the cohort of their members who are approaching retirement.

These products are important to individual Australians, as well as for the economy more generally. As such, there is a case that APRA should monitor these products on an ongoing basis against the promises and commitments that have been made to retirees' to manage their financial risks. ASFA suggests that a specialist unit is formed within APRA, resourced with staff with expertise in superannuation, investments and life insurance.

Public policy does not usually achieve its maximum effectiveness through a single policy, but through the consistent application across a number of policy initiatives. ASFA sees the introduction of a trustee-nominated retirement product, as the first step in improving retirement outcomes for individual members and improving overall system efficiency. Taxation and social security settings are another way to help steer retirees in the right direction in terms of managing their assets in retirement. Taxation arrangements should be restructured to complement this FSI recommendation, thereby giving a better probability of success. Social security settings should also be reviewed to ensure that there is consistency and alignment across these interlinked public policy areas.

ASFA has been strongly advocating for a greater range of retirement products to be offered within the superannuation system, most recently in our November 2014 paper, *The future of Australia's super: a new framework for a better system*, and is pleased to see this recommendation included within the FSI report. The proposed approach is a sensible, well-considered solution to the practical problems of transitioning assets within the superannuation system to retirement vehicles.

ASFA recommends that trustees are given the flexibility to offer more than one CIPR within the superannuation fund. This flexibility would allow trustees to offer products which are appropriate for specific retirement needs rather than forcing a 'one-size fits all' approach.

Maintaining trust in the superannuation and retirement system is paramount. As such, ASFA believes that appropriate regulation of these retirement products is critical, that APRA oversight is appropriate and that this oversight should continue past the initial approval stage, given the importance of these products to the retirement outcomes for Australians.

ASFA also recommends that tax and social security settings are reviewed, to ensure that individuals are incentivised to invest in products that are consistent with the objective of providing income in retirement.

2.2 Clarifying the objectives of the system

In its response to the FSI Interim Report, ASFA stated *"Without clarity of purpose, superannuation and retirement policy and regulatory architecture cannot be aligned and therefore, cannot deliver the right outcomes".*

ASFA's submission to that report recommended that:

- the objectives of the system were clear and measurable
- that there was bipartisan agreement on what success would look like and that the system was measured against this target
- regulation was consistent with system objectives and regulators were held accountable against appropriate indicators in assessing their performance
- emerging gaps and risks in the system design, regulatory architecture and regulatory reach were monitored.

The FSI Final Report supports this ASFA position. Recommendation 9 of the FSI Report proposes that broad agreement is sought for the objectives of the superannuation system. It recommends that these objectives are enshrined in legislation and there is public reporting on how public policy proposals are consistent with achieving these objectives over the long term. The FSI Report proposes that the primary objective of the system should be:

To provide income in retirement to substitute or supplement the Age Pension

The Report also recommends that the government should seek broad agreement on the subsidiary objectives of the superannuation system, namely:

- facilitate consumption smoothing over the course of an individual's life
- help people manage financial risks in retirement
- be fully funded from savings
- be invested in the best interests of superannuation fund members
- alleviate fiscal pressures on the government from the retirement income system
- be simple and efficient, and provide safeguards.

ASFA supports these primary and subsidiary objectives and recommends that a discussion on how and where they should be enshrined in a legislative framework should commence as soon as is practically possible.

However, implementing the FSI recommendation alone will not be enough to ensure success. To succeed, we will need to do more than simply enshrining the objective in legislation and requiring public reporting on how the future policy proposals are consistent with these objectives. While both these initiatives will be critical to developing a truly efficient superannuation system, to ensure success we will also need to agree tangible measures of success and monitor progress against these.

ASFA notes that the FSI Report discusses the option of establishing a publicly funded independent body to assess the superannuation system's performance and report on superannuation policy changes. ASFA has concerns with this proposal, as it may create another layer of bureaucracy that is unnecessary and may indeed add to the administrative burden of the industry. Rather, we propose that measurable objectives and outcomes for the superannuation system are agreed by a panel of individuals drawn from policymakers, regulators, academics and system participants. Agreement should also be reached on how these should be monitored on an ongoing basis. This panel could sit under an existing structure such as the Productivity Commission and its remit should be flexible to the extent that it is able to assess the interaction of pensions and other social security provisions with the super system.

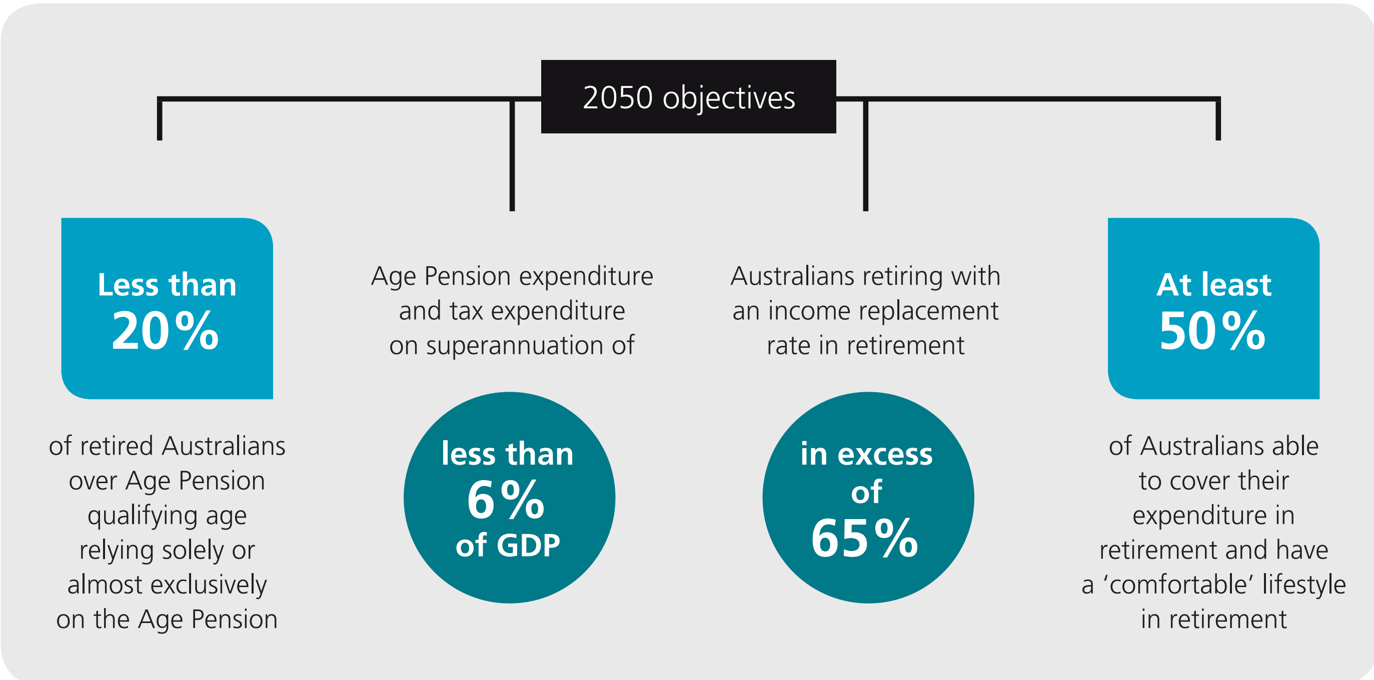
In this submission, we discuss some of the potential metrics that ASFA believes are appropriate markers for the measuring performance of the superannuation and retirement system.

ASFA strongly endorses the recommendation of the FSI to develop objectives for the superannuation industry. It is critical that the primary objectives are universally endorsed, across political lines and the superannuation system. ASFA also sees the benefit of having the high-level objectives enshrined within a legislative framework while more tangible and measurable goals are agreed, measured and monitored outside the legislative framework.

ASFA has concerns about the creation of a new industry body to monitor progress against these goals and objectives, on the basis of the need for flexibility and the additional layers of bureaucracy it may create. Rather, ASFA recommends that a panel of system participants, academics, policymakers and regulators work collaboratively to agree the objectives, and to determine how they will be monitored on an ongoing basis. This panel could sit under existing structures such as the Productivity Commission.

Measuring the performance of the superannuation and retirement system

In our submission to the FSI in regard to its Interim Report, ASFA proposed four quantitative objectives for the superannuation and retirement system in order to guide the design of superannuation and retirement income policy settings. These objectives focused on the cost of the Age Pension and tax concessions for superannuation relative to gross domestic product (GDP), levels of reliance on the Age Pension, the level of income replacement in retirement and the percentage of the retired population living at a standard equivalent at least to the ASFA Retirement Standard 'comfortable' budget.



ASFA believes there must be clear – and apolitical – support for objectives and that future policy measures or proposals must be judged in terms of how they would impact on the achievement of those objectives.

Of course we expect that this will, at times, require the balancing of one objective against another. There can be tensions between or even within some of the objectives described above. For instance, reducing expenditure on the Age Pension through reducing the maximum amount payable per retiree or by tightening the means test can impact on the adequacy objectives. As well, reducing tax concessions for superannuation in order to contain overall system costs can adversely impact on both Age Pension expenditure and adequacy of retirement incomes.

A relevant recent example is the policy decision to suspend the increases in the Superannuation Guarantee (SG). A policy based on short-term concerns about costs to the government and employers to not increase the rate of the SG above the current rate of 9.5 per cent of wages may compromise the achievement of the various long term objectives of the system, including the ongoing cost to the government of the Age Pension.

Are there objectives in addition to those already proposed by ASFA that should be adopted?

There is a case for extending the objectives to include some efficiency measures, for example a single accumulation account for each individual member, unless additional accounts are specifically desired. ASFA's response to Recommendation 10 sets out our proposals on processes for improving the efficiency of the superannuation system and how success in terms of improved efficiency might be measured.

Where should the objectives be set out?

ASFA considers that appropriate places to set out broad objectives are in government and ministerial statements. They also could be included via reference in an Explanatory Memorandum or preambles to legislation. Other groups could also choose to adopt the objectives and to document this.

ASFA does not consider that more detailed objectives and quantitative goals should be in legislation, particularly longer-term objectives, which might be hostage to future developments in investment returns or other factors outside of the control of funds or policymakers. As well, there is a very real question as to what the response should be if a specified objective or specified objectives are not achieved.

In many cases, a range of coordinated policies will be needed, including budget allocations for the Age Pension. Setting out objectives in legislation will not generally be the best way of ensuring that such objectives are achieved. A better way is to have broad political and community support for a set of objectives with this then influencing the development and refinement of policy settings in a variety of areas over time.

Should a new body be set up to monitor these goals/objectives and the progress towards them?

ASFA has concerns about the setting up of a new independent body to assess progress towards meeting set objectives and to review new policy proposals. Our view is that it should be for policymakers, informed by industry and public discussion and debate, to undertake such reviews rather than an independent body. The question of how such a body, if established, could act on its findings also is an issue.

That said, it is appropriate from time to time for governments to establish a review or inquiry process that examines certain aspects of the retirement income system. This could involve a standing body, such as the Productivity Commission, or it could involve a specially constituted review committee with a finite life. Parliamentary committees may also have a role to play. In any, or all, of these cases, it will be critical that the entity charged with this review has staff with the appropriate skill set and resources to undertake this work.

ASFA's preference – as outlined in the Executive Summary – is that a cross-sectional Superannuation System Review Panel is established, which has membership across system participants, academia, policymakers and regulators. This group should be tasked with agreeing the various measures of success for the system.

2.3 Price-based competition

If together, the industry, policymakers and regulators are able to deliver on:

- flexible and innovative retirement products that help individual members manage the financial risk of retirement and
- the agreed, appropriate and measurable objectives of the superannuation system,

we will be making good progress towards a more competitive, and therefore more efficient, superannuation system.

Competition is, rightly, regarded as a positive force in most industries. It should improve the efficiency of the industry, quality of services, innovation and international competitiveness. The Murray report questions the strength of competitive forces within the superannuation industry. The report suggests that scale benefits should be available, and if they are not there must be structural or operational inefficiencies that need to be overcome. Particularly, it suggests that good competition should see scale benefits flow through to individual members in the form of lower fees.

The superannuation system is, and will increasingly become, critical to the development of the Australian economy and to the future wellbeing of Australians in retirement. We need to understand any potential areas of inefficiency and impediments to competition, which will limit the system's ability to achieve its objectives.

The assumption of the FSI Report is that if the superannuation system is unable to demonstrate competitiveness by 2020, then there are clearly structural impediments to meeting this goal, which can only be overcome by government intervention. If we go down the proposed auction approach to allocating new default fund members into MySuper products, we will be acknowledging that competition is not working effectively in the default segment of the superannuation market.

As outlined in our response to the FSI Interim Report, the adoption of a single national default would further undermine providers' efforts to engage members and be highly unlikely to result in a substantive reduction in fees.

The FSI Report recognises that the benefits of the recent reforms of Stronger Super, FoFA and SuperStream are nascent. As such, they recommend that an assessment of competition and efficiency in the superannuation system be undertaken in five years, and a decision made at that point whether to implement an auction-style approach to default superannuation contributions.

In the ASFA submission to the Interim Report, we believe we provided a balanced discussion of the state of competition in the superannuation industry, acknowledging that there are both demand and supply side complexities, and noting the ancillary benefits, such as insurance, which are often not factored into assessments of the costs of providing services. The superannuation and retirement system is complicated and ASFA agrees that a comprehensive assessment of the system is required before any judgement can be made as to its efficiency.

However, it is critical that we begin this process of assessment early to develop a time series of data upon which to form a framework for any future review. Progress could then be analysed on an ongoing basis, as well as at points in time, such as 2020. This will enable public policymakers to make decisions relating to the future direction of the system, well informed by evidence-based analysis.

This type of approach to assessing the overall function of a critical part of the financial system has been done previously. The periodic reviews of the costs of the payment system by the Reserve Bank of Australia are an exemplar. The ongoing data collections of key payment system statistics help inform public policy in this area, as well as providing useful information to industry participants.

Another example is the work done globally by Ernst & Young in assessing superannuation system efficiency. That work looks at both efficiency and effectiveness from the perspective of the member, and from the perspective of the superannuation fund, creating a member efficiency index (MEX) and fund efficiency index (FEX). The work is able to extract key findings on both an industry and participant level; findings include targeting areas of improvement such as mass transaction operating models and process architecture, as well as long term investment performance and product design.

ASFA acknowledges that the process of measuring competition and efficiency is not simple. Differences in business and legal structures will mean that costs may not be readily compared from one organisation to another. And at times, data will be difficult to extract and separate from other activities that may be being undertaken. However, there are precedents of how this has been done, and given appropriate time and resources, it is an achievable objective.

In the section that follows, ASFA presents a framework for considering how we could measure efficiency across the superannuation and retirement system, including a scorecard, which could be used for a snapshot assessment at points in time. It is a first pass at what could be some sensible measures of efficiency against which the system can be assessed.

ASFA recommends that a Superannuation System Review Panel is established to determine the key components of industry efficiency and on this basis gather relevant data. This approach will allow a current and ongoing assessment of industry efficiency and competitiveness. The industry will be able to use this data to self-assess – and improve – while public policymakers will be informed of the status of competitive forces through timely, relevant and dynamic information.

2.4 Measuring and monitoring efficiency

In this section, we provide some preliminary discussion around ASFA's views of how overall system efficiency should be assessed, and suggest some possible measures to monitor efficiency.

The FSI process has highlighted the difficulties in assessing system efficiency and getting an overall feel for the relative strength and weaknesses of the system. ASFA considers the need to develop a methodology/framework to measure efficiency and to measure success.

ASFA also sees appeal in a scorecard approach as one way in which we could be monitoring performance on an ongoing basis across the various facets of the system.

ASFA thinks about the impact of competitiveness on three levels. Firstly, from the viewpoint of the overall economy, secondly, considering the operation of the superannuation and retirement system, and thirdly, from the perspective of the individual member. Below and on the following pages, we discuss each of these in turn.

Economic benefits

Taken in its broadest sense, the superannuation system needs to be efficient in the way it interacts with, and contributes to, the Australian economy.

Better economic outcomes will result from:

- better co-ordination of superannuation policy with other areas of public policy
- better targeting of superannuation policy
- promoting fiscal sustainability and
- enabling greater contribution to economic growth.

