



AIST submission

**Superannuation Legislation Amendment
(Trustee Obligations and Prudential Standards)
Bill 2012**

13 January 2012

Background

The Government has announced its decisions on key design aspects of its Stronger Super reforms, and is now proposing to implement these reforms in several tranches of legislation: of which this Bill is the second tranche.

The Exposure Draft introduces expanded duties for Registrable Superannuation Entity (RSE) licensees, including duties relating to MySuper products, and personal duties for directors or corporate trustees. It also provides the Australian Prudential Regulation Authority (APRA) with the power to make prudential standards.

AIST had representation on each group set up by the Government to consult on each element of the Stronger Super reforms, having previously made submissions and representations to the Superannuation System Review.

AIST is supportive of the Government's superannuation reform agenda, and is concerned to ensure that it is implemented in a practical, balanced and consistent way; fundamentally focused on delivering optimal retirement savings for all Australians. In part, AIST does this by testing legislative proposals for MySuper against the Government's core objectives of "simplicity, transparency and comparability".

As further Stronger Super changes will be released in subsequent tranches of legislation, this submission has regard to the first tranche of legislation and the APRA framework for the making of prudential standards, while also anticipating and making informed assumptions about the content of subsequent tranches of legislation and of the prudential standards themselves.

The staggered release of the various elements of Stronger Super may have been driven by the tight implementation schedule, but it has not aided clarity or consistency. As more details become available, AIST may have to revisit and recalibrate previous positions.

In its submission on the first tranche, AIST strongly argued for the trustee duties relating to MySuper products to be defined at the earliest opportunity, and is pleased that this has now occurred.

AIST consents to all information contained in this submission being made available to the public.

AIST

The Australian Institute of Superannuation Trustees (AIST) is a national not-for-profit organisation whose members are superannuation fund trustee directors and officers of industry, public sector, and corporate superannuation funds who operate with a representative trustee board of directors.

AIST advocates on behalf of its members, it undertakes research, develops policy and provides professional training, consulting services and supports trustee directors and staff to help meet the challenges of managing superannuation funds and advancing the interests of their fund members. AIST members manage \$450 billion of retirement savings for Australian workers.

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Executive summary

AIST supports the priority given by the Government in addressing trustee duties and prudential standards in the second tranche of Stronger Super legislation.

AIST has identified a number of new formulations of words and concepts whose meanings are unclear and are not legally settled. The use of new terms should be avoided wherever possible, so that extensive, time-consuming and uncertain litigation is avoided, and the intent of the Government's reform agenda is more clearly implemented.

AIST makes the following key recommendations:

- The determination, variation and cancellation of MySuper authorisations by APRA should be accompanied by greater protection for super funds, members and employers than is currently provided in the Bill.
- The legislation should require the annual determination of scale as an integrated exercise forming part of a super funds risk management processes.
- The legislation should clarify the conduct that would be in contravention of scale requirements.
- The financial interests comparison of MySuper products should be totally or overwhelmingly based on net returns to members together with a standardised risk measure. The introduction of ancillary services to members into the concept of financial interests is at odds with the core objectives of MySuper.
- Breach of sections 29VN and 29VO should not result in a cause of action for loss or damage by fund members or beneficiaries.
- Unnecessary fee duplication in the transition to MySuper should be explicitly identified as conduct in breach of the financial interests test.
- The new concept of "prudent superannuation trustee" should be abandoned in favour of the established concept of the "prudent person of business" as recommended in the Stronger Super consultations.
- The legislation should explicitly allow persons who have never been directors of a corporate trustee to be appointed without being unreasonably and immediately exposed to the risk of legal action against them.

