

SUPER SYSTEM REVIEW FINAL REPORT

CHAPTER 10

Regulatory settings

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KEY THEMES

Issue

The superannuation regulatory regime must be fully effective if the Review is to achieve the efficiencies it seeks for the industry. Efficiency concerns include having more than one regulator involved in superannuation, gaps in the powers currently provided to APRA, tax and legislative impediments to rationalisation of legacy products and the complexity of the SIS Act.

Proposed solution

The Panel proposes measures, including:

- expansion of APRA's mandate and giving APRA a standards-making power in superannuation;
- improved cooperation between ASIC and APRA and adequate measures for the ATO to carry out its new SuperStream function;
- the Productivity Commission to review the effectiveness of the implementation of the Panel's recommendations five years after the Government's response to this report;
- re-write and restructure of the SIS Act to address the different sectors of the choice architecture model; and
- helping the industry in rationalising legacy products.

Benefits for members

Members will benefit from these measures as:

- making the regulatory regime more effective will avoid duplication and the consequent increased costs for members;
- a greater focus is being placed on member outcomes; and
- there will be an improved confidence in the integrity and stability of the system.

1 MAKING IT ALL WORK

1.1 Regulator efficiencies

The Panel is mindful that the successful implementation of its recommendations depends in large part on the regulators who are charged with overseeing the superannuation industry. Accordingly, the Panel has considered whether the current regulatory regime itself needs to be made more efficient and the regulators themselves better resourced in order to achieve the important changes that the Panel has identified.

Submissions highlighted that there are a range of practical issues which arise from APRA, ASIC, the ATO and AUSTRAC all having roles in superannuation. A common example was regulatory overlap in reporting obligations to multiple regulators in relation to identity fraud, regulatory breaches, changes in directors, officers and details, and audited accounts. Another example was duplication and significant costs in time and administration for trustees arising from the collection of similar data from the same entity by different agencies. This can arise in the performance of different regulators' supervisory or review functions.

Submissions also highlighted some areas where a particular aspect of the trustee's operation is overseen by more than one regulator and each has a different approach and emphasis. Examples included: proof of identity requirements; the definition and nature of a 'superannuation interest'; what constitutes an 'income stream'; and the management of conflicts.

Several submissions considered that the removal of regulator overlap as a point in favour of having only a single regulator for the superannuation industry. However, other submissions commented on some of the problems of having more than one regulator, but still preferred the status quo.

1.2 Suggestions for enhanced regulatory efficiencies

The Panel considers there is a powerful logic in seeking better efficiency through the enhanced alignment and coordination of the main superannuation regulatory agencies and their regulatory requirements. This would complement the range of efficiencies to be derived from the recommendation in chapter 9.

The Standard Business Reporting approach currently under development by the Commonwealth Government, an initiative to reduce the business-to-government reporting burden, should substantially assist as there will be a single portal for trustees to meet all reporting obligations.¹ However, there was also a significant theme in the submissions that in, general, all issues needed to be reviewed and addressed through one process or one body. Suggestions included:

- a joint forum, expanded from APRA and ASIC to include the ATO and AUSTRAC, with greater transparency to industry;
- three-yearly assessment of the performance of regulators by an independent body such as the Australian National Audit Office;
- an oversight body that includes industry representatives and practitioners; or

- an independent consultant.

The Panel considers that, while these suggestions have merit, it favours a slightly different approach, based on the following four ideas:

1. a wider APRA mandate, with increased powers to oversee the efficiency of the system, particularly MySuper, including a standards-making power in superannuation;
2. a closer working relationship between APRA and ASIC, including a possible co-location of superannuation capabilities and cooperation agreement for APRA and ASIC;
3. ensuring adequate resources for the ATO with respect to its role in the superannuation system; and
4. an examination of the Panel's recommendations by the Productivity Commission five years after the Government's response to this report.

Each of these ideas is discussed in turn below.

2 INCREASED APRA MANDATE — STANDARDS-MAKING POWER

Through its recommendations, the Panel has highlighted that a major aspect of the solution to the issues it has identified is enhanced regulatory supervision. APRA's role as the prudential regulator has been developed over time in a piecemeal way. As a result, there are gaps in its mandate. The Panel believes that there needs to be a new role for APRA, expanded and deliberately designed to carry out what the Panel has recommended and to be in accord with the super policy principles (see Part One of this report) that have guided the Review.

The Wallis Report expressed the view that a prudential regulator with respect to superannuation was at the 'lower end' of intensity. While the Panel does not want to re-open that issue, it is of the view that, based on what the Panel has recommended, APRA needs to be given a role that is more focused on improving outcomes for members. This also results from a recognition that APRA needs to drive the changes to achieve efficiency in the industry as members are not in a position to drive the changes themselves.

Accordingly, the Panel is recommending that APRA be given a broader mandate, with an additional role directed primarily towards overseeing and promoting the overall efficiency and transparency of the superannuation system, to the ultimate benefit of members. The Panel does not envisage APRA's role as extending to intervening in the trustee's decisions. Instead, APRA would give consideration to issues such as the cost structures in the operation of the fund, including investment costs, tax management and administration (and other issues detailed in chapter 4).

At the core of these new responsibilities, the Panel believes that the role proposed for APRA in gathering and publishing additional investment and cost-related data, and ensuring standardised investment option level reporting by trustees (also discussed in chapter 4), would facilitate market responses to constrain costs. APRA would also be required to administer the MySuper reforms and much of the SuperStream development and implementation as well as take responsibility for the licensing and regulation of administrators as covered in chapter 6.

The Panel expects that APRA's routine fund reviews would extend to matters such as trustees' approaches to meeting their new duties in relation to their MySuper product (chapter 1); the extent to which they meet the standards set out in the proposed Code of Trustee Governance (chapter 2) and their level of compliance with the principles of outcomes transparency explained in chapter 4.

2.1 Standards-making power

The need for a more finely calibrated capacity for APRA to supervise and regulate the superannuation industry in ways that extend beyond prudential issues raises the question whether APRA should have standards-making powers similar to those which it has in relation to Authorised Deposit-taking Institutions (**ADIs**) and in the insurance sector. The relevant legislation governing ADIs, life insurance and general insurance companies give this power to APRA.