These are discussed below.

Better co-ordination with other areas of public policy

For greater efficiency, it is critical that the various areas of public policy work together to ensure that policies relating to superannuation are complementary, and consistent with, those of other related departments. Most particularly, we identify:

- taxation
- social security, particularly Age Pension, settings
- ageing and aged health care arrangements.

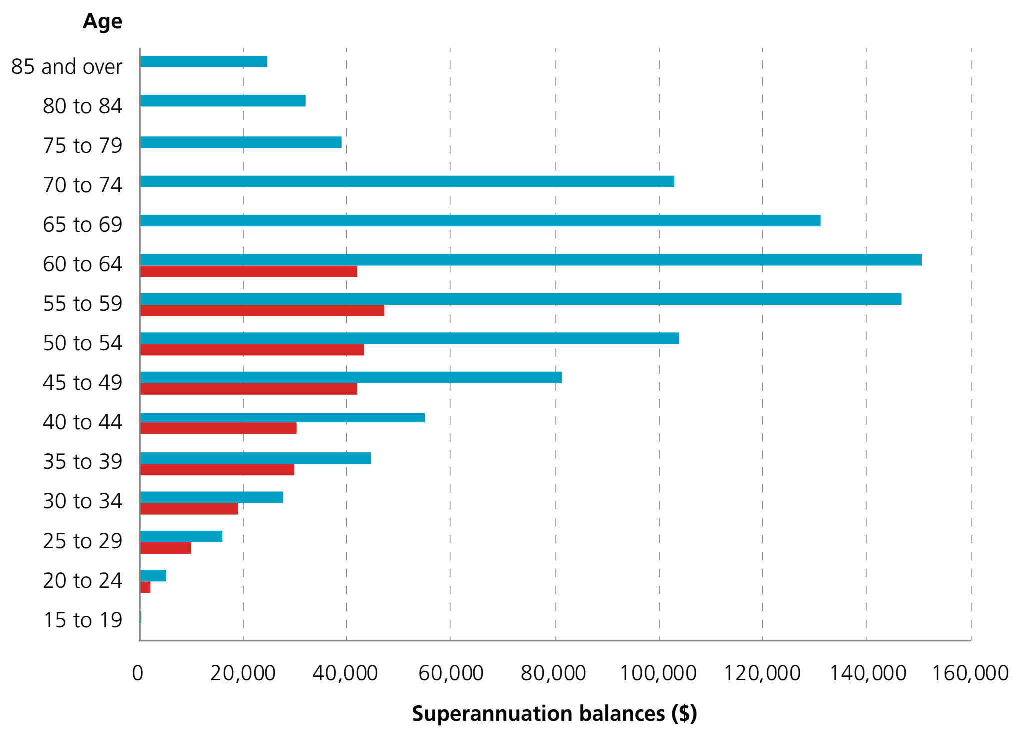
Currently, changes in policy are open to public submissions and are presumably discussed at an interdepartmental level within the government. However, we may need to do more to make this process more effective. One suggestion may be to leverage the proposal of the FSI Committee to report publically on how policy proposals are consistent with achieving superannuation objectives over the long term. This could be done through regulatory impact statements (RIS) where related policy departments – for example, taxation, social services – were required to include consideration of the impact on superannuation objectives and indicate what consultation had been undertaken.

Over a 12-month period, we will have seen three key reports that will have significant implications for the superannuation industry. These are the tax white paper, the Intergenerational Report (IGR) and the FSI Report. It is critical that these are looked at from the perspective of their collective impact on the industry, to ensure the outcome is consistent with the objectives for superannuation and retirement.

Better targeting of superannuation policy

Efficiency across the economy may also be enhanced by the more effective targeting of superannuation policy. Under current arrangements, superannuation tax concessions for contributions primarily apply to employees in Australia and to eligible self-employed workers who make contributions. There also are tax concessions relating to investment earnings related to superannuation accounts that apply to all individuals with superannuation. However, despite the existence of tax concessions and the operation of compulsory superannuation contributions, many individuals are still well short of the savings needed to meet their future retirement income needs. Data on average account balances drawn from the ABS Survey of Income and Housing conducted in 2011/2012, which surveyed over 14,500 households containing nearly 45,000 individuals, are provided in the graph on the following page. This data shows both the average (mean) superannuation balance for age bands of those surveyed (blue bars), and the median superannuation balance (red bars).

Graph 1: Average superannuation balances (as at 2011/2012)



The graph highlights two key issues:

1. firstly, that the average balances are still relatively low, and certainly well below what is required to self-fund retirement with no call on the Age Pension
2. secondly, the median of the survey balances – that point where half of the individuals surveyed have a balance of less than this amount and the other half have a higher balance – is considerably lower than the average. This means that a significant proportion of the survey group across all ages has nil or little superannuation

The main public policy challenge that must be addressed is how to get average Australians on a self-funded path to a comfortable retirement. While average balances will increase over time through SG contributions and investment earnings, ASFA modelling shows that even younger Australians, with decades to retirement, are likely to have to contribute more than the compulsory SG amount to ensure a good probability of a comfortable lifestyle in retirement.

While we know that the average Australian is where the policy challenge lies, time and energy is spent considering the policy implications for the smaller group of members who have relatively large balances. The policy issues for this smaller group are those of equity and foregone tax revenue for the government and these issues need to be dealt with separately under the banner of fiscal sustainability.

The efficiency of the system will be enhanced if policy and objectives are focused on the cohort of individuals who need most assistance to meet retirement objectives. Without clarity around which sector of the population the superannuation system is looking to assist, system and product design will be limited in its effectiveness to meet the greater challenge of retirement income for most Australians.

Ensure fiscal sustainability

Fiscal sustainability means ensuring that the expenditure on Age Pension and tax concessions for superannuation, as proportion of a broad measure of the economy such as GDP, is managed and controlled to affordable and sustainable levels.

A measure of efficiency is the ability of the superannuation and retirement system to be self-funding. Self-funding means that individuals save enough money during their working life to fund their own retirement income. The FSI Report identifies this as a subsidiary objective of the system. This was also highlighted in the ASFA submission to the Interim Report.

The system can only be sustainable if incentive structure for the superannuation system is set correctly for members with lower superannuation balances as well as those with higher superannuation balances.

At the lower balance end of the spectrum, members must be appropriately incentivised to contribute to superannuation. Greater efficiency can be obtained by encouraging individuals to 'save more, earlier'. The compounding effect of having larger, earlier balances within superannuation is significant. Therefore, a dollar of tax concession to a younger superannuation member is a more efficient investment for the government than a dollar concession given to an individual member with, say, five years to retire. While there are some social consequences here – younger members may be looking to establish a family, and perhaps purchase a home – the efficiency uplift of early superannuation contributions is significant. Consistent with this, ASFA supports both the continuation of the Low Income Superannuation Contribution (LISC) beyond its scheduled abolition date of 2017 and the introduction of the 12 per cent SG contribution as soon as possible.

By contrast, the system will not be sustainable if it continues to provide tax concessions, regardless of the size of the superannuation balance. It is critical that the superannuation system is used to generate income to live on in retirement. If the income is well in excess of reasonable levels, then it is more likely that the funds are being used for estate planning purposes, which is not consistent with the objectives of the system.

ASFA has been advocating that we need to question whether or not the same tax concessions that are applied to lower balances should equally be applied to individuals with very high levels of super. As noted in the FSI Interim Report, recent changes to concessional and non-concessional contribution caps and a higher contributions tax rate for very-high-income earners (30 per cent above $300,000) have begun to move the goalposts towards more equitable outcomes. ASFA agrees with the Committee that further adjustments to policy settings may be required. ASFA research is currently focused on this area and will form the basis of the ASFA response to the tax white paper later in 2015.

Enable assets to be invested in such a way as to contribute to the overall economy

In ASFA's first submission to the FSI, we noted the importance of the compulsory superannuation system to various elements of the economy, including the contribution to national savings, participation in the domestic equity markets and helping to stabilise financial markets.

We should be working on ways in which the superannuation system can further improve its contribution to the overall economy. Maximising the pool of wealth that sits within the superannuation and retirement system is one way to increase the net benefit to the Australian economy.

Changes in the structure of the industry have meant more superannuation assets are ending up invested in term deposits and blue-chip shares, through self-managed superannuation fund (SMSF) activity, and in retirement, through direct investment in deposits and share portfolios. Institutionally held assets have a greater investment footprint into investments which more broadly support the Australian economy, in particular, infrastructure, private equity and non-residential property. Institutional superannuation funds have also demonstrated their ability to provide a stabilising influence on local financial markets, most recently in market disruption around the global financial crisis (GFC). The FSI Report has identified that the large sums of money held in shares and bank deposits through SMSF accounts have a greater potential to generate a run on a bank in Australia, or a sharp drop in the capitalisation of a listed Australian company.

As the system matures, an increasingly significant pool of money will sit across balances of retirees, and it is critical that this pool is contributing to the system funding and economic growth.

The trend of retirees to invest their retirement savings in term deposits and blue-chip shares in preference to purpose-built retirement products may reflect the lack of availability of these products in the market. There is no doubt that retirees' balance and share portfolios contribute to the funding of the Australian banking system and the capitalisation of major companies. However, there would be benefits for both the investor and the economy if this asset pool were invested in a more productive, diversified way across the economy.

Incentivising people to keep assets within the institutional superannuation sector through high- quality retirement income products is likely to result in these assets being more productively invested in the economy. As an example, a characteristic of many mature infrastructure assets is a steady income stream, which is an ideal investment vehicle for individuals in retirement. At the moment, it is predominantly accumulation assets that are being invested in these types of assets.

Again, tax setting may have a role to play in nudging superannuation investment into asset classes which are likely to provide the greatest contribution to the overall economy.

System efficiency

At an industry level, the operation of the superannuation and retirement system must be efficient to ensure that system-wide inefficiencies are not a drag on meeting objectives. A particular focus of the FSI Report is whether scale benefits are being captured effectively by the system. To objectively assess the efficiency of the system's operation requires the consideration of the many different facets of the superannuation and retirement system.

Below we discuss:

- operational efficiency
- investment costs
- insurance
- costs of regulatory change.

Operational efficiency

Recent analysis provided to ASFA by Rice Warner suggests that operating expenses have been increasing faster than either inflation or member growth. Rice Warner believes that this trend reflects the increasing burden of regulatory and technology costs, while somewhat offset by the increasing scale of the industry. However, these observations, and more detailed analysis, are limited by the relatively high level nature of the data available.

It is difficult to analyse precise drivers of operating expenses, although the APRA fund level statistics do provide some base level information.

However, this data is not able to appropriately identify the drivers of costs across the system, nor does it provide an insight into the areas where there may be potential to improve cost outcomes. Finally, the analysis is not able to link higher costs, with additional services or benefits that flow to members. These benefits include insurance, member advice and so on.

Absent detailed analysis of costs, and without a clear link to member benefits, it is difficult to make an appropriate analysis on the relative efficiency or inefficiency of the operation of superannuation funds or the superannuation system. As we noted earlier, cost analysis within the superannuation system is not a simple exercise, due to the difference in legal and business structures and the sharing of various resources across different parts of some businesses.

We believe that, while complex, an analysis of the cost drivers across the superannuation system is possible, given the right commitment of time and resources. As noted above, we have examples where cost and efficiency assessments have been undertaken – Ernst & Young and the Reserve Bank of Australia. On this basis, it seems reasonable that we would be able to develop a similar benchmark for the Australian superannuation system.

Investment costs

Investment expenses are expressed as a percentage of total fund assets and are comprised of:

- investment management fees (direct and indirect, including performance based fees)
- custody fees
- asset consulting fees
- expenses relating to in-house investment teams etc.

Of these, the most significant is the investment management fees, which represent around 90 per cent of the total investment expenses.

Recent initiatives arising from the Stronger Super reforms have required funds to more openly disclose investment management fees to members. In theory, this allows greater transparency, particularly around fees that are incurred when a fund invests through a number of feeder funds, multi-manager funds, or performance-based fees, which are incorporated into unit prices directly. However, there is still some way to go to achieve consistency in the way in which fees are reported across different providers. As a result, the individual member will still struggle to sensibly compare different products on a like-for-like basis.

Outside transparency issues, significant variation in investment fees also occur through differences in investment strategies. There will be dispersion in investment fees expenses as a result of: passive/indexed based strategies, variations in asset allocations, use of more expensive non-traditional asset classes, such as direct infrastructure. This makes it difficult to clearly identify the impact of growing scale in the superannuation industry on investment fees.

A key issue concerning the Murray Inquiry has been the lack of clear evidence that the build-up of funds under management within superannuation is generating economies of scale that ultimately benefit the individual member.

A sensible discussion can only take place following the evaluation of accurate and timely data. The new APRA statistics will be key to this process, but we will need to wait for this data series to be bedded down and for at least a few years of data collected before robust analysis can be undertaken. In the meantime, a concerted effort to improve the consistency of fee reporting must be made across the superannuation industry.

Insurance

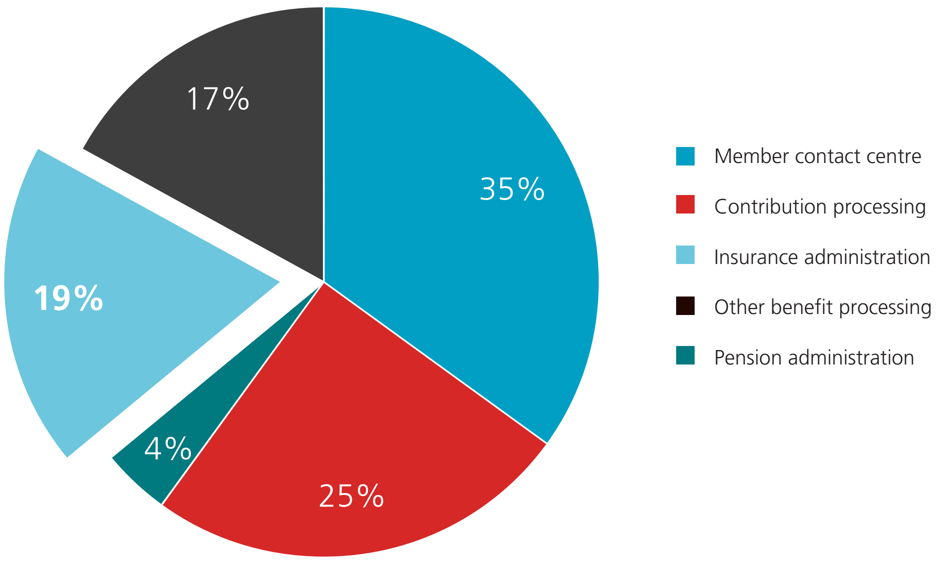
Underinsurance remains a significant challenge for Australia. Rice Warner has estimated that the gap between an appropriate level of insurance cover and current levels of insurance across the Australian population is around $1,553 million per annum in insurance premiums. It is indisputably the case that this gap would be much larger without group insurance in superannuation. Group insurance in superannuation covers the disengaged – who are typically underinsured – and effectively pools risk, thereby reducing cost and increasing efficiency.

Underinsurance has significant economic implications for individuals who face personal tragedy and their families. In addition, individuals and families without insurance add significantly to the call on the public purse via social security benefits such as disability payments and single parent allowances. Rice Warner estimates that the annual benefit to the government of these savings is in the order of $400 million.

As outlined in the ASFA submission to the FSI Interim Report, Australian superannuation is unusual in its provision of insurance as an ancillary benefit. There are few superannuation systems around the world where insurance is automatically provided with membership of the fund.

ASFA commissioned Rice Warner to do some high-level analysis of the cost of the provision of insurance protection within superannuation as part of its response to the Interim Report. This analysis indicates that insurance administration is responsible for around 20 per cent of total administrative expenses and is almost as large as contribution processing. What is seldom calculated, however, is the benefit that this provides to the individual member in the form of relatively cheap personal insurance, with little effort on their part. (From an economic perspective, it also reduces the level of underinsurance in the economy, and represents a saving on costs that might otherwise be borne by social security.)

Graph 2: Administrative expenses per member by component (as at end-June 2013)



Source: Rice Warner.

The cost of regulatory change

The implementation of regulatory change is a non-discretionary cost that is borne by the superannuation system.