Table of issues

Section (ED)/ Paragraph (EM)	Issue	Comment
29U(2)(ca) and 1.29	Cancellation of MySuper authorisation	<p>AIST supports the proposition that superannuation, banking and insurance should be subject to the same level of prudential supervision, and that the form of this supervision, while broadly similar, should also have regard to the individual nature of each segment of the financial services industry. For example, the nature of the superannuation “promise” is different from that proffered by a banking product.</p> <p>AIST submits that APRA should be subject to a higher level of accountability than is currently provided for in the Bill.</p> <p>While prudential standards are legislative instruments, disallowable in the Senate, and subject to scrutiny by the Standing Committee on Regulations and Ordinances, they also require legislative consultation, review and notification mechanisms as part of their development and ongoing revision. This should be explicitly required in the legislation.</p> <p>Cancellation of a MySuper authorisation (or an RSE licence) will result in lasting damage to a fund and the reputation of its directors, even if it is subsequently overturned. It should not be cancelled lightly, and there should be controls against the unreasonable exercise of this power.</p> <p>Cancellation of a MySuper authorisation where an employer contributing to the fund has not been given reasonable notice could also cause damage to an innocent third party. This could occur where an employer is legally required to make default Superannuation Guarantee contributions to the MySuper product. If an employer is not notified with reasonable notice,</p>

they may breach their SG requirements.

Power to cancel MySuper authorisation should be qualified by giving the RSE licensee a reasonable opportunity to correct the failure, provided the financial interests of beneficiaries are not in jeopardy.

While a decision to cancel, determine or vary a MySuper authorisation is to be a “reviewable decision” this protection should be further enhanced.

The terms of the clause should be amended to read “...APRA is no longer satisfied *on reasonable grounds* that the directors...” [proposed new words in italics].

AIST also submits that the extension to the definition of “reviewable decision” should be to all of the entities and classes of entities named in section 34C, and not be limited to paragraph 34C(e) and (f).

While the provision in the Bill is similar to APRA’s current powers in relation to RSE licences, the current legislative program proposes to greatly extend APRA’s powers, and the extension of these powers should be accompanied by appropriate checks and balances.

29VN	Beneficiaries and members	References to “beneficiaries” should be changed to “members” or “beneficiaries at the time”, as persons in these categories are known whereas beneficiaries are not necessarily known.
29VN(b) and (c)	Annual determination of scale	<p>The legislation provides for two separate assessments of scale; for investment scale (paragraph 29VN(b)) and sufficient numbers of members (paragraph 29VN(c)).</p> <p>These measures are inter-related, and the legislation should provide that both assessments take place simultaneously as part of the same process. This could be done by merging the two clauses.</p>

The documentation of scale assessment only within the investment strategy is odd and inappropriate, not least because the financial impact may be in the provision of administration services, or some other part of a fund unconnected with investments. Documentation of the scale assessment would be better included within the compliance and risk management framework, and referenced in the investment strategy.

29VN(b) and (c) and 1.15 Comparison of MySuper products

Along with simplicity and value for money, the Government has identified comparability as a key characteristic of MySuper products. The legislation will create an obligation for trustees to undertake an annual comparison in their assessment of scale. AIST supports the requirement for a comparison of MySuper products but is concerned about the potential for unintended consequences.

Trustees will be required to undertake the comparison of the financial interests between different MySuper products, with the most significant (but not sole) component being net return to members.

AIST is concerned to ensure that the comparison has clarity, and is properly focused upon maximising retirement benefits. The sole purpose test requires that each trustee of a superannuation fund must ensure that the fund is maintained solely for the provision of benefits for each member of the fund at the time they are eligible for their benefits, and this should be reflected in the comparison methodology.

While the range of member services offered by superannuation funds (such as access to financial advice, insurance and online services) are important ancillary services, they do not directly improve net returns, and should not form part of a member's financial interests.

Paragraph 1.15 of the EM states (as an example) that offering "financial advice may be in the financial interests of members" while also identifying that it "may not directly promote net returns". It does so in the context of implying that a range of member services offered by

superannuation funds might contribute to a member's financial interests. AIST submits that this is incorrect, and that financial interest comparisons involving other components are more complicated, subjective and wrongly based.