After some deliberations, the Panel believes that APRA should be given a general standards-making power in relation to superannuation.

Operating standards are not the same as prudential standards because operating standards are a form of subordinate legislation (like the SIS Regulations) made by the Executive Council. Prudential standards, on the other hand, are made directly by APRA (although both give APRA a way of providing additional detail to an industry on prudential matters).

For example, the information that APRA currently sets out in its practice guides to the industry would have the force of law if that guidance were instead issued as a prudential standard. As subordinate legislative instruments, prudential standards (like regulations) are disallowable in the Senate, subject to scrutiny by the Standing Committee on Regulations and Ordinances and require extensive industry consultation. The Panel believes that APRA needs to be given a standards-making power in superannuation that encompasses, but goes beyond, prudential matters. The power needs to be focused on transparency, efficiency and outcomes; a power unique to the issues facing the superannuation system. In chapter 4, the Panel has called standards that could be made in these areas: 'outcomes reporting standards'. This is not intended to limit the areas in which APRA should be able to make standards.

Standards can be made and varied more quickly than regulations which means that, if required, the law can be quickly adjusted to respond to developments in the industry. Further, complete topics could be addressed under a single standard whereas, at present, a topic may be found in several places in the SIS Regulations. As mentioned in chapter 2, the Panel believes that it is important that trustee duties not be sprinkled across several places but, rather, be readily available to trustee-directors in one place. This also means that a standard has the capacity to leave less room for uncertainty than the promulgation of regulations on the same topic.

Recommendation 10.1

APRA's mandate should be broadened to include the task of overseeing and promoting the efficiency of the funds it regulates and the system in which they operate.

Recommendation 10.2

APRA should be given general standards-making power in relation to superannuation (including prudential matters) in order to address the recommendations in this report and to drive efficiencies in the industry.

2.2 New trustee duties

As part of the MySuper proposal outlined in chapter 1, and the trustee governance and investment governance proposals in chapters 2 and 3, respectively, the Panel has recommended that trustees be given new duties specifically tailored towards achieving the outcomes the Panel believes will be necessary in order for MySuper and its other reforms to produce the necessary benefits for members. These would involve APRA having a broader range of regulatory functions that might call for new skills, resources and perspectives.

2.3 Regulating for scale

2.3.1 MySuper requirements

The Panel has recommended in chapter 1 that, as part of the grant of a MySuper RSE licence, a MySuper trustee would have to demonstrate to APRA that the product had sufficient scale or, if a new entrant to the industry, that there was a credible path to building the necessary scale. Further, on an annual basis, a trustee would have to determine whether it would continue to have sufficient scale in relation to its MySuper product (with respect to both assets and number of members) to deliver optimal benefits to members.

The Panel has also recommended in chapter 1 that scale would be part of APRA's ongoing review of MySuper products. The way the scale concept is administered would, of course, need to deal with a fund's individual circumstances, features particular to certain occupations and to allowing competition from new entrants to the market. The aim would be to see those funds that were providing sub-standard outcomes to members, due to their lack of economies of scale, being the subject of sanctions or other regulatory intervention.

The interaction between the trustee's duty and APRA's regulatory role is obviously important.

2.3.2 Why is scale important?

There were 429 large APRA funds at 31 March 2010.² A submission from Chant West pointed out that, at 30 June 2008, 70 per cent of large APRA funds had less than \$1B in assets and collectively accounted for only 7 per cent of the total net assets of all large APRA funds.³ The submission said:

“for most small funds, merging with larger funds will provide even better value for members” and that small funds “should be required to demonstrate to APRA why they should remain stand-alone funds”.

The Panel shares these views.

The cumulative effect of the advantages that large funds have over small funds is significant. These include lower investment fees, in-house investment expertise, private placement capabilities, ability to spread investment risk through diversification, reduced administrative unit costs, and enhanced availability of education, information and service.⁴

Keith Ambachtsheer, director of the Rotman International Centre for Pension Management, believes that increased scale expands the capabilities of pension funds, while also enhancing their operations and lowering costs. He says that larger funds:

- have investment advantages in that they are able to invest in asset classes like direct real estate, infrastructure and private equity and earn a genuine illiquidity premium that is not available to smaller funds; and
- can do things internally as they can afford to hire talent (which he believes is cheaper than outsourcing).

He has identified the scale ‘sweet spot’ where a fund starts to see these benefits is over US\$25B (A\$28B). By contrast, at 30 December 2009, the average Australian fund size was \$1.86B⁵ and at 30 June 2009, only four Australian superannuation funds (that is, less than 1 per cent of funds), had achieved a scale close to or over the \$28B mark.⁶

The Deloitte report into the MySuper proposal also highlights the significant impact that scale can have on reducing total operating and advice costs to members.⁷ Investment management costs are not included in this particular analysis because they will differ according to the investment strategy selected (although investment management costs still show scale benefits as the Deloitte work shows).

Deloitte estimated that, for members with an average account balance of \$25,000, the operating and advice costs per member could be reduced from 50bps per annum in a medium-sized (\$2B) fund to 30bps in a large (\$20B) fund. In dollar terms, this would be a reduction from \$125 to \$75 per annum. Equivalent figures across a range of account sizes and fund scales are illustrated in Table 10.1.

Table 10.1: Illustration of the potential impact of scale on operating and advice costs per member

Estimated total operating costs for MySuper products of varying sizes							
(basis points for varying account sizes) & inclusive of cost of intra-fund advice							
Fund size: \$M	<100	500	1,000	2,000	5,000	10,000	>20,000
Fund size: Membership*	4,000	20,000	40,000	80,000	200,000	400,000	800,000
Account size							
\$10,000	262	210	162	125	98	86	74
\$25,000	105	84	65	50	39	34	30
\$50,000	52	42	32	25	20	17	15
\$100,000	26	21	16	13	10	9	7
\$250,000	10	8	6	5	4	3	3

Note: * Membership based on an average account balance of \$25,000.

Source: Deloitte, Default Fund costs under the MySuper proposals.

The Panel recognises that throughout 2009/10, a number of superannuation funds have announced intentions to merge, citing the benefits to members of greater scale.⁸ While the Panel believes that the benefits of scale are being more widely recognised, and does not propose mandatory

consolidation of funds, it is keen that all trustees of MySuper products formally consider this issue on a regular basis.