A particular concern to ASFA members, and also raised in the Final Report, has been the heavy agenda of regulatory change across the superannuation system. Regulatory change has an impact on costs and fees.

Costs associated with implementing reforms such as Stronger Super, SuperStream and MySuper have been significant and have ultimately been borne by members. Greater accountability must be taken by both government and regulators for the cost benefit analysis of these shifts in policy. An assessment must be made of the benefits that arise from regulatory changes to the superannuation and retirement industry, to ensure that members' savings are not eroded by changes that do not provide them with better investment outcomes or demonstrable improvements in consumer protection.

ASFA recommends that post-implementation reviews of all significant regulatory reforms are undertaken to ensure that the outcome is consistent with the intent, and that the forecast downstream benefits have actually been achieved.

In addition, the development of any methodology/framework that assesses fees and costs needs to take into account the impact of regulatory change.

Structural flexibility

In terms of system efficiency, we need to also look at the structure of the system to ensure that it is flexible enough to allow effective competition.

Consistent with previous ASFA submissions, we are aware that the absence of strong demand side engagement from members has some knock-on impact to the structure of the superannuation industry. Like transactional banking, once the investment decision is made, the superannuation investor is very 'sticky'. Movement across funds or products is relatively uncommon, and when it does occur, is typically linked to a change in employment.

In this submission, ASFA has acknowledged the need to continue to work on the engagement of members with their superannuation fund accounts. We have proposed that, as an initial step, individual members receive a statement of their total superannuation balances across all of their superannuation funds with their annual taxation assessment notice. This would be provided by the Australian Taxation Office (ATO) using data currently available on the myGov website.

While we point to evidence of inflexibility, we should acknowledge that there is some evidence of structural flexibility. The MySuper legislation has led to opportunities for providers to launch new products to compete alongside traditional funds. Examples include the “low cost” or “no cost” superannuation products launched in 2013, often making use of low cost indexed investments and/or innovative administration systems.

Member efficiency

From a member perspective, we need to ensure that the system is able to offer an efficient way to save towards retirement security. In many ways, the assessment of an efficient outcome for the individual member is far simpler, and links closely with the objectives of the superannuation and retirement system. Once again though, emphasis must be placed on having sensible, measurable goals against which the progress towards these objectives can be assessed.

Fees paid

A discussion of efficiency from a member perspective must start with the cost to the member. It is critical, however, that member outcomes are not simply assessed on the basis of how low fees are. The fees must be assessed against the benefits that are accruing to the member; most particularly, an explicit calculation of investment returns net of fees. However, the picture will not be complete unless the benefit to the member is calculated on the basis of all benefits, rather than simply the investment benefits. In particular, it will be important to include any incidental insurance cover and any other benefits.

While Rice Warner estimates that costs have increased, by contrast, fees (as a percentage of assets) have decreased between 2011 and 2013. Rice Warner attributes this decrease to:

- lower investment costs, which have resulted from greater investment in indexed assets and larger investment mandates
- a technical decrease due to increased average account balances, reflecting strong returns in investment markets for 2012/13.

The largest changes occurred in retirement savings accounts (decrease of 160 basis points [bps]), small and medium corporate super master trusts (decrease of 52 and 53 bps respectively) and personal superannuation (decrease of 14 bps).

Services received

The services provided by the superannuation industry must be appropriate for what members need. A very low cost cash account may look appealing, but unless it is meeting the retirement needs of members and helping them to overcome longevity and other financial risks, then it is actually not an efficient outcome. The right services must be delivered to Australians throughout both the accumulation and retirement phases.

Simplicity

Simplicity in the system has the major benefit for consumers of reducing complexity and increasing member engagement. Removing regulatory complexity has the added benefit of significantly reducing compliance costs, which increases net benefits to members.

An efficient system will be one which allows the member to engage easily, minimising unnecessary transactions. Limiting the number of superannuation accounts to those which an individual consciously chooses to hold is a key measure of the efficiency of the system from an individual perspective.

However, a simple approach to future planning is also needed. Critically, in accumulation, members must be able to understand what they need to save for their retirement and to be able to monitor their progress towards that goal. In retirement, simplicity becomes paramount. Members must be able to understand their income and budget appropriately and the system must be accessible to those Australians whose mental faculties fade with age.

Outcome gained/end result

The ultimate assessment of efficiency of the system is whether we have enabled Australians to save enough during their productive life to ensure that their retirement income meets a reasonably comfortable standard.

Scorecard

ASFA sees benefit in developing a scorecard to facilitate the assessment of the efficiency of the superannuation system. This process would allow the assessment at a point in time, as well as observing trends in the performance of the system against identifiable targets.

In the following table, we provide an incomplete draft of how this scorecard might look. *Please note that the detail is only for illustrative purposes, rather than a formal proposal of content.*

SUPERANNUATION SYSTEM SCORECARD

	Target	2015
Economic benefits		
Demographic targeting of superannuation policy		
Average projected retirement incomes at age 67 of: • 35-year-old female • 50-year-old male etc	 $50,000 p.a. $44,500 p.a.	 $27,500 p.a. $38,500 p.a.
Economic contribution		
Proportion of superannuation system assets in: • Publicly-owned domestic infrastructure • Bank term deposits • Top 10 ASX shares by capitalisation	 - - -	 $x bn (%) $y bn (%) $z bn (%)
Fiscal sustainability		
Expenditure on Age Pension and tax concessions (as a % of GDP)	6.0%	7.1%
System efficiency		
Operational efficiency (average across APRA-regulated funds)		
Operation cost per member of MySuper products	$12.50 p.a.	$13.45 p.a.
Benchmark cost level (% of fee)	yy%	xx%
Ratio of costs to funds under management	zz%	yy%
Investment costs (average across APRA-regulated funds)		
Average MySuper investment cost per member	$21.50 p.a.	$33.45 p.a.
Average insurance cost per member	$11.20 p.a.	$10.00 p.a.
Ratio of fees to funds under management		
Insurance (average across APRA-regulated funds)		
Average insurance cover per member across system	$300,000	$126,000
Share of total costs derived from insurance costs	4%	5%
Implied social security benefits	$1,234m	$1,234m
Regulation (average across APRA-regulated funds)		
Existing regulation New regulation (current year)	- -	$128m $37.2m
Cost of regulation per fund and per individual member across system		
Structural flexibility		
Average number of superannuation accounts per individual member	1.1	2.18
Member experience		
Fees		
Average fees paid per member: • Active + insurance • Passive + insurance ($1m balance)	 75bps 45bps	 83bps 48bps
Net returns		
Average net return over previous 5 years per member: • Active + insurance • Passive + insurance ($1m balance)	 - -	 7.5% p.a. 6.7% p.a.
Services received		
Average retirement income for current year retirees	-	$19,800 p.a.

Recommendation 8

Capital levels

Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.

ASFA supports prohibiting direct leverage in superannuation. We believe that leverage is, in most cases, inconsistent with the objectives of superannuation and may lead to financial instability.

The strong performance of Australia during the global financial crisis and the role superannuation funds played in stabilising markets was noted in ASFA's first submission to the Inquiry. That role was only possible through the largely unleveraged nature of the superannuation pool and its structurally longer term investment horizon.

We have three concerns with respect to borrowing within the superannuation system:

1. In borrowing to invest in superannuation assets, the consumer is reaping a tax benefit and it is not clear the extent to which this is matched by an equivalent reduction in future social security liabilities for the government.

2. In an unleveraged portfolio, you can experience significant losses but, provided you do not need the money, you are able to ride out the volatility until such time as the markets recover. In a leveraged portfolio, however, this option may disappear as you may be forced to realise some of, or even your entire, portfolio to meet interest repayments and/or margin calls. This risk is highest when:
   - markets are overvalued
   - the portfolio is not well diversified
   - interest rates are low or
   - the credit institution faces capital constraints.

   Using leverage to provide additional returns is a high-risk strategy, which may result in significant losses.

3. It is important that the superannuation system does not allow significant exposure to particular risks that may work against the overall stability of the financial system. If a sudden market adjustment were to occur, in an environment where asset prices are high and interest rates are low, increased leverage in superannuation has the potential to disrupt the economy. An example, relevant today, would be a correction in residential property prices alongside an increase in interest rates.

There can be particular concerns with respect to liquidity that result from superannuation funds leveraging over illiquid assets such as property. Where a fund, most likely an SMSF, has borrowed to acquire a property, where the property is untenanted for a period of time, or rental payments are late or reduced, this can create significant issues with respect to cash flow and servicing the loan. This is exacerbated if the fund is in the drawdown phase and not in receipt of contributions.

As noted in our Interim Report submission, many managed investment schemes, property trusts and similar investment vehicles have some form of leverage embedded into their structure. By way of example, many property vehicles are leveraged, usually around 30 per cent, to provide liquidity across a portfolio of what are 'lumpy' assets. This type of investment is acceptable for superannuation investors, particularly as part of a diversified portfolio.

However, given that the current settings have been in place for some time, it will be important that the transition arrangements to the new regime are well managed. It will likely be most practical that the prohibition on leverage is not retrospective in its application.

Recommendation 9

Objectives of the superannuation system
Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.

ASFA strongly supports the recommendation that broad political agreement is reached on the objectives of the superannuation and retirement system. We propose that the primary objective, as set out in the FSI Report is enshrined in legislation, through Explanatory Memoranda, or preambles to legislation. We also propose that a cross-sectional Superannuation System Review Panel is established to agree more quantitative measures against which success is measured and monitored.

Refer to the earlier discussion in section 2.2 of this submission.

Recommendation 10

Improving efficiency during accumulation
Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.

ASFA supports a comprehensive assessment of the efficiency of the superannuation system. We recommend that this process commences as soon as possible, to allow an appropriate timeframe over which the system and its dynamics may be assessed ahead of any future review.

ASFA recommends that a Superannuation System Review Panel is established to determine appropriate measures of competition and efficiency and on this basis gather relevant data. This approach will allow a current and ongoing assessment of industry efficiency and competitiveness. The industry will be able to use this data to self-assess – and improve – while public policymakers will be informed of the status of competitive forces through timely, relevant and dynamic information.

Refer to the earlier discussion in section 2.4 of this submission.

Recommendation 11

The retirement phase of superannuation
Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.

ASFA fully supports this pragmatic recommendation which should lead to significant improvement in the retirement income system. ASFA suggests that trustees are given the flexibility to offer more than one retirement income product and other government policies, such as taxation settings, are aligned to maximise the probability of success. ASFA also notes the importance of appropriate regulatory oversight by APRA of these products.

Refer to the earlier discussion in section 2.1 of this submission.

Recommendation 12

Choice of fund
Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.

While supporting the principle of choice within the superannuation system, ASFA is cognisant of specific circumstances where providing full choice may result in an impractical or costly outcome. ASFA does not support extending choice of fund to circumstances where employer contributions are made to employees who are members of defined benefit funds. ASFA also notes the complex factors that are at play in a recommendation to provide all employees with the ability to choose their own fund. Portability arrangements, while not a perfect solution, do also provide the functionality for a member to move monies to the fund of their choice.

Around 25 per cent of employees currently do not have choice of fund because they are a member of a defined benefit fund or because they are covered by a collective agreement that does not allow an employee to exercise choice of fund. These exemptions from choice have been in the Commonwealth choice of fund legislation since it was originally introduced in July 2005 by the then Coalition Government.

Defined benefit fund members

ASFA considers that employers should not be required to offer choice of fund to members of defined benefit funds. This reflects what would be the benefit and funding implications of members of such funds having contributions paid to another fund.

An interest in a defined benefit fund is not something that can be turned off and on, particularly when the fund member continues in employment with the employer sponsor of the defined benefit fund. Typically the benefit design is based on salary and years of service. Trust deeds do not make provision for the suspension of membership or finalisation of benefit for employees who continue in employment with the employer.

In addition, a number of major public sector defined benefit funds are not funded or only partially funded on a 'pay as you go' basis. In such funds, there is no opportunity to take a benefit and transfer it to another fund prior to retirement or otherwise becoming entitled to a benefit. Some employers may offer to 'buy out' defined benefit members but this happens relatively infrequently.

If an employee had reached their maximum benefit in a defined benefit fund given the number of years they had been employed, providing such an employee with choice in terms of future contributions would lead to an increase in funding costs for the employer. It would be unfair to require such an employer to make further contributions in regard to such an employee given that the defined benefit being provided will generally involve contributions by the employer considerably in excess of the SG.

Even if were legally possible for a member to cease accruing benefits in a defined benefit fund and instead have employer contributions directed to another fund, issues would arise as to whether individuals would have sufficient information and advice to make an informed decision. Choosing between a defined benefit fund interest and an accumulation interest is not a simple matter. If an employee was allowed to opt out from further accruals to their defined benefit interest there is a real risk that, at a later stage, the member might wish to reverse that decision on the basis there was not full disclosure by the employer or fund about the possible consequences of the decision.

For these reasons related to practicality, equity and cost to employers, ASFA does not support extending choice of fund to employees who are members of defined benefit funds.

Members covered by a collective industrial agreement

The area of industrial relations is complex and, as a matter of principle, ASFA does not advocate on this issue. However, we do make the following observations.

The SG and choice of fund legislation recognise the binding nature of collective industrial agreements on employers and employees. The legislation provides an exemption from choice of fund requirements for employers where collective industrial agreements are in place that deal with the fund to which contributions are to be made. Offering choice of fund is not one of the minimum standards required of collective agreements. Currently, some – but not all – collective industrial agreements specify the fund to which contributions will be made by the employer and in these instances employees do not have choice of fund. This applies to up to 15 per cent of employees.

There are a number of reasons to support the continued exemption of employers with collective industrial agreements in place from providing choice of fund:

- requiring an employer to offer choice would lead to substantial compliance costs in industries where there is a high turnover of employees, such as in the retail and hospitality sectors
- SuperStream arrangements, which facilitate the making of contributions to multiple funds, are not yet fully operational
- insurance rates that have been negotiated in some funds reflect that all employees of a company will be in that fund. Allowing employees choice in such circumstances could compromise automatic acceptance for insurance cover and could lead to higher premiums
- allowing individuals to opt out from a fund specified in an enterprise agreement could lead to the loss of insurance benefits for members, both directly if they leave the specified fund, or indirectly, as the bespoke agreement may become unviable if a significant number of members opt out
- for many employers and unions, specifying the employees superannuation fund is regarded as being within the scope of what can and should be covered by a collective agreement. To require choice of fund to be offered would override what are customary industrial relations practices in these sectors. In these circumstances, the agreement of the fund between the employer and employees is considered to be as much an industrial relations matter as a superannuation matter
- employees who are not able to exercise choice of fund still have portability of their superannuation assets, and are able to transfer on a regular basis all or most of their account balance in the fund specified in the collective agreement to their preferred fund.

As industrial relations practices evolve and as arrangements for making contributions to multiple funds further develop, there may be a case for reviewing at some time in the future whether choice of fund should be offered to employees covered by a collective industrial agreement.

There also may be scope for facilitating the transfer of account balances from a fund that is receiving contributions to another fund chosen by the employee. This might require the development of standing directions to a fund that take effect on a regular basis rather than a new direction being required for each transfer.

Recommendation 13

Governance of superannuation funds

Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.

ASFA supports better governance of superannuation funds. ASFA recommends that at least *one-third* of the board should be independent directors; that trustee boards should be required to appoint an independent chair; and that there should be a general requirement to strengthen conflict of interest requirements. ASFA does not support the alignment of the director penalty regime with managed investment schemes at this stage. Rather, ASFA proposes that this be reviewed more holistically, to provide greater consistency with other fiduciary responsibilities across the financial system.

Proportion of independent directors

ASFA has been an advocate for increasing the number of independent directors on the boards of superannuation funds. Independent directors are able to offer diversity of thought and the benefit of experience which may not be otherwise available. However, there is no single piece of research that can be used to determine the 'right number or proportion' of independent trustees.

There is no doubt that in many circumstances a highly skilled, experienced and informed independent director can add real value to board decision making. However, there is also research that indicates that forcing boards to have independent directors could, if anything, result in less discursive boards and, ultimately, potentially inferior decision-making. (Refer to research by Professor Sally Wheeler, Professor in the Faculty of Law, Queen's University Belfast.)