AIST supports the introduction of a specific financial interests obligation, but on the basis that it is totally or overwhelmingly based on net returns to members, and the level of risk appropriate to the assets delivering the returns. That is, the factors identified in paragraph 29VN(e) should be explicitly identified as being the determinants of a member's financial interests.

The legislation should be amended to include a definition on this basis for "financial interests of the members of the fund". This would both clarify the meaning to address this point, and avoid the uncertainty, litigation and extensive costs of courts determining the meaning. This would in turn assist the development of APRA's net return methodology and measures of risk.

It would be an unsatisfactory outcome if the comparison model resulting from this requirement ended up looking like those currently used by superannuation ratings agencies. A valid criticism of some models is that they introduce a multiplicity of factors; the inclusion of which is required for the optimal score. These may diminish or cloud the importance of achieving the optimal retirement savings for members. For example, does the use of unit-pricing versus crediting rates impact on a member's financial interest, and what weighting should this be given? Also, an emphasis on "bells and whistles" is likely to fall prey to short-term measurements, rather than longer-term outcomes. If other services are included as components, this will necessarily diminish the weighting given to net returns and risk.

Unnecessary fee duplication

Although transition arrangements will be covered in a subsequent tranche of legislation, paragraph 29VN should be extended to ensure that the financial interests of a member in a MySuper product are not disadvantaged by the maintenance of any previous default benefit, when the default benefit is not transitioned to a MySuper product. That is, that they do not pay two administration fees.

If a two-step transition of default contributions and balances into a MySuper product results in members paying an additional set of fees, and receiving an additional statement, then the rationale of MySuper will have been compromised.

Similarly, the financial interests of a member who has benefits in both a default option and a Choice product will be disadvantaged if the transition of their default account to a MySuper product result in their payment of two administration fees (where they previously paid one).

29VN(e) Level of investment risk

Consistent with comments above, paragraph 29VN(3) should state the 10 year investment return target be “expressed as a net return”.

There is an assumption in the paragraph that an older membership profile may require lower risk investments. Firstly, this may be an incorrect assumption. Secondly, the formalisation of this requirement may compel trustees to establish a lifecycle investment strategy that is not the intent of the policy. AIST recommends that the words after “assets” in paragraph 34(e)(ii) be deleted.

29VP, 55(5) Contravention of scale requirements

The proposed provision is unclear about the conduct that would be in contravention of scale requirements. While the test will involve comparison with other MySuper products - and this may include comparison of net return, level of risk, and other services and offerings – the magnitude of contravention required to breach the test is unclear. Does a person suffer loss or damage if their fund delivers below average returns, or is not in the top quartile of performers, or doesn't offer a wide range of services to members, or does there have to be some failure in the trustee's scale determination process?

Contravention of sections 29VN or 29VO lead to a cause of action for a person who suffers loss or damage as a result. We strongly disagree with the creation of this cause of action.

AIST supports additional trustee obligations in relation to MySuper. These trustee obligations

should be monitored and supervised by APRA. AIST submits that APRA has sufficient powers to deal with failure by trustees to take these additional obligations seriously. APRA should be encouraged to require trustees who fail to promote the financial interests of beneficiaries, or fail to make appropriate determinations on scale (regarding assets on member numbers) in comparison to other MySuper offerings with other funds, to rectify these issues in a timely manner. Failure to do so could eventually lead to cancellation of the trustee's licence.

AIST does not support the rights of beneficiaries being extended to pursuing compensation for their fund achieving lower net returns than another fund. There is no standard (let alone agreed) net return measure that could fairly determine how one fund protects the financial interests of beneficiaries better than another. MySuper products will take different formats, and accordingly fair comparison becomes difficult. A net annual return comparison is also counter-intuitive to the long-term nature of superannuation investment, and accordingly should not be a factor in creating a cause of action for individual fund members, or a potential class action.