2.3.3 APRA powers to assist in regulating scale

The Panel believes that several of its recommendations would help APRA in guiding trustees as to what is a reasonable scale for funds in order to effect savings for members. For example, the outcomes reporting standards (chapter 4) will help identify whether a fund is achieving optimal outcomes, given its scale. In addition, APRA will be able to assess capital requirements on a risk-weighted basis (chapter 6) so that if risks are regarded as having increased because of the size of a MySuper product, APRA will be able to respond with an adjustment to capital.

2.4 Data collection, publication and research

The Panel considers that APRA needs to be charged with the responsibility of providing more in-depth data and analysis on the superannuation sector. For example, under the *Financial Sector (Collection of Data) Act 2001 (FS (CoD) Act)*, APRA collects data from a variety of sources, but is not presently charged with analysing or using the data to drive efficiency in the industry or increasing the level of knowledge about how the data could be more effectively used. One aspect of the analysis that would be important is determining what level of scale is optimal in the Australian superannuation industry (much like that set out in table 10.1 above) and equipping trustees with that knowledge so that trustees can better assess the situation of their fund. There are many other issues affecting superannuation where good quality data and analysis would improve outcomes for members and the system as a whole.

The Panel has been surprised, on occasions, at the lack of quality data available on a range of issues relating to aspects on which APRA does not currently collect data, particularly at the member level. This is not a criticism of APRA, but rather a reflection of its mandate. As a prudential regulator, it is not concerned, for example, about data regarding fees charged to members or insurance premiums paid. The Panel believes that this needs to change and much higher quality data on aspects relevant to efficiency, price competition and member outcomes needs to be collected and published.

Another issue is the need to quantify and understand the investment performance of superannuation funds. Investment performance measurement and attribution have been subjects of considerable research over the past decades.

The use of high quality data will help to further improve investment performance analysis, leading to better information for all users. As advances in investment performance analysis are made, new types of data collection may be required. The Panel recognises that investment performance methodologies are not static knowledge, but are dynamic and evolving. There is therefore a need to encourage further investment performance research.

In addition to just publishing data, APRA needs the mandate and resources to research and analyse the data for the benefit of the system as a whole. An example of an organisation that fulfils a similar role is the Employee Benefits Research Institute (EBRI) in the United States.⁹ Formed in 1978, EBRI is a not-for-profit, non-partisan organisation that carries out objective research into retirement-related issues.

Recommendation 10.3

That APRA’s mandate be broadened to include the collection and publication of data aimed at the efficiency and outcomes of superannuation funds and research into issues arising from that data to assist trustees in achieving better outcomes for members.

2.5 Graduated enforcement powers and regulatory sanctions

In any regulated environment, there will be a temptation for a minority of players to push the boundaries to the limit. Even when the primary regulatory model is based around consultation and suasion, a credible enforcement capacity and willingness on the part of the regulator is a precondition for ongoing regulatory effectiveness. On the other hand, enforcement has to be proportionate and appropriate to have maximum impact.

Enforcement must clearly be a tool for achieving a desired outcome, rather than ever being an end in itself, and it is valuable for regulators to have a wide range of potential responses available to them. They also need the ability, supported where necessary in legislation, to use them flexibly according to their assessment of the risk inherent in the behaviour being addressed.¹⁰ Analysis of risks, selection of the appropriate regulatory tools — of which enforcement is usually the least used in a principles-based regulatory environment — and effective application of the optimal tool are all key elements in effective regulation.¹¹

A contributor to efficiency for both regulator and regulated entities is that enforcement powers should be flexible and operate at as low a cost as possible for both parties, consistent with achieving the necessary regulatory outcome.

In chapter 8, the Panel has recommended that the ATO have access to infringement notice penalties to respond to certain breaches in SMSFs, rather than being forced to disregard a breach unless it was of such seriousness as to warrant the removal of all tax concessions by way of making the fund non-complying, or recommending that the Director of Public Prosecutions initiate criminal action.

Similar considerations apply in the APRA-regulated sector. APRA has already demonstrated the effectiveness of comparable powers under the FS (CoD) Act where the capacity to levy a modest penalty (contestable in the court if the institution objected) resulted in a substantial improvement in the timeliness of lodgement of regulatory returns. The power has only been exercised on a handful of occasions, and no penalty has been contested. Had prosecution been required, both APRA and the affected trustees would have been faced with substantial legal and other costs.

Recommendation 10.4

Legislation should be amended to give APRA an administrative power to impose fines, contestable in a court, as an alternative to criminal prosecution in relation to selected SIS Act provisions.

2.6 What would be the enforcement lever for efficiency?

APRA's standard supervisory approach is to engage with trustees to secure an improved outcome for members before emerging problems in a fund become severe. This is appropriate in considerations of fund efficiency as well as fund safety. Should a trustee not respond effectively to this approach, APRA would have available to it the standard set of regulatory tools, including variations to licence conditions. In the most severe cases, depending on the construction of relevant legislation, it would be able to withdraw a trustee's licence, or initiate appropriate court action.

In addition, the Panel envisages that APRA would collect and publish a large amount of high quality data specific to each MySuper product so that there would be a much higher level of transparent and accurate data available than is currently the case. The Panel believes that this transparency alone would be one of the most powerful regulatory tools available.

3 CLOSER COOPERATION BETWEEN APRA AND ASIC

As discussed above, submissions identified that sometimes the division of duties between APRA and ASIC has led to inefficiencies and different approaches to matters in the industry.

Accordingly, the Panel believes that closer cooperation between APRA and ASIC is imperative for many reasons, including ensuring the effectiveness of MySuper and the Panel's recommendations relating to transparency, communications, disclosure and outcomes. The Panel believes that both APRA and ASIC want to assist the superannuation industry in becoming more efficient and transparent and are willing to coordinate their activities in an effort to do so. Better coordination and cooperation between the two could be achieved in a number of ways, ranging from the modest and simple to the more complex. For example:

- a memorandum of understanding and secondment arrangements aimed at closer cooperation in relation to superannuation functions;
- an operational merger with or without a co-location in major offices, effectively merging their superannuation capabilities in an operational sense, while preserving the existing separate agencies and regulatory mandates; or
- delegations of certain powers from the respective organisations to staff of the other and arrangements in relation to premises, security and confidentiality.