While there is no conclusive research on the appropriate proportion, ASFA supports the Super System Review (2010) recommendation that at least one-third of the directors on superannuation boards should be independent.

ASFA believes that at a minimum:

(i) a trustee board must have the flexibility to appoint the right people with the right level of experience, skills and knowledge

(ii) a person should not automatically be entitled to a board position based upon their role within a holding company or employer/union sponsor

(iii) there must be the ability to appoint directors who provide diversity and are able to manage the rapidly changing superannuation environment, including an increasing proportion of post retirement members

(iv) trustee board structures should reflect changing community expectations.

The ASX Corporate Governance Principles and Recommendations (ASX Principles) also provide good guidance on trustee board structure.

Currently, the *Superannuation Industry (Supervision) Act 1993* (SIS Act) is specific about the representation around the trustee board table. The SIS Act allows equal representation rules to be met if the trustee board includes one independent director who has no casting vote. APRA can modify the operation of the equal representation rules to allow a trustee board to appoint more than one independent director. However, without such a modification from APRA, trustee boards complying with the equal representation rules cannot, at this time, appoint more than one independent director. In implementing this proposal, the SIS Act should be amended appropriately.

ASFA recommends that careful thought is given to the transition arrangements to any change to the number of independent directors. It will likely make sense to allow directors to serve out their existing terms (which could be up to three or four years). This transition period would give funds time to amend their internal processes and procedures to comply with the new requirements, particularly given the number of funds and potentially limited supply of appropriately qualified candidates. ASFA recommends a *minimum* transition timeframe of three years is necessary if there is a change to the requirement regarding the minimum number/proportion of independent directors, regardless of how any changes are to be affected (that is, by legislation, an APRA Prudential Standard, industry self-regulation or a combination of these).

Independent chair

ASFA supports the requirement for trustee boards to appoint an independent chair. This recommendation is consistent with contemporary governance standards and with requirements of other prudentially regulated entities, including Prudential Standard CPS 510 – Governance. ASFA also recommends that the (independent) chair should in all instances have the ability to vote, but, given the chair generally already exerts significant influence on the board, not necessarily have a casting vote (that is, an *extra* vote to decide an issue). Instead, it should be left up to each board to have procedures in place to deal with deadlocks.

From a good governance perspective, trustee boards should seek to achieve consensus on all decisions wherever possible. Where there is insufficient support for a decision, trustee boards should be encouraged to undertake more work/discussion to resolve the impasse rather than force a 'tie breaker' scenario through an additional vote from the chair.

ASFA's view is that the chair should be a strong leader, independent of the sponsor and appointed interests. The importance of the role played by the chair in ensuring the effectiveness of a trustee board cannot be overstated. The trustee board therefore should consider the characteristics it seeks in a chair and devise suitable procedures for the chair's appointment.

In addition, from a good governance perspective, we believe that the roles of the chair and chief executive officer should not be held by the same individual. Such a requirement, if introduced, should be addressed in the Prudential Standards rather than through legislated requirements, with an appropriate transition period provided.

Definition of independence

ASFA recommends that there is clarity around the definition of 'independence'. Regardless of the number or proportion of independent directors required to serve on trustee boards, it is important to get the definition of independence right. ASFA supports the statement in the FSI Final Report that "[a]n arm's length definition of independence should apply".

ASFA's view is that neither the SIS Act nor the ASX Principles, on their own, adequately reflect the appropriate characteristics of independence that is required in the context of superannuation trustee boards.

The SIS Act definitions of 'independent director' and 'independent trustee' are contained in section 10 of the Act: www.austlii.edu.au/au/legis/cth/consol_act/sia1993473/s10.html

The ASX Principles definition of independence is articulated in 3rd edition of the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations: www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf

While providing a useful reference point for companies about their corporate governance structures and practices, the ASX Principles are not mandatory and do not seek to prescribe the corporate governance practices that a listed entity must adopt. The choice of such practices is fundamentally a matter for the entity's board of directors. Indeed, the third edition of the ASX Principles states that "different entities may legitimately adopt different governance practices, based on a range of factors, including their size, complexity, history and corporate culture". Fundamentally, an individual must be free from any interest in any business or other relationship that could materially interfere, or be perceived to materially interfere (on an objective basis), with the individual's ability to act in the members' best interests.

ASFA is of the view that due to the nature of superannuation trust structures, the compulsory nature of the system, and the fact that trustees are fiduciaries, the definition of independence should be as follows:

> *"An individual should be taken to be 'independent' in the context of a superannuation fund trustee board if he/she:*
>
> 1. *is not, or has not within the last three years been, a director of, a representative of or employed at an executive level by:*
>   - *the fund, the RSE licensee or a related entity of the fund or RSE licensee*
>   - *a standard employer-sponsor or sponsoring organisation of the fund or a related entity of the fund or RSE licensee*

- *any organisation directly representing the interests of one or more members (or groups of members)*
- *any organisation directly representing the interests of one or more standard employer-sponsors of the fund*
- *an associate (as defined in section 10 of the SIS Act) of any such entities listed above or*

2. *as a principal, director or employee of a material service provider, professional adviser or consultant to the fund, the RSE licensee or a related entity to the fund or RSE licensee – has not had significant and material involvement with a service provided to the fund, the RSE licensee or a related entity to the fund or RSE licensee within the last three years*
3. *is not a substantial shareholder of the RSE licensee or an officer of, or otherwise associated directly with, a substantial shareholder of the RSE licensee*
4. *is not an officer or employed at an executive level by a material supplier to the fund, the RSE licensee or a related entity and*
5. *does not have a material contractual relationship with the fund, the RSE licensee or a related entity other than as a director."*

ASFA recommends that the definition of independence should be removed from the SIS Act and instead be included in a Prudential Standard. The structure of the industry and the standards relating to governance are constantly evolving and Prudential Standards are easier to change/update than legislation. In addition, Prudential Standards are more flexible instruments in that, although the requirements in the Prudential Standards are legally binding, there is scope for trustee boards to lodge an application to APRA for an adjustment or exclusion from specific prudential requirements in the Prudential Standards.

Having the definition of independence in a Prudential Standard would allow boards to make an application to APRA for special consideration in particular circumstances – for example, where an individual does not quite satisfy all the requirements in the definition in order to be classified as independent, say as a result of having been associated with standard employer-sponsor or sponsoring organisation two-and-a-half years ago (that is, within the three-year requirement) and special consideration is sought.

Aligning the director penalty regime with managed investment schemes

At this stage, ASFA is not inclined to support the aligning of the director penalty regime for superannuation with managed investment schemes (MISs) through the application of criminal and civil penalties. ASFA considers that the 'best interest test' already requires trustee directors to act in the interests of their members, and we note the already high level of regulatory scrutiny on directors by ASIC and APRA. A better approach would be to reconsider the existing requirements for directors across banking, superannuation and MISs to create greater consistency.

Any future decision regarding whether or not to align the director penalty regime with MISs should consider the fact that the legal and regulatory obligations placed on directors of superannuation funds and directors of MISs are markedly different. While the *Corporations Act 2001* clearly sets out the need for directors of an MIS to protect the interests of investors, the regulatory framework is not as comprehensive as in the equivalent APRA-regulated superannuation trust environment.

Thomson Geer Lawyers, on behalf of ASFA, have undertaken a comparative review of the regulations (statutory and APRA Prudential Standards) that apply to superannuation, banking and the MIS sector. An extract of their report was provided in ASFA's submission in response to the Interim Report, showing the disparity in the regulatory approach across these sectors.

Any decision on whether or not to align the penalty regime with MISs should, in ASFA's view, consider the objectives of superannuation and the duty of care owed by trustee directors to consumers within the superannuation system, and that owed to consumers outside the superannuation framework.

Further, changes to the director penalty regime for superannuation are likely not sensible until the composition of superannuation trustee boards (that is, minimum number/proportion of independent directors) is determined.

Strengthening the conflict of interest requirements

ASFA supports the view that robust management of conflicts of interest is required within superannuation. A trustee board has a fiduciary duty to ensure that the decisions of directors are not compromised or biased by conflict. ASFA's position is that superannuation trustee boards in any part of the system must have the flexibility to appoint the right people, with the right skills, knowledge and experience to deliver the best outcomes for fund members, and without conflicts of interest.

ASFA supports the assertion in the FSI Final Report that "conflict of interest requirements need to be particularly strong for superannuation funds because there is a trustee relationship between the fund and members, and most members are required by law to participate in the superannuation system".

ASFA considers that there is merit in the FSI Final Report's recommendation that each board member must acknowledge when a director adds an interest to the trustee board's register of director interests. That is, each director's interests should be deemed to have been disclosed only when acknowledged by all other directors. In ASFA's view, such a requirement would help to strengthen the conflict of interest requirements by focusing the attention of the board on director interests and promoting a rigorous oversight process.

Other measures that ASFA believes could strengthen the conflict of interest regime include:

i. pre-appointment disclosure of potential conflicts of interest or duty at the time an individual is nominated for appointment or election to the trustee board
ii. ongoing disclosure of potential conflicts of interest and duty in the fund's annual report
iii. a requirement for trustee directors to excuse themselves from all board meeting agenda items, discussions, communications and decisions relating to matters where a conflict of interest or duty exists and
iv. a requirement for trustee boards to consider whether multiple trustee board directorships (where they exist for their fund) is a conflict that can be adequately managed.

With respect to item (iv) above, a not uncommon situation is that one individual is a director on more than one superannuation fund trustee board. There are also situations where a professional trustee company, with the same board (composed of the same directors), acts as the trustee for multiple funds, often including public offer funds that may be competing in the same space. Such situations lead to the potential for conflicts of interest or conflicts of duty to arise.

The key issues to consider with respect to such conflicts of interest or duty are:

- whether an individual who is on the trustee board of more than one APRA-regulated superannuation fund can properly fulfil their fiduciary duties
- does the presence of that individual compromise discussion at board level? For example, whether their presence would impact on the ability or willingness of other board members to discuss issues which may be commercially sensitive or involve proprietary information
- what would fund members think of the presence of that individual? That is, the perception of a conflict, which arguably can be as important as the existence of an actual conflict
- if a trustee director has an association with a service provider that is, or could be, used by the fund, the question in this situation is whether the actual or potential conflict of interest or duty which would arise can adequately be managed.

New covenants in section 52 and 52A of the SIS Act require that trustee boards and directors must give priority to the duties owed to, and interests of, beneficiaries over those of other persons, and must ensure that this duty of priority is met despite any conflict. This obligation takes priority over any conflicting obligations an executive officer or employee of a corporate trustee has under Part 2D.1 of the *Corporations Act 2001* or Division 4 of Part 3 of the *Commonwealth Authorities and Companies Act 1997*.

Arguably, if the tests outlined above are applied in practice, then such conflicts are being managed according to the law and consistent with the APRA Prudential Standard. There is, therefore, an argument that these heightened obligations in relation to the management of conflicts and the duty of priority, which must be satisfied by trustee boards and individual directors, are sufficiently robust to allow trustee boards to fulfil their fiduciary duties, despite the presence of directors who serve on the board of more than one APRA-regulated superannuation fund. That is, the enhanced trustee duties with respect to conflicts management and the duty of priority provide for adequate accountability.

That being said, there is a counter-argument that, despite the heightened obligations that have been imposed on trustee board and directors as a result of these new legislative provisions and the APRA Prudential Standards, the potential conflicts of interest or duty arising from individuals serving on more than one APRA-regulated superannuation trustee board cannot sufficiently be overcome. There may be circumstances where the severity of such conflicts is limited, for example where one of the multiple directorships relates to a closed defined benefit fund or a related fund.

ASFA's view is that, as a minimum, trustee boards should be required (as part of their conflicts management policy) to consider whether the risks and conflicts associated with a director on their board serving on the board of one or more other APRA-regulated superannuation funds can be adequately managed.

Recommendation 14

Collaboration to enable innovation

Establish a permanent public–private sector collaborative committee, the 'Innovation Collaboration', to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.

ASFA does not support this recommendation as it believes that market forces are the best way to foster innovation.

While the objective is noble, and there are some interesting innovation collaboration facilities being developed around the globe (for example in the United Kingdom and United States), ASFA believes that market forces alone will result in greater innovation than if a public-private collaborative committee is involved. As stated in our response to the interim report: "… innovation is controlled by the marketplace, not governments".

This does not discount the potential for the government to play some role in encouraging and enabling innovation. ASFA sees the government's role as providing the framework in which innovation can thrive and promoting a consistency of approach to innovation between sectors. Key to this is the adoption of an overarching policy with respect to the review of existing, and development of new, legislation so as to overcome the existing barriers to innovation.

However, the government should only intervene directly where market failure is evident and public policy warrants intervention.

One recent example is in the superannuation industry where the absence of a standardised method for the payment of contributions and the transfer of the associated data between employers and funds was considered to have adverse economic impacts on employers and members of funds.

To address the market failure, the government launched the SuperStream initiative with its legislated mandated use of electronic commerce by employers and fund trustees.

The implementation of the data standards has had immediate impact:

- the rolling over of superannuation benefits is now completed within three working days
- employers are able to select a single method to deliver their superannuation contributions and the associated data to any superannuation fund
- end-to-end transaction costs are lower, transaction risks are lower and data integrity is improved.

ASFA has identified a number of other areas of superannuation administration that would equally be enhanced through legislated data standards.

While the superannuation sector has demonstrated a capacity to successfully collaborate on the development of new initiatives, implementation is proving more challenging.

In this context, ASFA reiterates its response to the FSI interim report and specifically calls again for government support to enable the development and maintenance of mandated industry standards through a 'statutory self-regulatory approach'. While such an entity should not be considered to be an innovation hub, the superannuation sector, and the financial services sector more broadly, with its large number and vast network of stakeholders (for example, extending to doctors) could benefit from the presence of a government-supported body tasked with addressing system-wide efficiency.

Recommendation 15

Digital identity
Develop a national strategy for a federated-style model of trusted digital identities.

ASFA strongly supports this recommendation.

ASFA has developed a set of *Key Design Principles for Industry-Wide Electronic Commerce Initiatives*. Principle 2 is: An acceptable level of digital authentication between stakeholders should be defined and a process established whereby intermediaries can 'carry' and respect that authentication.

A key challenge to the expansion of electronic transactions is the issue of confidence with the identity of the transactor.

Resolving the identity verification and authentication issues will open up a considerable range of additional electronic transactions. For example, within the superannuation industry there is a range of transactions which may only occur with the authorisation of the member. Typically, these relate to the superannuation fund contacting a third party to seek personal information about the member. The presence of trusted digital identities would facilitate member consent being 'carried' along the transaction chain, significantly reducing the processing time and producing economic benefits across the entire transaction chain.

Recommendation 19

Data access and use
Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.

ASFA supports this recommendation; releasing more datasets would lead to better informed public and private sector decision making.

ASFA notes that the objective of this recommendation is:

- to improve the quality of business and consumer decision making, public policy development and implementation, and research into how the financial system and broader economy function
- to better enable innovative business models that rely on data, where they improve user outcomes and overall system efficiency and
- to increase the utility of public institutions that hold data.

We also note the proposal that the process commence with a Productivity Commission Inquiry into the costs and benefits of increasing access to and use of both public and private data.

The Report notes that, with respect to public sector held data, the Australian Government has released 3,200 datasets, compared with 10,000 datasets in the UK and 200,000 in the United States.

ASFA considers that releasing more datasets would lead to better informed public and private sector decision making. From an ASFA perspective, greater access to ABS superannuation data would assist in policy development in a number of areas. Access to such information has been promised by the Australian Prudential Regulation Authority for a number of years but recent information is that the delivery of an appropriate access mechanism has been indefinitely deferred. ASFA would support a direction by government that the information be made available immediately and by whatever method is reasonably practical.

ASFA notes that while the example on page 103 of the Report shows how access to data can enhance economic outcomes, it does not address what disclosures have been made to, or should be sought from, customers with respect to their private data being made available to a third party.

ASFA considers that the proposed first step of a reference to the Productivity Commission for an inquiry into the subject is the appropriate way to proceed.

Recommendation 21

Strengthen product issuer and distributor accountability
Introduce a targeted and principles-based product design and distribution obligation.

ASFA cautiously supports this recommendation.