AIST recommends that paragraphs 3 and 4 of section 29VP be deleted and replaced with an obligation on APRA to monitor and supervise trustee's compliance with the new obligations.

Where a trustee establishes a MySuper product only with new contributions, it appears that such an arrangement is unlikely to be able to meet scale requirements. This effective prohibition should be made clearer to avoid confusion and unnecessary cost, and potential cancellation of a MySuper authorisation.

55(5)	Defense to an action of investment loss	The defence provided in this section is only available to a defendant if they can prove that they complied with each of the covenants in sections 52, 53, 52A (and if related to a MySuper product, also sections 29VN and 29VO). This is a much broader requirement than the current section 55(5) which relates only to the investment being made in accordance with the investment strategy formulated under paragraph 52(2)(f). Breach of any of the covenants (of which there are many), even in a minor way, will mean that the defendant cannot avail
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themselves of the defence. Even if the breach was immaterial and/or not in any way related to the loss or damage suffered, the defence does not apply. AIST does not support this outcome and recommends that materiality and causation form essential elements of the plaintiff's cause of action.

52(2)(b) and 52A(2)(b) General covenants – prudent trustee

The “*prudent* superannuation trustee” test appears to be higher and different from the “prudent person of business” test. Unlike the “prudent person of business”, the “prudent superannuation trustee” does not have settled meaning (although it is understood to derive from state trustee legislation), and the establishment of this category will lead to uncertainty, litigation and extensive costs as courts determine the required level of care, skill and diligence.

The separate “office of superannuation trustee director” was considered then rejected during the Stronger Super consultation process; in part, because it introduces a new concept not known to the law. The same problem exists here. The legislation should revert to the “prudent person of business” test, as recommended in the Stronger Super consultation process.

The EM also states (paragraph 1.115) that these: “*amendments are aimed at raising the requirements for those who are undertaking the role of director of a corporate trustee of an RSE, not from stopping individuals who have never been a director of a corporate trustee previously from becoming one now.*” While this intention is strongly supported by AIST, the ED does not provide an allowance for an individual director, who may be relatively new to superannuation, to take time to reach a mature level of skill and experience. In particular, such a director should not be individually exposed to the risk of litigation during their development stage.

52(2)(h) General covenants – separation of assets

The requirement to keep assets of the fund separate from the trustee's personal assets is taken to mean that they can be pooled but separately identifiable. This reflects the existing requirements.

52(6)(a)	Investment covenants – investment strategy	This requirement may pressure funds with large numbers of investment options (sometimes hundreds) to reduce the number of options they offer. They will not be able to offer a third-party investment option on their investment platform unless the trustee has formulated its own investment strategy for each option. These are typically “wrap” products where retail providers provide access to a wide range of investment products. This may be a major exercise for these funds, but AIST supports the covenant on the basis of it being a necessary trustee responsibility in relation to investments.
52(6)(c) and 1.76	Investment covenants - diversification	<p>The terminology used is unclear. The intention (as explained in the EM and in the Stronger Super consultations) is understood to be that members can select from a diversified range of Choice options, where Choice options are offered by the trustee.</p> <p>However, the existing terminology in the ED could be read to mean that each investment option has to be diversified. This meaning is clarified in the EM but should also be clarified in the ED.</p> <p>The paragraph could also be read to mean that trustees offering a MySuper product (which is required to be diversified), also have to offer Choice options. The ED should be amended to clarify that paragraph 52(6)(c) make it clear that the requirement to offer diversified investment options only applies when a trustee determines to offer Choice options.</p>
52(7)	Insurance covenants	<p>The requirement in paragraph (a) provides a reasonable basis for the establishment of an insurance strategy, and is in accordance with the outcome of the Stronger Super consultations. However, the requirement to consider the demographic composition of the fund should not be read to preclude a trustee from determining that a basic, standardised, low-cost insurance offering may be appropriate for a superannuation fund.</p> <p>The requirement in paragraph (c) to offer insurance only if its cost does not inappropriately erode retirement balances is vague and unclear. Unless clear guidance is provided in the</p>

legislation or consequent regulations, this test will lead to litigation and extensive costs as courts determine the meaning of “inappropriately erode”. Further, trustees require certainty about allowable insurance structures so they can provide appropriate minimum levels of insurance across their membership, and can know the size of their risk pool.