Any of these arrangement could be for a limited duration (which could then be reviewed for effectiveness) or, alternatively, could be made permanent. Further, any of these proposals would make progress toward achieving a 'one-stop-shop' for trustees of large APRA funds in dealing with ASIC and APRA.

Recommendation 10.5

The Government should explore with APRA and ASIC ways in which the two regulators can work more closely together in discharging their superannuation mandates, in particular in implementing the Review’s recommendations in relation to MySuper and increased efficiency more generally.

4 ATO ROLE

The ATO carries a range of responsibilities in relation to superannuation, covering traditional tax collection, assessment of contribution limits, administration of the co-contribution, administration of the superannuation guarantee, maintenance of the lost member register and supervision of SMSFs. These functions need to compete for resources with other ATO priorities, particularly broader revenue collection.

The Panel notes the ATO has a critical role in implementing the substantial microeconomic reforms in the SuperStream proposals, and the savings in relation to systemic enhancements to the ‘back office’ of superannuation have been estimated in several submissions to be in the order of \$850M to \$1B per annum.¹² This implementation may place greater pressure on existing capacity in the ATO. Stakeholders are also vitally interested in the ATO following up with employers to ensure thousands of Australians receive their SG Act entitlements every year and in appropriately supervising SMSFs (which account for a very large and growing proportion of Australia’s superannuation assets).

Therefore, the Panel is of the view that the ATO needs to be adequately resourced to ensure that the industry-wide benefits embodied in SuperStream and other Panel recommendations are realised, while also continuing the ATO’s existing superannuation functions.

Recommendation 10.6

The Government should ensure that the ATO is adequately resourced to continue its existing superannuation responsibilities, including the new functions it will administer under SuperStream and other Panel recommendations.

5 REVIEWS BY THE PRODUCTIVITY COMMISSION

The Panel has made recommendations for a wide range of changes that aim to ensure the superannuation system has a focus on efficiency and on producing better outcomes for fund members. Of course, all the intended benefits would not all accrue immediately and many depend on subtle changes in behaviour brought about by increased transparency. There would be an implementation/transition phase in relation to the Panel’s recommended changes. The Panel also recognises that there would be a period over which the intended benefits of the recommended changes should begin, collectively, to emerge and become consistent features of a more efficient superannuation system. At the same time, elements of the new system might need fine tuning in the light of experience in order to optimise outcomes for super fund members.

The Panel believes the Government should review the implementation and outcomes of the Panel's recommendations, at a future time when the intended benefits of My Super and SuperStream should have become observable. It would also be timely to examine the market for retirement products.

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. It is also the Government's principal advisory body on all aspects of microeconomic reform. The Productivity Commission can bring economic and community perceptions to an examination of the delivery of the outcomes intended by the Panel.

There is precedent for establishing from the outset a plan to assess the progress of outcomes intended by a major review into retirement systems. In March 2000, the UK government asked Paul Myners to review the quality of institutional investment decision-making. When Myners issued his report in March 2001, he recommended the adoption of principles for investment decisions made by institutions, including pension plans.¹³ Part of that recommendation was that there be a review, two years after implementation, as to whether the principles had been effective in bringing about behavioural change in the industry. HM Treasury in the UK duly followed up two years later and issued a report in December 2004 summarising its views on progress that had been made and recommending some amended principles.

Recommendation 10.7

The Government should consider arrangements for the Productivity Commission to assess, in relation to the Review's recommendations implemented by the Government, five years after the Government's response to this report:

- (a) the implementation and impact of the MySuper regime;**
- (b) the implementation and impact of the SuperStream changes; and**
- (c) the functioning of the market for retirement products.**

6 FUTURE REGULATORY SETTINGS

A number of submissions supported the idea of a distinct entity with responsibility for all, or certain aspects, of the super system. Industry Funds Forum and QSuper expressly supported the concept.¹⁴ Rice Warner Actuaries suggested a new data publishing body.¹⁵

The Panel's four ideas (in section 1) do not include an over-arching body or single regulator for superannuation. However, the Panel is at least partly sympathetic to that idea.

It is true that the superannuation system seems to lack a place in the institutional framework of the economy. At first blush, this seems like an odd proposition for a system that currently has at least six government agencies performing various functions around super.¹⁶ However, there is no single body charged with fostering and improving the superannuation system as a whole. The super system lacks 'systemic governance' and many of the problems the Review has identified (back office situation, poor investment return information, conflicts of interest and inadequate accounting standards) could be seen to flow from this deficiency in one way or another. The system has so far lacked a body that

could pursue a range of themes aimed at improving its efficiency and outcomes. The Panel believes its increased mandate for APRA and the closer cooperation it proposes with ASIC could be the most cost effective and efficient way of achieving this.

One of the biggest criticisms of the Australian super system is that it is liable to constant and often incoherent or conflicting changes, such that confidence in the overall concept of superannuation is undermined. This problem was repeatedly referred to in submissions and the dialogue surrounding the Review. While any complex system needs regular maintenance and realignment with its goals, the superannuation system seems susceptible to amendment to the point of it affecting its overall integrity. As the size and significance of the savings pool grows, this problem becomes even more acute.

A recent independent review into pensions in Ontario called for a new government agency — a ‘Pension Champion’ — that would assume responsibility for collecting and disseminating reliable information about the pension system, for thinking creatively about new pension strategies and policies, and for working with stakeholders to improve the pension system.¹⁷

As the superannuation industry grows to its projected size of \$6.1T (in nominal dollars) in 2035, it has to be asked whether the current regulatory division between trustees regulated by the SIS Act and fund managers regulated under the ‘light touch’ provisions of the Corporations Act will be adequate or whether a regulator responsible for all entities ‘that look after other people’s money’ would be more effective. One of the key advantages in doing this would be to see the regulation of trustees and fund managers under the one roof. This would be more likely to see the appropriate specialist skills and uniformity of approach housed in one organisation. It is possible that in the longer term there would be grounds for the complete integration of APRA and ASIC’s jurisdiction over defined contribution super funds (leaving defined benefit funds with APRA in its traditional prudential capacity) but the Panel does not see a sufficient justification at the moment.