ASFA understands that some of the thinking by the FSI panel in relation to this recommendation is that by placing greater accountability on product issuers and distributors, increased levels of product regulation may not be needed. If this recommendation is considered, we urge policymakers and regulators to ensure there are checks and balances in place so that product issuers have certainty about the ambit of their obligations.

We acknowledge that prevention is better than cure but it is vital that regulation does not inhibit innovation nor increase compliance and risk management costs unnecessarily. It should be noted that superannuation trustees already have substantial product design (and oversight) obligations. These are set out in the attachment. Any change to product issuer and distributor accountability would need to take into account current obligations, as well as any product intervention power that ASIC may obtain.

ASFA believes that as we move into the delivery of income stream products and the market is opened up to new offerings, the regulatory framework must consider the balance between issuer liability and product regulation. We urge policymakers not to regulate at both levels of this new market area.

Recommendation 22

Introduce product intervention power
Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.

ASFA supports amending the law to provide ASIC with a proactive product intervention power, while noting that this power should be designed to occur relatively infrequently, when consumers' best interests are clearly at significant risk.

While supporting the recommendation, ASFA emphasises the importance of this power being limited to last-resort scenarios, or used as a pre-emptive measure where there is a real risk of significant consumer detriment. ASFA sees the intention of this power as ensuring that unreasonably opaque, risky, expensive, inappropriate or unnecessary products are not directed to vulnerable consumers.

ASFA suggests that, in these circumstances, the power should be designed to allow the regulator to remove or ban financial products, change marketing documents, add consumer warnings, change labelling or terminology and impose distribution restrictions. Regardless, any product intervention by ASIC should be the subject of consultation prior to imposition and be reviewable after imposition. ASIC would need to be held to a high level of accountability for its use.

Recommendation 23

Facilitate innovative disclosure

Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

ASFA strongly supports this recommendation and welcomes initiatives to improve transparency around financial products and to make communication with consumers simpler and more effective. ASFA advocates that legislative changes should be addressed as a priority to enable greater innovation in this area.

The overarching goal of the recent changes in financial services disclosure requirements has been to promote clear, concise and effective disclosure of information to consumers of financial services.

The financial services industry – and superannuation funds in particular – are very keen to adopt technologies that would facilitate the delivery of financial product disclosures in a more efficient, timely and cost effective way and, importantly, deliver disclosures in a manner that would be more engaging and relevant for consumers of financial services.

The significant barriers to achieving these goals have proven to be legislative constraints, combined with the relatively conservative approach adopted in regulatory guidance material. ASFA is pleased to see that, in its recent Consultation Paper CP224 *Facilitating electronic financial services disclosure*, ASIC is proposing a more facilitative approach in its guidance material on disclosure.

Technology and consumers

ASFA considers that the key to improving the effectiveness of disclosure lies in taking advantage of technologies to engage with consumers in ways in which they are comfortable and which take advantage of the technology's capabilities to deliver relevant and focused information. It is also important that consumers have clear options about how much information they want to access and in what form – for example, tables and graphs rather than words. Making better use of these technologies could play a key role in improving financial literacy.

If technology neutrality and flexibility is built into the regulatory regime, then the financial services industry can focus on giving consumers what they want, when they want it and how they want it.

Consistent with the desire of the financial services industry for better use of technology, we note the 'digital by default' approach adopted by the ATO in its dealing with clients. The success of the *myGov* and *myTax* initiatives (over 3 million taxpayers signed up for *myTax* in the second half of 2014) reflects the willingness of consumers to adopt new technologies. The government's commitment and support for such an approach is reflected in its December 2014 announcement of the single touch payroll initiative which will be rolled out to employers in 2016.

ASFA considers that, while the time is right for adoption of a new technologies and a 'digital by default' approach for financial services disclosures, the initial move to new technologies may be relatively slow and piecemeal as providers identify, and determine how to mitigate, the emerging risks associated with electronic disclosure.

On 28 November 2014, ASIC announced that, as part of its broader work in promoting digitisation and the use of new media in improving the effectiveness of financial disclosures, it will work with AMP and Vanguard to develop and user test a short, online 'key facts' sheet and a self-assessment tool to guide investor understanding. ASFA is strongly supportive of this initiative and in particular the commitment to working with consumers to gauge effectiveness. Consumer testing using robust methodologies is essential to ensure that any change will deliver the expected benefits to both consumers and providers and that there are no unintended consequences.

ASFA commends this initiative and suggests that, once the preliminary results are identified, work should commence on determining how best to support broader implementation.

Improvements to disclosure

Before any meaningful change can occur, a change in ASIC's guidance material on disclosure is required. The current Regulatory Guide RG 221 *Facilitating electronic financial services disclosure* adopts a conservative approach to interpreting the law. We note, and strongly support and endorse ASIC's current consultative process to interpret the law in a manner that will better facilitate electronic disclosure.

ASFA considers that the fundamental challenge in communications is to engage with consumers in a manner that meets their requirements and satisfies their preferences. The communications challenge is greater for financial disclosures due to the desirability of drawing the consumer's attention to information that they may not necessarily seek, but of which they should be aware.

ASFA considers that a key element to improving financial decision making is engaging with consumers in a manner with which they are comfortable and using language and structures with which they are comfortable. Such an approach is not possible when disclosure is constrained by mandated layouts, formats and font sizes.

The FSI Final Report notes that, although the disclosure regime has evolved to reduce complexity over the last decade, consumer behavioural biases and commercial disincentives limit its effectiveness. ASFA anticipates that the interactive nature of the proposed solutions and the ability for the client to be shown and select the areas of disclosure documents that are of interest and relevant will empower consumers and facilitate better decisions.

Anecdotal information and third-party research reveals that many consumers do not read disclosure documents. There are significant benefits to all parties if we can, through whatever means possible, increase the percentage of clients who read and understand such documents.

As an overarching comment, ASFA considers that the development of a more innovative product disclosure statement (PDS) will not occur without clear, concise and effective good practice guidance from ASIC on the use of interactive PDSs. The guidance should reflect the minimum required information and make clear that the provider is not prevented from incorporating additional information.

Technology and older Australians

We note that, in its Final Report, the FSI expressed concern that electronic service delivery may result in older Australians being excluded (see pages 269-270). As a counter to this, it is ASFA's view that a carefully designed, technology neutral disclosure regime could cater for all demographics, facilitating access to printed material for those who desire it while also catering to those demographics that have demonstrated a high take-up rate for electronic communications. Importantly, electronic disclosure would encourage engagement in financial services by those in the younger demographics who prefer to interact electronically, have less knowledge of financial services, and would benefit financially both in the short and long term from better access to financial product information. It is of critical importance that consumers who currently receive paper disclosure are advised – by paper – of their ability to 'opt-out' of electronic disclosure and that return mail is monitored and actioned.

This should act as a sufficient safeguard to ensure that older Australians, in particular, are able to elect to continue to receive paper disclosure.

Benefits of electronic communication

ASFA considers that a significant benefit of electronic communication is an increase in consumers' awareness of their rights. By delivering electronically to consumers material that has been appropriately designed to highlight consumer warnings (for example notice of a 14-day cooling off period), there is an increased likelihood of the consumer becoming aware of their rights.

Delivering disclosure material electronically, through a medium with which the recipient is comfortable, both improves the timeliness of the receipt of the communication and increases the likelihood of any necessary action being taken in a timely manner.

In particular, electronic disclosure can provide additional benefits to consumers who are disadvantaged by location or circumstances as it can provide an easier and more convenient way to ask questions and raise issues.

Electronic disclosure also has the advantage of enabling more timely disclosures and updating of documents due to the reduced distribution timeframes when compared with paper disclosures.

Anecdotal evidence suggests clients find electronic documents easier to read, value being able to search for words and phrases in which they have a particular interest, can more easily reference relevant text in correspondence with others and can file electronic disclosures so the disclosures can be easily and readily retrieved at any time and from wherever the client may be.

Transparency of fees

The challenge remains as to how best to present information on risk and fees, notwithstanding the benefits of electronic disclosure. We must ensure that risk and fee information is not only accessible to consumers in a physical sense but also in a way that consumers can better interpret the information and compare competing product offerings.

With respect to the proposal that the "Industry should develop standards for disclosing risk and fees, and, if significant progress is not made within a short time frame, Government should consider a regulatory approach", the immediate challenge is to achieve a consensus on how fees and costs are to be calculated. In this respect, we note that ASIC is currently conducting consultations on a revised version of Regulatory Guide RG 97 *Disclosing fees and costs in PDSs and periodic statements*.

ASFA considers that effectively achieving innovative financial services disclosures will require a revision of the law such that there is a consistency of terminology and approach.

Consistent legislation

A specific concern is that the current focus of ASIC appears to be the *Corporations Act 2001* and the *National Consumer Credit Protection Act 2009*. However, financial service providers must also give consideration to other legislation that impedes or blocks electronic disclosure, in particular the *Insurance Contracts Act 1984*, *Life Insurance Act 1995* and *Superannuation Industry (Supervision) Act 1993*. As a minimum, the existence of such legislation and the need for providers to consider any impact on how disclosures are made should be recognised in the guidance.

The willingness of providers to innovate based on guidance is inhibited when the guidance fails to recognise and, where appropriate, address issues raised by the presence of competing and conflicting legislation.

Resolution of these limitations on financial electronic transactions and electronic disclosure documents may require an interdepartmental, multi-agency approach, with broad ranging consultation. Ultimately, Parliament may need to enact overarching legislation or amending existing legislation on a consistent basis. This gives weight to the call for a phased implementation of the proposed reforms, as outlined previously and recommended by the Inquiry.

An additional challenge that will need to be addressed is how electronic documents are to be witnessed. This should be considered on a whole-of-government basis as such requirements are spread throughout Commonwealth and State/Territory legislation. But one example of this is regulation 6.17A of the *Superannuation Industry (Supervision) Regulations 1994,* which states that, in order for a binding death nomination to be valid, it must be witnessed by two people.

In an era where consumers expect to be able to lodge forms electronically, there is a need for legislation to consider and accommodate the electronic witnessing of documents.

The legislative framework should, in ASFA's view, be expanded to incorporate e-signature if the intent is to meaningfully facilitate an electronic exchange between providers and customer.

The legislative framework and supporting guidance material also needs to address the issue of a provider's ability to use an email address that has been provided by a third party, such as may happen when an employer enrols an employee in a default MySuper arrangement.

Recommendation 24

Align the interests of financial firms and consumers

Better align the interests of financial firms with those of consumers by raising industry standards,enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.

ASFA supports this recommendation, consistent with its submission to the FSI Interim Report.

Align the interests of financial firms and consumers

In its submission to the FSI Interim Report, ASFA made the point that professionalism in the broader financial planning industry could be further improved through a suite of initiatives. These include: raising the minimum educational and ongoing competency requirements; requiring all financial planners to be members of industry associations with mandatory professional codes of conduct; and the introduction of an enhanced public register of financial advisers. This register would enable consumers to verify that their individual financial adviser is appropriately authorised to provide advice and to find out more information about the financial adviser before receiving financial advice.

Enhance the power to ban individuals from management

ASFA also supports enhancing ASIC's power to include banning individuals from managing a financial services business. ASFA believes that a banning power together with other initiatives to enhance professionalism, in particular the creation of a national register of advisers, will assist ASIC in locating and removing advisers and individuals who do not comply with legal requirements or who do not act in the best interests of clients.

Recommendation 25

Raise the competency of advisers

Raise the competency of financial advice providers and introduce an enhanced register of advisers.

ASFA supports this recommendation, consistent with its submission to the FSI Interim Report. ASFA also supports a national, universal and consolidated register for all financial advisers.

Raise the competency of financial advice providers

In short, ASFA continues to support higher educational standards and other measures designed to safeguard the trust of clients and raise the standards in the financial advice industry. This should include, for all new advisers providing full personal advice on tier-one products, a requirement to be degree qualified (in a finance or business-related discipline) and an appropriate transition time for existing advisers to meet higher qualifications (for example, advanced diploma in financial planning or a degree). ASFA also believes that advisers providing 'retirement advice' should meet specialist requirements that may include: annuity products, longevity risk and aged care financing.

Introduce an enhanced register of advisers

ASFA also supports a national, universal and consolidated register for all financial advisers. ASFA notes that the *Corporations Amendment (Register of Relevant Providers) Regulation 2015* was registered on 16 February 2015. It makes a number of amendments to the *Corporations Regulations 2001* to establish a register of financial advisers. The purpose of the Regulation is to create a register of all natural persons who provide personal advice on more complex products to retail clients under a licence. This would enable consumers to verify that their individual financial adviser is appropriately authorised to provide advice and find out more information about the financial adviser before receiving financial advice. These are all concepts that ASFA supports.

Recommendation 27

Regulator accountability
Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates. Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.

ASFA broadly supports this recommendation, but notes that there are a number of issues that are important to resolve ahead of implementation. These include the proposed funding model, detail of the mandate, resourcing, board composition and how consultation with stakeholders will occur. ASFA also believes that the conflicts, or perceived conflicts, associated with this body sitting within Treasury, will need to be addressed.

Establishment of a Financial Regulator Assessment Board

ASFA agrees with the Committee's observation that the current regulatory arrangements fail to provide the government with a structured and regular mechanism to assess the performance of its financial regulators.

ASFA is generally supportive of the Committee's recommendation that a new Financial Regulator Assessment Board (FRAB) be created to advise government annually on how financial regulators have implemented their mandate. We note, however, that further clarity is required on a number of key issues. These include:

- the proposed funding model for the FRAB
- the details of its mandate
- its resourcing/composition and its consultation with stakeholders
- the sourcing of its secretariat from within the Department of Treasury.

Funding of the FRAB

ASFA is strongly of the view that the establishment and ongoing operation of the FRAB should not result in any increase in the supervisory levies currently paid by entities regulated by APRA and ASIC, or through the creation of any new or 'special' levy. ASFA considers that the FRAB should be funded from existing revenue sources.

Mandate of the FRAB

ASFA agrees with the observation of the FSI Committee that the establishment of a review mechanism to provide government with regular, formal advice on regulators' overall performance has the potential to improve regulator accountability, *if implemented effectively*.

We welcome the Committee's tacit recognition that failure to implement this proposal effectively might result in the FRAB becoming simply another accountability process, adding cost but not value. In that respect, we agree that the FRAB should seek to base its assessments on existing regulator outputs in the first instance, and see merit in the Committee's suggestion that the FRAB could act as the validation body for each regulator's annual self-assessment under the new Regulator Performance Framework.

The FSI Committee has indicated that the FRAB should assess regulators against their statutory mandates "as well as against the priorities identified in Statements of Intent (SOIs)". As SOIs are essentially a static document, prepared at a point in time in response to the government's statement of expectations (SOE), it will be important to ensure that any FRAB assessment also takes into account the regulators' responsiveness to changing priorities within their regulated environment during the review period.

Further, it is essential that the assessments undertaken by the FRAB satisfy best practice requirements of accountability, through clear objectives and measures of success against which performance is monitored. The assessments must include clear analysis of successes and failures, analysis of the way in which complaints have been addressed, timelines and quality of work, communication with the industry, measures of innovation. Specific measures that would be desirable include:

- the percentage of time spent by regulators on different sectors of the industry and the risk assessment supporting this
- the efficiency with which regulators utilise the levies collected from regulated entities
- the quality of surveillance and 'shadow shopping'
- the quality of consumer testing undertaken
- measures of transparency
- meaningful and regular interaction with the industry.

In ASFA's view, it will be important to ensure that, in addition to the legislative instruments necessary to create the FRAB, the specific scope of the assessments to be conducted by the FRAB are formalised in some level of detail and made public, so that it is possible, in future, to assess the FRAB's own performance against its mandate.

We also consider it appropriate that the FRAB's assessment reports should be made public, and that publication should occur in a timely manner.

Resourcing/composition of the FRAB and consultation with stakeholders

ASFA strongly supports the Committee's suggestion that the members of the FRAB should have industry expertise. We consider it appropriate that current employees of regulated entities are ineligible for membership of the FRAB.