The requirement in paragraph (d) to reasonably pursue beneficiaries’ insurance claims is reasonable. However, the legislation should further clarify the meaning of doing “everything that is reasonable” and “reasonable prospect of success” to avoid the uncertainty, litigation and extensive costs of courts determining the meaning. The definition of reasonable should have regards to the cost of pursuing the claim in relation to the disputed benefit, and allow for some alternate resolution when the likely costs far exceed the possible benefit.

The references in paragraph (a), and (b) [but not (c) or (d)] to “beneficiaries” should be changed to “beneficiaries at the time”, as persons in these categories are known whereas beneficiaries are not necessarily known.

Chapter 2 Prudential standards

The prudential standards making power is very wide, and could be used to circumvent parliamentary processes unless further protections and limitations are included in the legislation.

Paragraph 2.5 states that the standards require extensive industry consultation as part of their development and ongoing revision, but this is not reflected in the ED.

This, and other controls, process and oversight, should be incorporated into paragraph 34C(6). This concern is further explained in the comments on the definition of prudential matter.

34C(2) Differential prudential standards

While different standards may be imposed on different licensees or in different situations/activities, APRA should be prohibited from applying different levels or nature of standards without good reason. While APRA can currently add special licence conditions to an RSE licence, it is undesirable for APRA to apply special rules to individual trustees on a

		widespread basis. These can result in practical difficulties of inconsistency and lack of transparency.
34C(3)	Coverage of prudential standards	The paragraph identifies what entities are covered by the standard (ie, RSE licensees), and so the preliminary words -“Without limiting the prudential matters in relation to which APRA may determine a prudential standard...” - have no work to do and are redundant.
34C(4)	Definition of prudential matter	<p>The definition is broader than and not entirely consistent with definitions in banking and insurance legislation.</p> <p>The EM identifies that the superannuation requirements are different from those in banking and insurance, and explains this on the basis of the “different considerations applying to superannuation”.</p> <p>The requirements in the Bill that are not in the banking and insurance legislation relate to:</p> <ol style="list-style-type: none">1. protecting the interests of beneficiaries;2. meeting beneficiaries’ expectations; <p>Requirement 1 appears to relate to “different considerations” and so is reasonable, but requirement 2 is explained with reasons that appear equally applicable to banking and insurance. For example, consumers of banking and insurance products are just as likely as superannuation consumers to want their expectations on “product features” met.</p> <p>AIST understands that the Government is taking steps to achieve greater alignment between prudential requirements of banking, insurance and superannuation. However, it should explain the rationale for both areas of alignment and areas of difference.</p> <p>There is one key area of difference that is not recognised or addressed in the legislation. That concerns the structure and status of superannuation trustee companies in the not-for-profit sector. A not-for-profit trustee company is often an entity with limited trustee capital and</p>

limited access to capital. The APRA discussion paper on prudential standards for superannuation (23 September 2011) recognised this in considering how funds might manage operational risk financial arrangements: “APRA considers that a specific fund reserve, trustee capital or a combination of both would be appropriate to fulfill an operational risk financial requirement.” (page 45)

In recognition of this, the definition of prudential matters should be amended to provide that the prudential obligation of an RSE is to keep the superannuation entity for which it is responsible in a sound financial position, rather than a prudential obligation relating to the trustee company.

34E(3) Failure to notify standards

Standards are legislative instruments that can apply variously to all, some or a single RSE licensee, and can apply from the day a standard is made. It is therefore not fair if APRA’s failure to communicate the making or variation of a standard does not affect the validity of the standard making, or to have no other consequence.