In the Panel’s view, the regulatory settings issues which it has identified in the course of this Review are in line with those raised in the Australian Financial Centre Forum report on Australia as a Financial Centre (the November 2009 Johnson Report).¹⁸ That report (at recommendation 4.2) expressed the opinion that Australia needs to ensure that its financial services regulatory system remains ‘best practice’ in order to promote Australia as a regional financial services hub and to demonstrate that Australia is competitive at an international level.

The Panel believes that the Productivity Commission’s assessment of the superannuation industry’s regulatory framework as suggested in this report would be a valuable contribution in this regard.

Recommendation 10.8

The Government should have the Productivity Commission assess and advise on possible improvements to the regulatory framework for superannuation five years after the Government response to this report.

7 ONGOING RATIONALISATION ISSUES

7.1 Legacy products

The term ‘legacy products’ is generally used in the financial services industry to refer to issues arising from historic products that have been purchased and which cannot be rationalised for a variety of reasons. Consequently, ‘legacy products’ are drivers of increased cost and operational risk. IFSA has estimated that 25 per cent of all funds under management (super and non-super) are in legacy products.¹⁹

However, the Panel has been made aware that in some instances providers with legacy products actually prefer to keep the products in existence because the fees are quite high and are used to subsidise lower fees in other products. The high fees are then justified by reason of the personal attention and manual processing that is required.

On 14 December 2009, Treasury issued a ‘Proposals Paper’ regarding ‘Product Rationalisation of Managed Investment Schemes and Life Insurance Products’. Superannuation products were carved out from the Paper’s considerations and the Paper says, among other things, that this is because the *“successor fund transfer process is generally appropriate for the superannuation industry”* and that *“legacy products are not as significant an issue in superannuation”*²⁰

However, submissions to the Review have complained that the successor fund mechanism is not of assistance in many cases and actually hinders rationalisation of superannuation legacy products.

Further, the tax treatment of legacy fund assets upon transfer has also been uniformly identified as a barrier to rationalisation and consolidation.

The consolidation and rationalisation of legacy products can provide benefits to members, including:

- better product disclosure and clearer reporting to members;
- lower costs — as cost savings will be passed on to members;
- enhanced and newer features, for example, BPay, internet/online transactions, investment choice, unbundled offerings, more transparent and easier to understand products; and
- improved service standards through better administration, greater flexibility, fewer systems and processes.²¹

Such benefits result principally from greater economies of scale and transfers to more modern and flexible products and systems.

7.1.1 Successor fund transfers

As mentioned previously, a number of submissions maintained that the ‘successor fund transfer’ mechanism provided under Regulation 1.03 of the SIS Regulations is not sufficient in respect of many superannuation legacy products. This is because a transfer can only occur if the trustees of both the transferring and the receiving funds agree that ‘equivalent rights’ are provided to the transferring members in the receiving fund after the transfer. APRA Superannuation Circular I.C.4 sets out APRA’s interpretation of what ‘equivalent rights’ requires and the superannuation industry has tended to

follow the Circular closely. In an abundance of caution, 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.

Consequently, successor fund transfers result in product complexities and other undesirable features being perpetuated and, as a result, legacy products are not rationalised. Trustees are careful to protect members' rights and also to protect themselves from any accusation that they did not act in the members' interests. 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 Panel's view, in order to deal satisfactorily with legacy products in superannuation, there needs to be a mechanism available to industry participants 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.

Unlike other sectors of the financial services industry whose obligations to clients are based on contract, a super fund trustee needs to obtain judicial assistance to be released from its obligations to members. Accordingly, the Panel believes that there should be an expedited mechanism with specialist jurists to address rationalisation of legacy products (and other situations) where a successor fund transfer cannot be achieved. The Panel is of the view that only a court will properly protect members' interests and appropriately address trustees' liability for the rationalisation. The standard against which the court must assess the proposed rationalisation or merger would be prescribed in legislation.

To further assist in this regard, the Panel considers 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.²²

Recommendation 10.9

The SIS Act should be amended so that the successor fund transfer test is one of 'no overall disadvantage' rather than 'equivalence'.

Recommendation 10.10

The Federal Court should be given new jurisdiction to determine and facilitate product rationalisation in the superannuation industry where the successor fund transfer regime (as amended by the recommendation made in this Review) still does not fulfil legacy product rationalisation objectives.

7.2 Capital gains tax relief

One of the Panel's main goals is to encourage efficiency throughout the superannuation system. As has been mentioned, a way of achieving this goal is through fund mergers and successor fund transfers as well as product rationalisation which contribute to meeting economies of scale.

Currently, superannuation funds have capital gains tax (CGT) rollover relief to protect losses in successor fund transfers and other asset transfers between funds.²³ That is, the current CGT relief only applies to losses and not gains. Further, the relief is only in place until 30 June 2011. The current CGT relief was provided in the context of the GFC — where the majority of funds had significant unrealised capital losses. If a transfer proceeded without such relief, funds would forgo the future benefit of those losses. This potential negative impact can result in some funds foregoing merger plans which would otherwise result in medium-to-long term benefits to the members and industry more broadly.

As part of the move to RSE licensing in 2006, CGT rollover relief was provided to superannuation funds and applied to gains and losses under the *Tax Laws Amendment (2005 Measures) Act 2005*. The government afforded this relief (between 30 June 2004 and 1 July 2006) to trustees that did not seek to be licensed and that, as a result, were required to transfer fund assets to other superannuation funds.²⁴ Given that the Act's relief extended to gains and losses, a significant number of successor fund transfers occurred during that period.

The Panel believes that the current CGT rollover relief should be amended to afford the same CGT relief provided to the industry in conjunction with RSE licensing during 2004 to 2006. Specifically, the current CGT rollover relief should cover gains as well as losses and should be permanently available to the industry.

Recommendation 10.11

CGT rollover relief should be given to superannuation funds in the terms previously afforded by the *Tax Laws Amendment (2005 Measures No.2) Act 2005* and should be permanently available to the industry.