ASFA agrees with the Committee's statement that, in order to fulfil its purported mandate, it will be necessary for the FRAB to consult extensively with industry and consumer stakeholders. In ASFA's view, it is critical that regulated bodies and their representatives are provided with an opportunity to participate in any assessments undertaken by the FRAB. We recommend that this process should include the formation of an industry advisory group to maximise the potential for effective consultation.

FRAB to be supported by a secretariat housed within the Department of Treasury

ASFA believes that it should not be necessary for the FRAB to be established as a separate agency.

However, if the FRAB secretariat is to be housed within Treasury, it will be critical to ensure that there is an appropriate level of independence (both formally and operationally) from those Treasury staff with any involvement in decision making as to regulator funding. This is, in ASFA's view, the *minimum* step necessary to ensure that the industry can have a level of confidence in any recommendations the FRAB might make regarding the impact of funding levels on regulators' performance.

To avoid any such conflict, or *perceived* conflict, ASFA recommends that the secretariat supporting the FRAB instead be co-located with another agency, outside Treasury.

Statements of expectation and use of performance indicators

ASFA agrees that there is scope to improve the clarity of SOEs issued to regulators. The current SOEs are very high level in nature and provide little in the way of meaningful guidance to regulators. In this respect, we note that the SOEs most recently issued to APRA, ASIC and the ATO appear to be both shorter and less detailed than the versions issued in 2007.

We agree with the Committee's observation that SOEs should clearly set out how regulators are to interpret their mandates, as well as setting out the strategic direction the government expects regulators to take (including in response to changing circumstances) and a broad outline of the government's tolerance for financial sector risk. ASFA also welcomes the Committee's recommendation that greater priority be given to the use of outcomes-focused performance indicators by regulators.

The current SOEs for APRA, ASIC and the ATO indicate the government intended to provide the regulators with further detail about a whole-of-government risk management framework, and expectations for their performance against specific performance indicators, in the second half of 2014. The latter part of this commitment was delivered through the release of the government's new Regulator Performance Framework in October 2014.

We note that the need to develop performance indicators for regulators has been well recognised for some time. For example, the matter is canvassed in the 2007 SOEs for APRA and ASIC, where the Treasurer recommended that a broader suite of indicators be developed, that they be reported in each regulator's annual report, and that they be accompanied by guidance as to their interpretation, particularly where outcomes may be influenced by factors outside the regulator's control.

In response, APRA noted that: "The development of meaningful performance indicators of the broader impact of prudential supervision is only at an embryonic stage, within APRA and globally." ASIC acknowledged the need for more comprehensive performance indicators, but noted that it would be a challenging task which would take some time to fulfil. As noted in the Committee's report, regulators' annual reports still do not typically include any discussion of performance indicators.

With little obvious progress in almost eight years, it is, in ASFA's view, time that the issue of performance indicators was resolved. We recommend that APRA and ASIC begin or continue their work to align their internal policy and practice with the Regulator Performance Framework in accordance with the transitional timetable set out in the Framework, in time for commencement of the first annual assessment period on 1 July 2015.

The Regulator Performance Framework sets out six key performance indicators (KPIs) for regulators, each with associated 'measures of good regulatory performance' and 'examples of output/activity-based evidence'. In ASFA's view, these KPIs are appropriate to be applied in assessing the performance of APRA and ASIC, and the process should commence without any further delay.

Recommendation 28

Execution of mandate

Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.

ASFA supports this recommendation. It is important that regulators are able to focus on fulfilling their core purpose of ensuring a safe and competitive financial system.

More stable funding for regulators

ASFA welcomes the Committee's recommendation that the regulators should be provided with more stability as to their funding. We agree that the current funding arrangements do not promote regulator independence and accountability, and that this should improve if funding levels are based on periodic funding reviews rather than annual decisions.

In ASFA's view, it is important to ensure that the operational capacity of financial regulators is not subject to the impact of annual budget allocations. Reliance on annual funding gives regulators little ability to forward plan their medium and longer term operations and reduces their ability to respond to changes within their regulated environment in an agile manner.

In particular, unexpected variances in the annual funding level, for example, via imposition of an 'efficiency dividend', may mean that regulators are forced to scale back, defer or completely abandon planned activities.

For example, we note comments from the ASIC Chairman, Greg Medcraft – appearing before the Senate Economics Legislation Committee (Budget Estimates 2014-15) in June 2014 – that ASIC's operating budget was cut by $44 million, or around 12 per cent in the 2014/15 financial year, with a resulting reduction in staffing level of 209 employees. While Mr Medcraft has indicated that ASIC "can still perform its statutory functions", he also conceded that in response to the funding reduction, "our proactive surveillance will substantially reduce across the sectors we regulate and, in some cases, it will stop".

The 2014-15 Budget papers indicated that the government intended to achieve savings of $120.1 million over five years by reducing funding to ASIC, and savings of $142.8 million over three years from 2015-16 by reducing the "departmental resourcing" of the ATO. In each case, these 'savings' are to be "redirected by the government to repair the Budget and fund policy priorities". This, in ASFA's view, clearly demonstrates the extent to which regulators' funding can be impacted by current political priorities.

ASFA considers that adoption of a three-year funding model will provide the regulators with much needed stability and allow them to plan their regulatory activities with more certainty.

In terms of the quantum of regulator funding that is sourced directly from the regulated industries, we note the comment by the FSI Committee that regulatory costs "should be borne by those contributing to the need for regulation". ASFA considers that the fees paid by, and the levies collected from, the superannuation industry are appropriate for the level of regulatory services it receives. As such, we do not consider that there should be any net increase in the level of regulatory charge imposed on the APRA-regulated superannuation industry. We have discussed this further in the context of recommendation 29, which proposes an industry-funding model for ASIC.

Transparency and accountability

As outlined in our response to the Interim Report, ASFA sees the regulators' current lack of autonomy in setting their budget and funding process as limiting their ability to be truly accountable to their regulated industries for the way in which they have applied the funding provided to them.

In submissions on financial industry levies over the last several years, ASFA has consistently highlighted the inherent lack of transparency in the process by which the levies are determined and allocated, particularly in relation to the costs that are sought to be recovered by the superannuation supervisory levy.

While pooled superannuation members currently pay millions of dollars in levies each year to fund the regulatory process, the industry currently has very little awareness of how those levies are allocated between, and utilised by, the relevant agencies: APRA, ASIC, the ATO and the Department of Human Services (DHS).

The breakdown provided to the industry during the annual levy determination process is at the very highest level, simply identifying a total allocated to each agency. No detail is typically provided to indicate how those amounts relate to the various activities conducted by each department.

In fact, the level of information provided to the industry during the levy setting process has in fact been reduced in recent times. For example, the consultation paper released during the levy setting process for 2014-15 failed to include any specific funding allocation for the Superannuation Complaints Tribunal (SCT) – a service of critical importance to APRA-regulated superannuation funds and their members, and one which suffers substantial backlogs due to resource constraints.

This lack of transparency over levies has led to a level of scepticism over whether the superannuation industry is effectively cross-subsidising other participants in the financial services industry, which are not subject to the levy regime.

The issue of transparency was recently acknowledged in a performance audit conducted by the Australian National Audit Office (ANAO) of the determination and collection of financial sector levies by APRA and the Treasury – Australian National Audit Office: The Auditor-General Audit Report No. 9 2013-14 - Performance Audit: Determination and Collection of Financial Industry Levies – Australian Prudential Regulation Authority, Department of the Treasury. It was also acknowledged in Treasury's response to that report. The ANAO report in particular noted that APRA had not, at that time, published a Cost Recovery Impact Statement (CRIS) in relation to its industry levies since 2006-07. The failure to publish a CRIS was in contravention of the Australian Government Cost Recovery Guidelines (July 2005) that applied at the time.

Treasury's response to the ANAO report drew these specific conclusions in relation to transparency of the levies methodology and process:

- there is a need to clarify when the levies are being used to recover costs in a manner consistent with the government's Cost Recovery Guidelines and when they are not
- there should be increased transparency of how the costs of an activity are recovered through the levies process.

APRA ultimately published a Cost Recovery Implementation Statement, in contrast to a CRIS in mid-2014. The level of detail contained in that CRIS was significantly less than industry had anticipated – in fact, ASFA questions whether it can be said to comply with the relevant government guidelines. In ASFA's view, publication of the CRIS did not materially advance the industry's understanding of the cost recovery model adopted by APRA and provides little genuine transparency about how levies are utilised.

For example, we note that the CRIS is a single document covering all supervisory levies collected by APRA from regulated industries, across a number of separate levy-collection regimes, including authorised deposit-taking institutions, authorised non-operating holding companies, life insurance companies, general insurance companies, retirement savings account providers, regulated superannuation entities and providers of First Home Saver Accounts. Financial estimates and financial performance figures are provided only at the highest, aggregate level – they are not broken down between the regulated industries and/or sectors.

Due to the limited information that is made available regarding the utilisation of levies, it is not possible for industry to assess whether the regulators and agencies have delivered value for money. In ASFA's view, this represents a significant shortfall in holding the regulatory process to account.

In our response to recommendation 27, we have indicated ASFA's in=principle support for the creation of the proposed FRAB. In ASFA's view, the FRAB's annual assessment of regulator performance should specifically consider the efficiency with which the regulators have used their levy allocation.

Capacity to pay competitive remuneration and increased operational flexibility

ASFA agrees that remuneration and staffing are matters that should appropriately be determined by the regulators, subject to overall funding considerations. These are not matters which should, in our view, be constrained by public-sector-wide industrial relations policies or the *Public Service Act 1999*.

However, while talent management is a growing problem within the regulatory community, we note that this is due to a range of factors, not simply the level of remuneration currently paid. These include, for example, the need to provide regulatory staff with appropriate opportunities for career advancement and professional development.

Periodic capability reviews

ASFA supports the proposal that the regulators undertake periodic capability reviews, but we consider that the reviews of ASIC and APRA should initially be conducted at three-year rather than six-year intervals.

It is not clear what form the Committee intends the capability reviews to take, or who would conduct them. ASFA considers it important that these reviews are conducted by an external party, and are not a self assessment process.

Organisations that might be suited to performing the review function might include:

- the ANAO, which conducts performance audits of agencies such as the ATO
- the Australian Public Service Commission (APSC), which has previously conducted capability reviews of the ATO and the ABS.
  (We note that the National Commission of Audit recommended that the functions of the APSC be transferred to other departments and agencies, and that the government indicated in response that the role of the APSC would be considered after the 2014-15 Budget. We have not, at this time seen any further indication of the government's intentions regarding the APSC.)

ASFA considers it important that capability reviews include clear action plans to address any identified deficiencies – for example, addressing identified gaps in skills or expertise through:

- the recruitment of suitably qualified and experienced staff, and/or
- the upskilling of existing staff, potentially via secondments into the industry for staff with little or no prior work experience.

Recommendation 29

Strengthening ASIC's funding and powers
Introduce an industry funding model for Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.

While ASFA supports adequate and appropriate funding for ASIC, ASFA does not support the raising of additional levies from the industry. Under current arrangements, there is little transparency over the use of industry funded levies by the various financial regulators. As a first step, we should be looking for greater detail on how industry levies are being used to support those budget items which directly relate to superannuation regulation. In terms of extra tools for regulators, ASFA believes that the current tools, used effectively, can deliver the right outcomes, however we need to assess how the regulators are currently applying them.

Industry funding model for ASIC

There appears to be growing acceptance within Australia - and indeed internationally - that ASIC's funding model warrants review. For example, in its 2012 Country Report (No. 12/314), the International Monetary Fund (IMF) has expressed concern over the "flattening" of ASIC's operating funding and its "not insignificant dependence on non-core funding". The IMF has recommended that the government ensure that ASIC's core funding will be sufficient to meet the future regulatory and supervisory challenges, and that ASIC should aim to allocate more resources to reach sufficient levels of proactive supervision of all types of entities under its supervision.

In principle, ASFA supports adequate and appropriate funding for ASIC, and we support the notion that all regulated industries should contribute to that funding via levies.

However, we note that the superannuation industry already makes a substantial contribution toward the cost of its regulation by ASIC, via the allocation ASIC receives from the supervisory levies collected from APRA-regulated funds. ASIC was budgeted to recover around $28.5 million from these levies in 2014/15.

ASIC has not, in ASFA's view, clearly demonstrated that this allocation is inadequate to fund its regulatory activities in relation to superannuation. Accordingly, ASFA does not support an increase in the quantum of the overall levy burden currently imposed on the super industry.

In our response to recommendation 28, we have raised concerns regarding the lack of transparency and accountability around the process by which levies are determined, allocated between regulatory agencies, and utilised by those agencies. Issues of transparency and accountability are critical in the context of any discussion of an alternate funding model for ASIC.

The current lack of transparency over levies makes it extremely difficult for the industry to objectively assess the level of funding that would be required to allow ASIC to operate effectively. The FSI Committee itself noted that it has not undertaken its own assessment of the adequacy of regulator funding, although it appears to have been persuaded by submissions that "ASIC is not adequately funded to carry out its current consumer protection mandate in relation to the financial services industry, let alone the more proactive role the Inquiry recommends ASIC should adopt in the future".

Similarly, the lack of true accountability in the current process has created a situation where the financial services industry is not confident that ASIC (and indeed the other regulatory agencies) are utilising the funding allocated to them from levies in an efficient manner.

In addition, we note that industry has been provided with very little detail to indicate how ASIC's proposed industry funding model might operate. This adds to the difficulty of assessing the potential merits of any such model.

As at June 2014, ASIC indicated that its proposed 'user pays' funding model would:

> "recover $286.55 million from industry through a combination of:
>
> - fees for service of $37.8 million (13 per cent), where charges are directly linked to the cost of ASIC delivering a particular service (for example, takeover approvals); and

- sector-based levies of $248.7 million (87 per cent) where sector participants pay an annual fee based on a cost-driver metric. A cost-recovery model for each of ASIC's industry sectors has been developed and the impact of cost recovery assessed for those sectors."

ASIC has further indicated that there would be an adjustment of fees paid now by some sectors, with fees tiered to align the cost of ASIC's work with the sectors that drive the cost. However, no detail has been provided to enable the industry to understand the 'cost-driver metrics' ASIC intends to employ in setting its sector-based levies, and the regulated sectors have not had any opportunity to comment on ASIC's cost-recovery model.

We note that ASIC's regulatory activities cover a large and very diverse group of regulated sectors. This means it would be extremely challenging to construct an industry funding model that is equitable *for all sectors*. It also means that full transparency is absolutely critical – without transparency, the perception will always persist that one or more sectors are cross-subsidising regulatory activities undertaken by ASIC in respect of other sectors.

In ASFA's view, there is a need to address the issues of transparency and accountability inherent in the current regulator funding model, before embarking on any changes to that model. Only once confidence has been restored in the current process will it be possible to engage in a debate about potential future funding models for ASIC in an informed and meaningful way.

Stronger regulatory tools for ASIC

In our response to recommendation 22, we have indicated ASFA's support for the introduction of a proactive product intervention power. With that one exception, ASFA does not consider that a compelling case has yet been made for any significant increase in ASIC's regulatory tools and powers.

We acknowledge that ASIC has called for changes to the penalty regime, including in its Report 387: Penalties for Corporate Wrongdoing, and that this has received support from the Senate Economics References Committee.

However, in ASFA's view, ASIC currently has an extensive array of regulatory tools which can be exercised in relation to financial products and financial services. In ASFA's view, *if utilised effectively*, these tools are sufficient to enable ASIC to fulfil its regulatory mandate as it applies in relation to superannuation products.

Indeed, the FSI Committee itself noted in its Final Report that few submissions to the Interim Report had commented on "ASIC enforcement powers or the adequacy of the current penalty regime", and that "[s]tronger enforcement of the *current* framework can reduce demands for new rules and regulations" (our emphasis).

We note that the recent IMF assessment did not identify any specific deficiencies in the regulatory powers and tools available to ASIC, but did find "relative weaknesses" in the supervisory functions carried out with regard to some parts of ASIC's regulated population. In particular, the IMF concluded that an expansion of ASIC's proactive supervision program is necessary – that is, ASIC should expand its use of regulatory tools currently available to it.