7.3 Particular products

There are several products created by statute that are widely available, but which no longer are required to fulfil their original policy objective.

7.3.1 Retirement Savings Accounts

At 30 June 2008, there were approximately 120,000 Retirement Savings Accounts (RSAs) with \$1.2B in assets, making up 0.32 per cent of assets in the retail sector.²⁵ The asset base jumped dramatically to \$6.2B by June 2009 due to the attraction of their capital guaranteed nature during the global financial crisis. Currently, there are ten institutions offering RSAs, most of which are credit unions.²⁶

RSAs have generally not been a success because they are a capital guaranteed product and there is currently no scope in the RSA framework for adding a market-linked investment where the risk of

loss is borne by the holder. RSAs are thus suitable only for individuals with an extremely low risk tolerance, and are essentially unsuitable for much of the accumulation phase of retirement saving.

The interest rate spreads used as a measure of the implicit fee in an RSA as the explicit account keeping fee is usually very low (typically between \$0 and \$30 a year).²⁷ Implicit fees for balances less than \$5,000 are, on average, 1.2 per cent and generally fall as the account balance increases.

Rice Warner estimates RSA expense charges for the year to 30 June 2008 to be 2.3 per cent of assets. Of this, 0.60 per cent is attributable to administration and 1.7 per cent to investment management.²⁸ Rice Warner explains the relatively high costs as a reflection of the low average account balances of RSAs.

The Panel considers that there has been little market demand for this product and they seem not to meet the low-cost objective for which they were originally intended. As such, the Panel believes the RSA product should be phased out and no new RSA should be established once MySuper products are available.

Recommendation 10.12

New Retirement Savings Accounts should not be allowed to be established after MySuper becomes effective and a mechanism should be considered for facilitating existing RSAs to be transferred to MySuper or other superannuation products.

7.3.2 Approved Deposit Funds

At June 2008, there were only 140 Approved Deposit Funds (ADFs), of which 136 were single member ADFs. At March 2010, the number of single member ADFs had fallen to 105.²⁹ Total assets in this class are less than \$0.1B.³⁰

The Panel does not believe that ADFs serve any residual purpose as the reason that they were necessary no longer exists (that is, super funds were previously prohibited from holding members' funds after they ceased employment in certain circumstances). Their dramatic decline over the years is a strong indicator that there is no demand for ADFs as they have been superseded by other products on the market. There seems to be no policy reason to revive them and they should be phased out.

Recommendation 10.13

New Approved Deposit Funds should not be allowed to be established after MySuper becomes effective and a mechanism should be considered for facilitating existing ADFs to be transferred to MySuper or other superannuation products.

7.4 Member protection

Member protection, the rule under which members with an account balance of less than \$1,000 cannot have that balance eroded by fees greater than the earnings accruing to their account, was introduced at a time when the SG Act contribution rate was only 3 per cent, and average wages were substantially lower than is the case today. In the current environment, any employee on a minimum

wage, but working more than 10 hours a week, would have more than \$1,000 in super after their first year of employment.

There are direct costs to funds in terms of cross-subsidising such low balance members. REST,³¹ which has an unusually high proportion of low balance members due to the youth and casual employment characteristic of its members, estimates that this protection costs between \$7M and \$17M in any given year. Further, every fund needs to provide for member protection in devising its administrative systems and procedures, adding both complexity and cost. REST's position was also supported by a number of other submissions.³²

The Panel considers that member protection operates as a disincentive for members to consolidate small account balances, is administratively inefficient and has outlived its usefulness.

For a member with an \$800 balance and typical administration fees of \$1.50 a week, a subsidy will occur if fund returns are anywhere between 0 and 9.75 per cent (that is, a very large proportion of the time). The argument for abolition goes to considerations of both efficiency and broader equity. The population which could benefit from it is both small and fluid, in that generally only those in the very earliest stage of workforce participation have balances as low as \$1,000. However, the cost to the system overall of being able to track those members and apply member protection if/when needed is substantial.

Recommendation 10.14

The Government should legislate to abolish the member protection rules.

8 ELIGIBLE ROLLOVER FUNDS

8.1 Background

The 16 eligible rollover funds (**ERFs**) form a unique segment of the superannuation system.³³ These funds were intended to be a temporary repository for the benefits of members who had lost connection with their superannuation, and to protect those members. In practice, ERFs also accept rollovers from superannuation funds for a number of other reasons where the member has not actively made a choice about their superannuation.

ERFs are obliged to receive payments from another super fund, an ADF, or an RSA. An ERF must also treat each member, regardless of their account balance, as a 'protected member'.³⁴ For all other super funds, a member is only 'protected' if they satisfy the conditions in SIS Regulation 1.03, primarily members whose balance is below \$1,000. The Panel is recommending that member protection be abolished — see section 7.4.

ERFs have not achieved their intended objectives because:

- (a) some funds do not send small inactive accounts to ERFs;
- (b) some ERFs appear to have made little effort to re-connect people with their superannuation. There is little incentive to align members with their money because of the cost of matching

and because ERFs continue to collect ongoing fees on these 'inactive' accounts. Rice Warner estimated that, for the year ended 30 June 2008, the average fee for ERFs was 2.49 per cent,³⁵ although this figure equates to an average of only \$23.16 per account per year because of the predominance of small accounts in ERFs. However, because of the very low level of activity inherent in the operation of an ERF, the member account perspective is less relevant than in a normal super fund;

- (c) there has been no unique member identifier to aid the process of re-uniting members with their accounts;
- (d) matching lost members with unclaimed super is costly. Ultimately, the cost of running the exercise depends on the volume of matches. In 2008, one ERF undertook cross-matching of 3 million accounts, leading to approximately 104,000 accounts (with a total value of \$39M) being matched; an average of \$400 per account. This exercise cost approximately \$625,000, being \$79.93 per 1,000 records, plus a cost of \$3.68 per successful match;³⁶ and
- (e) ERFs have adopted a wide range of investment strategies, from very conservative to very aggressive. Individual ERFs generated average annual rates of return over the three years to 30 June 2009 ranging from a low of -14.9 per cent up to 4.2 per cent.³⁷ In conjunction with high fees as a percentage of assets, these investment strategies do not effectively preserve the balance of lost members.

Legislation has been passed to give effect to the Government's 2009-10 Budget announcement that will require superannuation providers to transfer to the Commonwealth all 'lost member' accounts that have a balance of less than \$200, and all those accounts that have been inactive for more than five years and for which there are insufficient details to identify the owner. This will come into effect from 1 July 2010, and is expected to reduce the number of lost and unidentifiable accounts by about 40 per cent with consequential administrative savings for funds. It is expected that approximately \$238M will be transferred to the Commonwealth over the next three years. It will also remove the lowest value accounts from ERFs, making them somewhat more cost effective.

8.2 ERFs and choice architecture model

The Panel has adopted the view that MySuper members should enjoy the benefits of traditional trusteeship, with the trustee having more extensive responsibilities than apply in the choice sector. In similar terms, the Panel considers that the most disengaged members, whose retirement savings are held in an ERF, should have the benefit of at least that standard of care.

Therefore, the Panel considers that ERF trustees should be subject to the same duties and principles as apply to MySuper trustees; namely:

- (a) The trustee must provide members with a single, diversified investment strategy at an overall cost aimed at optimising their financial best interests;
- (b) An ERF trustee must form the view, on an annual basis, that its ERF has sufficient scale on its own (with respect to both assets and number of members) to provide optimal retirement savings for its members; and
- (c) There would be no entry (contribution) fees charged for an ERF, including on rollovers. Exit fees could only be charged on a cost recovery basis.

In addition, ERF trustees should be under an obligation at least annually to seek to match its account holders with any active account held by that person. Subject to Government agreement to the extended use of TFNs for member matching proposed in chapter 9, ERF trustees could seek the assistance of the ATO (as well as other funds) in undertaking this matching.

To facilitate implementation of these requirements on ERF trustees, the Panel considers that there should be a separate licence class for RSE licensees that act as trustee of an ERF.

Recommendation 10.15

The SIS Act should be amended to create a specific RSE licence class for trustees of ERFs. ERF trustees should be subject to very similar duties as apply to MySuper trustees (bearing in mind the different functions and characteristics of ERFs).

Recommendation 10.16

In order to have ERFs more effectively fulfil their intended function:

- (a) the RSE licence for each trustee of an ERF should be subject to the condition that they actively cross match with any active fund seeking the service. All ERF licensees must provide an online facility for people to search for lost super; and**
- (b) all funds should be required to cross match with ERFs for a new member.**

9 SUPERANNUATION COMPLAINTS TRIBUNAL

If a member has a problem with their superannuation, the first place for them to go is to the fund's trustee. Sometimes, all the member needs is clarification, but sometimes the member wants to lodge a complaint about a decision of the trustee. Under section 101 of the SIS Act, the trustee must have an internal complaints process for members.

If a member is not happy with the decision of the trustee in relation to a complaint, the member has two avenues of recourse. The member can seek to have the matter heard by a state court or the Superannuation Complaints Tribunal (**SCT**).

As part of the reforms instituted in 1993, the SCT was established under the *Superannuation (Resolution of Complaints) Act 1993 (Complaints Act)* to provide members of superannuation funds with a low cost forum for having their complaints against trustees heard. The SCT is not a court and, in fact, its processes lead to a much speedier resolution of matters than would be possible in a court. Members or trustees who are dissatisfied with the SCT's determination can appeal to the Federal Court on matters of law only.

The Financial Ombudsman Service (**FOS**) is a voluntary complaints service for the financial services industry. It does not hear complaints about superannuation that are within the jurisdiction of the SCT, but it is available to hear complaints which the SCT cannot entertain; for example, a complaint about advice given to the member by a trustee or financial adviser or complaints about an insurer.

No submissions advocated the elimination of the SCT, although one submission did suggest that perhaps FOS could handle all superannuation complaints as well.³⁸ Most submissions advocated a greater role for the SCT.

9.1 90-day time limit

The Panel does not see any reason to reduce the 90 day time period that the Complaints Act presently prescribes for the trustee to respond to the initial complaint through its internal complaints system. While the Panel would expect a trustee to be as speedy as possible in addressing member complaints, the Panel acknowledges that complaints frequently involve complex matters which require the trustee to assemble additional evidence and information and often the issue involves historic material as well as getting information from third parties.

Reducing the 90-day period could have the effect that many complaints cannot be resolved within the abbreviated period allowed, thus causing matters to be brought to the Tribunal which might otherwise be resolved without the need for escalation.

9.2 Change of name

The Panel considers that the name of the SCT should be changed to more appropriately reflect its role and suggests: ‘Superannuation Appeals Tribunal’. This name would more accurately represent that the SCT does not hear initial complaints, but only complaints that have not been settled between the trustee and the member in the first instance and are on appeal.

Recommendation 10.17

The name of the SCT should be changed to reflect more appropriately its role. ‘Superannuation Appeals Tribunal’ is suggested.

9.3 Disablement claims

The Panel recommends a change in the time limit in the Complaints Act regarding total and permanent disablement (TPD) claims. The details of this recommendation are dealt with fully in chapter 5.

10 THE SIS ACT

With a view to its goal of efficiency, the Panel has considered whether the SIS Act can be improved in this regard. Undoubtedly, the SIS Act is complex, both for the SMSF sector (as discussed in chapter 8) and APRA-regulated fund trustees. Within the SIS Act, there are provisions that apply solely to one sector. There are also other provisions which, while applying to all sectors, are more likely to have an impact on one sector than another.

These complexities can lead to inefficiencies between industry participants, such as trustees, service providers and regulators. The combination of complexity and the inherent differences between the sectors can result in regulators providing different risk assessments and perspectives, leading to

inconsistent interpretation across the regulators and, in turn, to different regulatory approaches and slower regulatory responses.

Submissions to the Review's Phase Three Issues Paper — Structure (including SMSFs) expressed a desire for the removal of unnecessary and complex requirements (aimed at APRA-regulated funds) which unnecessarily added to SMSF costs.³⁹ Many submissions pointed to a number of confusing and complex technical issues that needed to be addressed. The Panel does not intend to address these technical issues specifically.