Further, as noted in our response to the Interim Report, we do not consider that the efficacy of higher penalties vis-à-vis other forms of disincentive has been sufficiently explored and assessed. While we have no particular concern with increasing the ability of ASIC (or indeed APRA) to penalise individual institutions which are not behaving appropriately, we believe that this needs to be done in the context of the outcome that it will deliver. Specifically, ASFA has the following questions:

- **Is the absence of high penalties clearly linked to the failures in the system?**
  It is not, in ASFA's view, clear that increased penalties would have made any appreciable difference in the Storm Financial or Trio Capital cases.
- **Will customers be adversely impacted by any change to increase penalties?**
  In ASFA's view, it is not appropriate that the end customer ultimately bears the cost of increased penalties levied on the provider.

In ASFA's view, these issues must be addressed before increasing the penalty powers of regulators.

To the extent that there is any consideration of extending ASIC's regulatory powers or reviewing the current penalty regime, the process should commence with a thorough analysis of the likely costs, benefits and impacts. This will necessarily involve a detailed process of consultation with industry.

Recommendation 30

Strengthening the focus on competition in the financial system
Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.

ASFA supports the recommendation that the financial system is subject to periodic review, but recommends extending the time between reviews to five years, rather than three as proposed. ASFA also supports the recommendation to improve reporting of how regulators balance competition against their core objectives, but does not feel that it is appropriate to include competition within ASIC's mandate.

Review the state of competition in the financial sector every three years

The benefit of a Financial System Inquiry is that it provides an opportunity to stop and take stock of the current state of the financial system. However, the 15 to 20-year gap between such inquiries is likely longer than desirable. A more regular review, with a more consistent structure will allow public policymakers to assess the effectiveness of policy changes and be alert to changing trends and emerging risks. However, given the length of time it takes to conduct a thorough review, perform the analysis, publish the results and implement any accepted recommendations, a three-year cycle is too short. ASFA recommends that any review of competition in the financial sector should be performed at a minimum of five years.

In the superannuation sector, there have been wide-ranging and complex reforms over the past few years, including the Stronger Super reforms, incorporating MySuper, Prudential Standards and SuperStream. Time needs to be given to ascertain the effectiveness of these reforms and any effect on competition. ASFA recommends that any review of competition should be combined with the review of efficiency by 2020, as discussed earlier in this submission.

Improve reporting of how regulators balance competition against their core objectives

ASFA supports the recommendation to improve reporting of how regulators balance competition against their core objectives. This represents an important safeguard against excessive regulation and may assist in ensuring that the any prudential and consumer protections outcomes are balanced against the direct and indirect costs of regulation, including effects on competition.

Compelling the regulators, when designing and administering regulatory obligations and requirements, to disclose the extent to which they have considered trade-offs between regulatory objectives and competition would provide transparency and accountability to the regulatory process. This should include a consideration of barriers to entry and exit. Improving reporting on such matters will lead regulators to adopt a more holistic approach to industry issues as they perform their core responsibilities.

By way of an overseas example, the Financial Conduct Authority (FCA) in the UK is required to report annually on competition initiatives and have specific regard to competition considerations in undertaking both regulatory and enforcement actions.

Include consideration of competition in ASIC's mandate

ASFA's view is that ASIC should remain focused on performing its responsibilities as a conduct regulator, although, as per above, in performing that mandate, it should have regard to the effects of regulation on competition.

Most regulatory bodies that are similar to ASIC do not have a competition mandate (with a notable exemption being the FCA in the UK). Neither the Securities Exchange Commission (SEC) or Financial Industry Regulation Authority in the US have a specific competition mandate (the SEC's Office of Credit Ratings does have a mandate in respect of efficiency of the market but the focus is on solely on banking/credit institutions). Competition and consumer issues in the US are dealt with by the Federal Trading Commission, which is similar to the Australian Competition and Consumer Commission (ACCC).

The FCA, in April 2015, will be given new enforcement tools to tackle competition failures; however, it is important to note that these will be exercised concurrently with the Competition and Markets Authority.

Recommendation 31

Compliance costs and policy processes
Increase the time available for industry to implement complex regulatory change. Conduct post-implementation reviews of major regulatory changes more frequently.

ASFA strongly supports this recommendation. Recent experience has been less than desirable, and it is critical to trust in the superannuation and retirement system, that a more effective approach to regulatory change is found. Learning from past experience, both positive and negative is important, and ASFA supports the use of post-implementation reviews.

Increased time for implementation of complex regulatory change

ASFA welcomes and strongly endorses the Committee's recommendation that (except in exceptional circumstances) the industry be provided with longer implementation periods and also transitional periods for regulatory change. In particular, we agree with the Committee's recommendations that implementation periods should commence *from the time the regulatory changes are finalised*. Through our response to the Treasury Discussion Paper – better regulation & governance, enhanced transparency & improved competition, we have previously highlighted our concerns regarding the manifestly inadequate timeframes allowed for the implementation of many recent regulatory reforms, and the significant practical and cost implications that militate against providers commencing implementation of regulatory requirements prior to their finalisation.

However, while the Committee has recommended 'standard' implementation periods of at least six months, ASFA is of the view that longer should be provided for regulatory changes that are likely to involve significant implementation and compliance effort, and resultant cost, for stakeholders. ASFA considers that appropriate implementation times for significant regulatory change would be as follows:

- Regulation that affects the design of the superannuation system – no shorter than 24 months lead time, with a longer period for very substantial reform. For example, in our response to recommendation 13, we have outlined the need for a minimum three-year transition period for trustees to achieve full compliance with any mandated requirements regarding independent directors.
- Regulation which changes the disclosure framework: no shorter than 12 months' lead time.
- Regulation which requires stakeholders to change systems, processes and procedures: no shorter than 12 months' lead time.

Each of the above minimum timeframes should not commence to run until all relevant regulatory material has been finalised. We note that relevant regulatory material might include, for superannuation-related reform, primary legislation, delegated legislation (such as regulations, APRA Prudential Standards, APRA reporting standards and ATO data and payment standards) and guidance material (such as ASIC regulatory guides and APRA prudential practice guides).

In determining an appropriate lead time for the implementation of new regulatory obligations, it is necessary for lawmakers to recognise that implementation efforts cannot commence until a degree of regulatory certainty has been achieved. ASFA has observed numerous occasions where a manifestly insufficient period of time was allowed between the passage of legislation, or the release of regulatory material, and its commencement date.

While minor refinements to existing regulation can often be implemented with relatively little disruption to a fund trustee's operations, it needs to be acknowledged that the implementation of major regulatory change is not a 'business as usual' activity; it is an expensive undertaking, in terms of financial cost and the utilisation of resources. The ability of stakeholders to manage this cost is heavily impacted by the time allowed for implementation.

ASFA welcomes the Committee's recognition that additional transitional periods of 12-24 months will generally be appropriate to assist industry participants implement regulatory change. We also see merit in the suggestion that grouping the commencement of regulatory changes at fixed dates during the year would help participants to streamline their implementation effort.

Need for additional improvements to the consultation phase of the regulatory change process

We note that the Committee's recommendations focus on the implementation phase of the regulatory change process, and do not address the opportunities for improvement that arise at earlier phases of the process.

In particular, we note that the quality of the outcome produced from a regulatory change process often depends heavily on the adequacy of the consultation undertaken. Regrettably, in recent years, severely curtailed consultation periods have become commonplace for many key regulatory reforms in the financial sector – and the superannuation industry in particular – with many consultations failing to meet the government's own best practice guidelines.

In ASFA's view, ensuring that appropriate time and diligence is devoted to the consultation phase will – when teamed with the improvements to the implementation phase noted above – appreciably improve the outcome of regulatory change.

Post-implementation reviews

ASFA also strongly supports the recommendation that the government and regulators conduct more post-implementation reviews of major regulatory changes, to analyse their cost-effectiveness and to help develop better processes for future interventions.

Recently issued guidance from the Office of Best Practice Regulation (OBPR) generally recommends that Australian Government agencies undertake a Post-implementation Review (PIR) for new regulation in cases where either:

- The regulatory proposal was "noted as having a major economic impact by OBPR at the Preliminary Assessment stage of the regulation impact assessment process".
- An adequate RIS was not prepared for the final stage of the regulatory change, the change has affected businesses, community organisations or individuals, and the change was neither minor nor machinery in nature.

We note that while the above criteria are contained in a 'guidance note', the OBPR appears to take the view that the above criteria are mandatory in nature.

It is not clear, from any publicly available information, how the OBPR assesses whether a regulatory proposal has a 'major economic impact'. This makes it extremely difficult to assess whether the PIR process will, under the new guidelines, be applied in all situations where it is warranted. ASFA considers that the PIR process was not conducted frequently enough under the previous version of the guidelines.

The 'major economic impact' test would appear, in ASFA's view, to set a very high benchmark for determining when a PIR will be conducted. We note that many regulatory changes that are likely to have a significant (or major) impact on an industry or on a sector within that industry might nonetheless not be held to have a major impact on the economy overall.

In ASFA's view, the PIR process should be conducted for *all* new regulation that will have a material impact on the industry to which it applies.

Implementation of major regulatory change involves a significant investment of money and resources and, therefore, impacts on member's retirement incomes, as well as the products and services that trustees can provide. It is not unreasonable for trustees and members to expect that Government will, when setting requirements which impact on members' benefits in this way, bear a level of accountability with regard to the outcome.

ASFA has observed many instances where the manner in which regulatory change has been conducted has resulted in requirements that are 'over-engineered' and have imposed excessive cost and compliance burden without a commensurate improvement in members' benefits. The recent expansion of the APRA data collection standards for superannuation funds is a clear example of this.

Further, if a PIR is undertaken for all material regulation, the outcomes can be used to test the accuracy and completeness of the RIS, since the RIS was necessarily prepared on the basis of anticipated impacts. The PIR outcomes can also be used to inform and improve future consultations and implementation processes. The outcomes should be considered by responsible agencies whenever the regulatory settings in relevant areas are considered in future. A PIR conducted for one regulation should feed into the preparation of the RIS for any subsequent regulation on the same or related matters, so it forms part of a process of continuous improvement.

Recommendation 32

Impact investment

Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery. Provide guidance to superannuation trustees on the appropriateness of impact investment. Support law reform to classify a private ancillary fund as a 'sophisticated' or 'professional' investor, where the founder of the fund meets those definitions.

ASFA notes the structural constraints to the development of an impact investment market and the active participation of superannuation funds in these investments as and when they are identified as being in the best interests of members.

The development of an impact investment market

The most effective way to facilitate the development of an impact investment market would be for governments in Australia to introduce funding models for the provision of social and like services that involve payment for outcomes that are achieved. This would provide service providers with an income stream that could be used to support the financial obligations associated with social impact bonds or like financial instruments. Unless, and until, such income streams exist in Australia there will be little or no scope for superannuation funds to make what have been described as impact investments.

To date the main examples of impact investing facilitated by Australian governments have been in New South Wales.

On 4 February 2015, the NSW Government released its Social Impact Investment Policy. The Policy builds on the NSW Government's experience with social benefit bonds.

The Policy sets out how the Government intends to grow a social impact investment market in NSW. It includes 10 actions to:

- deliver more social impact investment transactions
- remove barriers to and promote social impact investment
- build the capacity of market participants.

The following priority areas were identified:

- managing chronic health conditions
- supporting offenders on parole to reduce their levels of re-offending
- managing mental health hospitalisations
- preventing or reducing homelessness among young people.

Whether or not such investment opportunities are suitable for a superannuation fund or funds depends on the nature of the bond or financing instrument on offer.

One consideration for fund trustees will be the risk profile attached to the bond or like instrument. Some such bonds offer high face value interest rates if specified outcomes are achieved but also the possibility of a capital loss if a specified outcome is not achieved. Assessing the likelihood of various outcomes can be challenging, particularly when a new organisation or funding activity is involved.

There also is the issue of liquidity. To date, there has been no real secondary market in regard to the impact bonds that have been issued. For funds that need to maintain a high degree of liquidity to deal with the inflow and outflow of account balances with associated daily unit pricing, impact investing may not be a particularly suitable class of investments.

Is more guidance needed for superannuation trustees?

The sole purpose test requires that the sole purpose of superannuation is to provide retirement income to members, while fund trustees are under a fiduciary duty to consider only the interests of fund members when exercising their trust powers, including investment. ASFA considers that this is well understood by fund trustees and that little, if any, additional guidance to trustees is needed. While the delivery of ancillary social benefits does not rule out superannuation funds making an investment, the existence of such social benefits should not be a reason for a fund accepting a lower return than for another investment with a comparable risk profile. Superannuation funds are not charities and the obligations applying to superannuation fund trustees do and should differ to the obligations that should apply to a trustee of a charitable trust.

Superannuation funds have invested, and will continue to invest, in a number of areas where investments will deliver positive social outcomes along with financial returns for superannuation funds. However, clearly the primary aim of superannuation funds is to deliver retirement savings for fund members. This cannot be compromised by the pursuit of investment proposals that compromise the desired investment return and risk profile of superannuation fund investment options.

The legal doubts that were canvassed in some submissions to the Financial System Inquiry appear to relate to the considerations that a trustee of a charitable trust can take into account when making an investment. If there are any such legal doubts, they are not relevant to the fiduciary responsibilities of superannuation fund trustees.

Should a private ancillary fund be classified as a sophisticated or professional investor?

ASFA does not have a view on whether a private ancillary fund should be regarded as a 'sophisticated investor' for the purposes of the *Corporations Act.* In all instances, APRA-regulated funds will meet the test of sophisticated investor and ASIC has already provided guidance to SMSF trustees on the operation of the sophisticated investor test.

Recommendation 37

Superannuation member engagement
Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance. Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.

ASFA strongly supports this recommendation. We have been an advocate for the mandatory inclusion of retirement income projections on member statements. However, ASFA recommends that trustees be given flexibility to determine which cohort of members should receive these projections.

To complement this initiative and further encourage member engagement, ASFA recommends that the ATO be tasked with providing a summary of the balances of members' superannuation accounts with their annual taxation assessment notice.

Superannuation member engagement

ASFA's support for the inclusion of retirement income projections on member statements has been well documented. ASFA first called for such projections in its response to the Henry Tax Review in 2009 and has subsequently repeated its position in numerous responses to ASIC on various forms of guidance that ASIC has issued and in *The future of Australia's super: a new framework for a better system* in November 2014.

Currently, the requirement to publish income projections with member statements is not compulsory, although a number superannuation funds choose to do so using the current guidelines published by ASIC in Regulatory Guide (RG) 229 *Superannuation Forecasts* and ASIC class orders CO 11/1227 *Relief for providers of retirement estimates* and CO 05/1122 *Relief for providers of generic calculators.*

ASFA supports the recommendation to make the provision of retirement projections compulsory.

ASFA recommends that the first step should be to allow trustees the flexibility to provide income projections to the cohort of members for which these projections might be most useful. The basis for selection could be account balance and/or member age. This would be a stepping stone to other, important, member engagement initiatives.

ASFA believes that trustees are best placed to know what cohort of members would be best served by projections in this first stage. These retirement income projections could be benchmarked against the ASFA Retirement Standard (which benchmarks the annual budget needed by Australians to fund either a comfortable or modest standard of living in the post-work years).

This first stage would then be followed by mandatory income projections for all members.

Additional member engagement options

This recommendation from the FSI Committee is all about better engaging members with their superannuation. As we have noted elsewhere in this submission, public policy is rarely effective if only one strategy is put in place; the most effective change will occur when problems are tackled consistently from a variety of angles.

To work with this member engagement initiative, ASFA recommends that better use is made of the amalgamated superannuation data that is reported annually to the ATO. While the myGov data is an excellent initiative and accessed by many Australians, the vast bulk of superannuation members are not accessing their superannuation data in this way. ASFA believes that providing individual Australians with a summary of their superannuation balances, through a mechanism that they are known to engage with, is a powerful tool to encourage better engagement.

ASFA recommends that in the interests of efficiency, consistency and privacy, and as the ATO holds the information, the ATO should be tasked with:

- consolidating, on an individual taxpayer basis, information from annual member contribution statements and
- using the information to prepare an amalgamated superannuation balance statement for inclusion with the notice of assessment of each taxpayer following the lodgement of their income tax return.

By placing the amalgamated data of each individual's superannuation account balances on their notices of assessment, ASFA believes that an effective mechanism is created to encourage individuals to consider consolidation of their superannuation accounts.