The majority of submissions did not support separate legislation for SMSFs and APRA-regulated funds, with CPA Australia advocating the retention of a 'level playing field'.⁴⁰ There were, however, submissions that recommended separate Acts, or separate divisions (within the SIS Act) for each of the sectors. The Panel recognises that some tension exists between the desire to remove unnecessary regulation and provide clarity of law and the concern that change might lead to one superannuation sector being unfairly favoured over another. However, the 'level playing field' argument only goes so far.

While the Panel believes that legislation should not give a material advantage to one sector over another, the fact remains that there is a distinct difference between opting to have one's superannuation looked after in a large APRA fund and deciding to take the responsibility for one's own retirement savings in the SMSF sector. The choice architecture model consciously recognises this.

Further, the Panel's recommendations in this report propose a number of changes to the SIS Act, many of which would only be applicable to specific sectors of the proposed choice architecture model.

Given the legislative distinctions that have been made in the past between the sectors and the distinctions that are recommended by the Panel, the Panel is of the view that a re-write of the SIS Act would contribute to achieving greater efficiencies in the superannuation industry.

The SIS Act could be restructured so as to set out clearly those provisions that are relevant to each sector of the industry under the choice architecture model. A re-write could address the roles of the various regulators as well as other technical issues that have been identified in submissions. This should all be done in a manner that still leaves a 'level playing field' insofar as the distinct models allow.

Recommendation 10.18

The SIS Act should be re-written and restructured to separate and to identify clearly those provisions that are common for all sectors of the superannuation industry and those provisions that are only applicable to particular sectors under the choice architecture model.

11 NEED FOR A SUPERANNUATION CONSUMER GROUP

There is currently no organisation in Australia to champion the interests of superannuation members. While shareholders have the Australian Shareholders' Association, there is no superannuation-specific consumer group.

The Review has focused much of its work at recommending member-oriented solutions; measures intended to address many concerns affecting ordinary members. These include MySuper (chapter 1), SuperStream (chapter 9), improved transparency and comparability (chapter 4) and expansion of the jurisdiction of the SCT on TPD claims (chapter 5).

Consequently, the Panel is of the view that it is premature to take the additional step of recommending the establishment of a consumer body for superannuation members before these recommendations are implemented and their effectiveness assessed.

It might well be that such an organisation is formed privately and not by government.

12 GENERAL EMPLOYEE ENTITLEMENT AND REDUNDANCY SCHEME

The General Employee Entitlement and Redundancy Scheme (**GEERS**) is a legislative scheme designed to help employees who lose their jobs as a result of the liquidation or bankruptcy of their employer and who are owed a range of employee entitlements. It is administered by the Department of Education, Employment and Workplace Relations. GEERS covers up to three months unpaid wages, as well as unpaid annual and long service leave, a maximum of five weeks unpaid pay in lieu of notice and a maximum of 16 weeks unpaid redundancy entitlement.

GEERS does not currently cover unpaid employer superannuation contributions, whether they be mandatory SG Act contributions or employer contributions above this amount. However, GEERS does cover up to three months of employee contributions, both after tax and salary sacrifice that an employer has failed to forward to an employee's superannuation fund, as the contributions are effectively regarded as unpaid salary.

Extending GEERS to cover some or all unremitted employer SG Act contributions would help protect the superannuation benefits of Australian workers. It would be of particular assistance to low income earners and casual workers since there is evidence that these groups most commonly miss out on getting their superannuation entitlements. Given that GEERS is funded from general revenue, extending the scheme would represent a cost to the Government.

The Panel did find, however, that there is a strong case for placing a limit on an extension of GEERS to cover employer superannuation contributions. Imposing a limit is consistent with the treatment of other entitlements under the scheme. Lastly, the implementation of the Panel's SuperStream recommendations should also reduce the extent of unremitted employer contributions.

Recommendation 10.19

GEERS should be extended to cover up to three months of unpaid employer SG Act contributions.

ENDNOTES

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- 6 APRA, 'Superannuation Fund-level Rates of Return', June 2009 (reissued 30 March 2010).
- 7 Deloitte, Default Fund costs under the MySuper proposals, 19 April 2010, reproduced as Appendix D to Part One of this Report.
- 8 For example: <[www.legalsuper.com.au/files/File/media%20release%20\(mergers\).pdf](http://www.legalsuper.com.au/files/File/media%20release%20(mergers).pdf)>; <www.specq.com.au/about-us/merger-discussions-with-esi-super.aspx>; <www.visionsuper.com.au/news/NID/63.htm>.
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- 13 Myners P, 'Institutional Investment in the United Kingdom – A Review', March 2001, UK Treasury.
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- 15 Rice Warner, Submission no. 233, p 23.
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- 21 AXA, Submission no. 34, p 13.
- 22 Treasury, 'Product rationalisation of managed investment schemes and life insurance products – proposal paper', 14 December 2009, <www.treasury.gov.au/documents/1694/PDF/Product_Rationalisation_Proposals_Paper.pdf>.
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- 24 Tax Laws Amendment (2005 Measures No. 2) Act 2005. No. 78, 2005, <[www.scaleplus.law.gov.au/ComLaw/Legislation/Act1.nsf/0/20A29F2E13F14E5BCA257034002A9FE6/\\$file/078-2005.pdf](http://www.scaleplus.law.gov.au/ComLaw/Legislation/Act1.nsf/0/20A29F2E13F14E5BCA257034002A9FE6/$file/078-2005.pdf)>.
- 25 IFSA and Rice Warner Actuaries, 'Superannuation Fees Report – Market Segment Analysis at 30 June 2008', December 2008,

- <www.ifsa.com.au/documents/2008_1218_FINAL%20RWA%20Superannuation%20Fees%20Report%202008.pdf>.
- 26 APRA, 'Quarterly Superannuation Performance', September 2009.
- 27 Essentially, the interest rate spread is the difference between the return offered to the holder and the return available to the institution in its lending and investment activities.
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- 30 APRA, 'Quarterly Superannuation Performance', March 2010.
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- 32 For example, ASFA, Submission no. 147, p 69; AIST, Submission no. 150, p 85.
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- 34 SIS regulation 10.06.
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- 36 SuperPartners - unpublished data.
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- 39 Taxation Institute of Australia, Submission no. 365, p 5.
- 40 CPA Australia, Submission no. 324, p 9.