ASFA also considers that further work should be done on whether the level of insurance cover held by members could be collected and provided by the ATO.

Recommendation 38

Cyber security

Update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation, and progress public-private sector and cross-industry collaboration. Establish a formal framework for cyber security information sharing and response to cyber threats.

ASFA is strongly supportive of this recommendation.

ASFA considers that the most effective responses to arising cyber security threats come from collaborative responses. We consider that the combining of private sector intelligence on vulnerabilities government-held information, combined with policy and regulatory frameworks that support effective and timely public-private sector information sharing, is the best approach to addressing cyber security issues.

ASFA notes the apparent effectiveness of the banking sector at communicating with each other when threats materialise and addressing those threats.

In other parts of the financial system where the players are more diverse and fragmented, the exchange of information does not happen in an efficient or an effective manner.

ASFA considers that the financial system as a whole would benefit from the development of formal information sharing mechanisms.

Recommendation 39

Technology neutrality

Identify, in consultation with the financial sector, and amend priority areas of regulation to be technology neutral. Embed consideration of the principle of technology neutrality into development processes for future regulation. Ensure regulation allows individuals to select alternative methods to access services to maintain fair treatment for all consumer segments.

ASFA is strongly supportive of this recommendation.

In ASFA's response to the FSI Interim Report we stated:

> "ASFA considers that for B2B and B2C transactions, principles-based standards should be the default. However, if policy suggests that technology-specific regulation is required, such a proposition should be subject to wide community consultation prior to a final determination being made and the reasoning for the final decision should be published."

That position is still supported.

However, ASFA is mindful that in supporting technology neutrality, consideration does needs to be given to the needs of all consumers.

The principles of technology neutrality underpin ASFA's response to the ASIC Consultation Paper 224: *Facilitating electronic financial services disclosures*.

ASFA considers that, in addition to providing better access to services and improving efficiencies, better use of technologies can improve the effectiveness of disclosure by engaging with consumers in ways in which they are comfortable and by taking advantage of the technology's capabilities to deliver relevant and focused information. A potential outcome from these new approaches is improved levels of financial literacy.

ASFA considers that it is also important that consumers have clear options about how much information they want to access and in what form, for example, tables and graphs rather than words. Making better use of these technologies could play a key role in improving financial literacy.

If technology neutrality and flexibility are built into the regulatory regime, then the financial services industry can focus on giving consumers what they want, when they want it and how they want it.

Consistent with the desire of the financial services industry for better use of technology, we note the 'digital by default' approach adopted by the ATO in its dealing with clients. The success of the myGov and myTax initiatives (over three million taxpayers signed up for myTax in the second half of 2014) reflects the desire of consumers to adopt new technologies and their comfort with them. The government's commitment and support for such an approach is reflected in its December 2014 announcement of the single touch payroll initiative, which will be rolled out to employers in 2016.

ASFA considers that, while the time is right for adoption of a new technologies and a 'digital by default' approach for financial services disclosures, the initial move to new technologies may be relatively slow and piecemeal as providers identify, and determine how to mitigate, the emerging risks associated with electronic disclosure.

However, in moving to a technology neutral approach, care must be taken to ensure that consumers are not forced down a non-preferred communications path. This is particularly important in a society with a compulsory superannuation system where holding a bank account is essential.

Where use of a service cannot be avoided, the relevant legislation, while permitting technology neutrality, must not exclude the right of a consumer to choose the method by which they receive disclosures (for example, the capacity to opt out of electronic receipt of disclosure documents).

Recommendation 43

Legacy products

Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.

ASFA strongly supports the introduction of a mechanism to facilitate the rationalisation of legacy products. This should occur across the financial services sector, and not be limited to the rationalisation of life insurance and managed investment products.

Efficiency, costs and services

Legacy products add significantly to the costs of running financial services businesses such as superannuation businesses. In this environment where the superannuation industry is under increasing scrutiny and expectation with respect to reducing costs, increasing efficiency and improving competition, the ability to rationalise legacy products is a critical component. Importantly, from a consumer perspective, the rationalisation of legacy products can also lead to improved service standards and enhanced/new features with the new product, for example, online transactions.

The issues associated with legacy products are complex. Maintaining legacy products, and supporting the systems upon which they are administered, is inefficient and expensive.

As every business model is different, the issues with respect to legacy products are not easy to solve and the resourcing to do so and implement rationalisation can prove significant.

Successor funds transfers and the 'equivalent rights' test

While the concept of successor fund transfers (SFT) within superannuation represents a material improvement to the position in other industries, such as insurance and managed investments, feedback from trustees indicates that the statutory 'equivalent rights' test can be a little difficult to apply and meet in practice.

One possible improvement may be to introduce an element of materiality into the test, with a suitable benchmark as to what 'material' may means in different contexts.

The Final Report of the Super System Review stated that:

> *"A number of submissions maintained that the 'successor fund transfer' mechanism … is not sufficient in respect of many superannuation legacy products. This is because a transfer can only occur if the trustees of both … funds agree that 'equivalent rights' are provided to the transferring members in the receiving fund … most trustees will not agree that there are 'equivalent rights' unless the transferring fund's governing rules are replicated in the receiving fund's governing rules".*

The Committee then went on to find that:

> *"Consequently, successor fund transfers result in product complexities and other undesirable features being perpetuated … Even where successor fund transfers can be achieved, this is often by subsuming the complex terms of a corporate fund into a new sub plan within a master trust, meaning that the administrative benefits of increased scale cannot be achieved.*

In the Committee's view:

> *"in order to deal satisfactorily with legacy products in superannuation, there needs to be a mechanism available … in addition to the successor fund transfer as such transfers cannot always address legacy product issues where 'equivalence' cannot be achieved.*
>
> *"This change could also be of use for trustees who may decide that their MySuper product does not have sufficient scale but cannot achieve 'equivalence' in order for a successor fund transfer to occur".*

The Committee recommended that:

> *"the SIS Act requirement of 'equivalence' with respect to successor fund transfers could be changed to a test of 'no overall disadvantage' without adversely affecting the legal protections afforded to transferring members. Generally, 'no overall disadvantage' would mean that, on balance, the total package of rights and entitlements that the member has in the existing fund must not be diminished in the new fund. This change would also mean that the test for rationalisation of superannuation products is in accord with the test recommended in the 'Product Rationalisation of Managed Investment Schemes and Life Insurance Products' Proposals Paper".*

ASFA agrees that consideration needs to be given to amending the 'equivalent rights' test to introduce an element of materiality and to enable the assessment to be made with respect to the membership as a whole. This could possibly be framed along the lines of a 'no overall disadvantage' test, as suggested in the in the Super System review. Any such, the test would need to be applied taking a holistic view across the membership, and potentially across different classes of members, but should not necessitate an assessment at the individual member level. It would also prove beneficial if any revised test for the rationalisation of legacy products could also be applied for intra-fund rationalisation.

Transition costs, including data migration and asset transition costs, can be material and can affect the withdrawal benefits, which in turn can prove a hurdle to a SFT taking place. Any SFT test could incorporate an appropriate treatment of transition costs, possibly by means of an assessment of the materiality of the effect.

A future complication may be posed when a fund that has a MySuper with a balanced investment portfolio is contemplating a SFT with a fund that has a lifecycle investment option.

Any revision to the SFT test needs to allow trustees to adopt a pragmatic approach to balancing the protection of member outcomes to minimise the grandfathering of benefit categories in transfer, which perpetuates the complexity and cost of supporting legacy product designs.

Group insurance, and to a lesser extent managed investment schemes, will always be a potential problem for SFTs in superannuation. This is an area which necessitates some improvements and ASFA supports the introduction of a mechanism to facilitate the rationalisation of legacy products in these industries.

Taxation

Taxation consequences – in particular the treatment of capital gains and losses – can also act as a material barrier to SFTs taking place. Members can be materially detrimentally affected by the tax treatment, to such an extent that the SFT does not take place.

Capital gains tax

The triggering of capital gains tax (CGT) events, such as the realisation of otherwise unrealised gains and the inability to carry forward losses, can prevent a trustee from entering into a successor fund transfer arrangement.

The absence of CGT rollover relief creates a significant barrier to fund mergers.

In determining whether to merge with another fund, a trustee of a superannuation fund is under a trust law duty to act in the best interests of the members of the fund. As such, the threshold decision as to whether or not to merge, as well as the specific decisions as to the other fund with which to merge and the timing of the merger, are all made taking into consideration the various benefits and costs to members of the potential merger.

The impact of the CGT tax can represent a significant consideration when determining the costs of a proposed merger and may well be a determining factor as to whether or not a merger proceeds.

Depending on the volatility of the market, after a downturn, a fund can carry deferred tax assets of an amount equivalent to 1.5 per cent or more of member account balances , the benefit of which would be lost if a merger were to go ahead without CGT relief. For a member with an average account balance of approximately $70,000, this could represent a reduction in the value of their superannuation account of over $1,000. In such circumstances, the absence of CGT rollover relief may cause the costs to members, through the extinguishment of deferred tax assets, to outweigh the benefits of any proposed merger.

It is important to note in this context that there is a distinction between circumstances where:

- both the legal and beneficial ownership of an assets changes (which can be considered to be a "true" CGT event); and
- only the legal ownership is transferred to another, leaving the beneficial ownership unchanged (which can be considered to be a "notional" CGT event).

An SFT can be considered to fall into the second category, as the members of the fund retain the beneficial interest.

From the outset, the CGT tax has allowed rollover relief in circumstances where asset ownership changes were associated with specified types of business reorganisations, where no change occurred in the underlying ownership of the asset concerned or where the underlying assets against which the taxpayers had a claim did not change. This is commonly known as the business reorganisation rule.

Permitting the rollover of CGT gains/losses on SFTs – where only the legal, and not the beneficial, ownership of the assets has changed – is entirely consistent with the business reorganisation rule. Arguably, the only reason that this did not occur at the time the CGT legislation came into existence in 1985 was the fact that superannuation was in its infancy and was not considered.

Other tax issues

There is a similar issue with respect to the loss of imputation credits due to the deemed disposal of assets and the potential reduction in the 'tax-free components' of some member accounts. These can act as barriers to a SFT being agreed.

There may need to be further examination of the loss transfer rules, especially the look -through aspects; there are many losses captured in PSTs held by super funds. If there is a holding in an underlying fund that has deferred tax liabilities, there should be an ability to take that proportionate amount up into the super fund and transfer it across to the successor fund.

While it is noted that this is a state-based issue, stamp duty incurred when transferring insurance arrangements can also act as an impediment.

SIS Act covenants relating to product design

Reference:
Recommendation 21

ASFA cautiously supports this recommendation.

Under section 52 of the SIS Act trustees are required:

(Sub-section (2) General Covenants)

(a) to act honestly in all matters concerning the entity;

(b) to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity of which it is trustee and on behalf of the beneficiaries of which it makes investments;

(c) to perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries;

(d) where there is a conflict between the duties of the trustee to the beneficiaries, or the interests of the beneficiaries, and the duties of the trustee to any other person or the interests of the trustee or an associate of the trustee:

(i) to give priority to the duties to and interests of the beneficiaries over the duties to and interests of other persons; and

(ii) to ensure that the duties to the beneficiaries are met despite the conflict; and

(iii) to ensure that the interests of the beneficiaries are not adversely affected by the conflict; and

(iv) to comply with the APRA Prudential Standards in relation to conflicts;

(e) to act fairly in dealing with classes of beneficiaries within the entity;

(f) to act fairly in dealing with beneficiaries within a class;

(g) to keep the money and other assets of the entity separate from any money and assets, respectively:

(i) that are held by the trustee personally; or

(ii) that are money or assets, as the case may be, of a standard employer-sponsor, or an associate of a standard employer-sponsor, of the entity;

(h) not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the trustee's functions and powers;

(i) if there are any reserves of the entity—to formulate, review regularly and give effect to a strategy for their prudential management, consistent with the entity's investment strategies and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due;

(j) to allow a beneficiary of the entity access to any prescribed information or any prescribed documents.

(Sub-section (6) Investment covenants)

(a) to formulate, review regularly and give effect to an investment strategy for the whole of the entity, and for each investment option offered by the trustee in the entity, having regard to:

(i) the risk involved in making, holding and realising, and the likely return from, the investments covered by the strategy, having regard to the trustee's objectives in relation to the strategy and to the expected cash flow requirements in relation to the entity; and

(ii) the composition of the investments covered by the strategy, including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification; and

(iii) the liquidity of the investments covered by the strategy, having regard to the expected cash flow requirements in relation to the entity; and

(iv) whether reliable valuation information is available in relation to the investments covered by the strategy; and

(v) the ability of the entity to discharge its existing and prospective liabilities; and

(vi) the expected tax consequences for the entity in relation to the investments covered by the strategy; and

(vii) the costs that might be incurred by the entity in relation to the investments covered by the strategy; and

(viii) any other relevant matters;

(b) to exercise due diligence in developing, offering and reviewing regularly each investment option;

(c) to ensure the investment options offered to each beneficiary allow adequate diversification.

(Sub-section (7) Insurance covenants)

(a) to formulate, review regularly and give effect to an insurance strategy for the benefit of beneficiaries of the entity that includes provisions addressing each of the following matters:

(i) the kinds of insurance that are to be offered to, or acquired for the benefit of, beneficiaries;

(ii) the level, or levels, of insurance cover to be offered to, or acquired for the benefit of, beneficiaries;

(iii) the basis for the decision to offer or acquire insurance of those kinds, with cover at that level or levels, having regard to the demographic composition of the beneficiaries of the entity;

(iv) the method by which the insurer is, or the insurers are, to be determined;

(b) to consider the cost to all beneficiaries of offering or acquiring insurance of a particular kind, or at a particular level;

(c) to only offer or acquire insurance of a particular kind, or at a particular level, if the cost of the insurance does not inappropriately erode the retirement income of beneficiaries;

(d) to do everything that is reasonable to pursue an insurance claim for the benefit of a beneficiary, if the claim has a reasonable prospect of success.

(Sub-section (8) Covenants relating to risk)

(a) to formulate, review regularly and give effect to a risk management strategy that relates to:

(i) the activities, or proposed activities, of the trustee, to the extent that they are relevant to the exercise of the trustee's powers, or the performance of the trustee's duties and functions, as trustee of the entity; and

(ii) the risks that arise in operating the entity;

(b) to maintain and manage in accordance with the Prudential Standards financial resources (whether capital of the trustee, a reserve of the entity or both) to cover the operational risk that relates to the entity.

Summary of the Prudential Standards that impact product design

Under Prudential Standard SPS 530 *Investment Governance,* trustees of regulated funds must:

- formulate specific and measurable investment objectives for each investment option, including return and risk objectives
- develop and implement an effective due diligence process for the selection of investments
- determine appropriate measures to monitor the performance of investments on an ongoing basis
- review the investment objectives and investment strategies on a periodic basis and
- formulate a liquidity management plan.

Under Prudential Standard SPS 250 *Insurance in Superannuation*, trustees of regulated funds must have in place an insurance management framework to manage making insured benefits available to beneficiaries. An RSE licensee's insurance management framework must, at a minimum, include:

- the insurance strategy required under section 52(7) of the SIS Act (see Attachment 1);
- policies and procedures of the RSE licensee relevant to making insured benefits available to beneficiaries, that cover but are not limited to:
  - » the process by which the cost to the RSE licensee of insurance premiums is recovered from the RSE(s)
  - » the process for monitoring and reviewing the administration of insurance
  - » underwriting and
  - » claims assessment.

Under SPS 250, insurance contractual arrangements must address:

- the level and type of insured benefits made available, including any exclusions
- the term of the insured benefits
- automatic acceptance limits (to the extent relevant)
- availability of opt in and/or opt out cover
- requirements for the beneficiaries' eligibility for, cessation of, and any reinstatement of entitlements to insured benefits where available
- premium structure, including any variable components
- procedures for notification and payment of claims
- dispute resolution arrangements
- agreed service standards
- reporting requirements for monitoring agreed service standards
- the provision of complete claims information to the RSE licensee on an annual basis which, at a minimum, includes the information required to be maintained by the RSE licensee under paragraph 15 (which relates to maintaining information for prospective insurers)
- liability and indemnity arrangements and
- review, termination and renewal provisions for the insurance arrangement.

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