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Cooper Review releases preliminary report on governance

The Review Panel on the Cooper Review's first issues paper on the governance of superannuation funds has released a preliminary interim report on Phase 1 of the Review, "*Clearer Super Choices: Matching Governance Solutions*".

The Panel is due to deliver a final report to the government by 30 June 2010.

We have summarised the key issues raised in the preliminary report below.

The preliminary report can be broken down into three broad areas:

- an "enhanced architecture for super", which the Panel calls a "choice architecture model"
- items that the Panel is still considering
- items that the Panel has decided not to pursue

1. A "choice architecture model"

A central concept in the preliminary report is the notion of a "choice architecture model" for Australia's superannuation system.

The model classifies members into three main types: universal, choice and self-managed. Universal would involve the least degree of member choice and member responsibility; self-managed would involve the most. All organisations would have to comply with the rules and regulations applying to a particular category, with very clear distinctions between the universal and choice categories.

Within this context, the Panel found that most people would be best served by lower-cost "universal" super funds, offering a single investment strategy and limited financial advice instead of the more costly options many are now using.

Others who want more control over their super - and more investment options - could opt for a higher-cost, more tailored "choice" fund, or a self-managed super fund.

Alternatively, people with no interest in the super system would be placed in conservative, extremely low-cost funds.

2. Items that the Panel is still considering

Listed company standard of governance

The Panel suggests that governance of APRA-related super funds should be equivalent to the standard applying to a listed company. The Panel is questioning whether the Australian Securities Exchange (ASX) Corporate Governance Council's Principles and Recommendations should be developed for superannuation and their trustees.

Trust model

The first issues paper on governance indicated that superannuation funds operate under a trustee model derived from the general law of equity. Given the nature of today's public offer, and other large, super funds, the paper questioned whether this model was still appropriate?

The interim report explains that few submissions seriously questioned the continued relevance of the trust model. On the one hand, many submissions identify features of the trust model that make it attractive; on the other hand some have identified the trust's flexibility as a source of risk.

Codification of duties

The first issues paper also questioned whether the full or partial codification of duties to act in good faith, avoid and/or disclose real or apparent conflict of interest and not seek personal profit would have a significant impact on trustee governance and the priorities given to various aspects of their operations?

The interim report indicates that submissions strongly opposed codifying trustee duties because of the potential for uncertainty if the codification were imperfect or incomplete in any respect.

Trustee knowledge, skills and training

The first issues paper questioned whether trustees were adequately equipped to do their jobs and/or whether there was too much expected of trustees?

The interim report found that submissions generally suggested that higher standard of knowledge and skills for trustee directors would be beneficial to members and the industry.

Performance measurement

The first issues paper questioned how trustee performance is measured. How should it be measured? Can and do trustees adequately measure their own performance? Are there adequate benchmarks? What are, or should be, the consequences for under-performance?

The interim report suggests that trustees should undergo regular, possibly annual, performance reviews. The Panel agrees that the actual 'return to members' may be the most significant indicator of trustee performance as such a return captures both investment performance and the trustee's management of costs and expenses. The Panel also believes that all trustees should have a standing committee charged with overseeing the performance appraisal of senior management as well as the board itself.

Accountability to member

The first issues paper questioned whether super funds, individually or as a class, are sufficiently accountable to members?

The Panel is considering alternative ways to make trustees of super funds more directly accountable to members, more particularly through disclosure. The Panel also considers recommending a change to the SIS Act so that trustees are required to give reasons for any decision when the trustees are responding to a member complaint.

Apprehension of personal liability

The first issues paper questioned whether trustee behaviour is adversely affected by their apprehension of personal liability, thereby making fund governance more problematic, or whether there is an adequate balance between the duties of trustees and their potential liability in the case of a contravention.

Some submissions did not think it was a significant issue, while others indicated that trustees found it hard to obtain affordable and suitable indemnity insurance.

Composition of the boards and succession planning

The first issues paper indicated that around three-quarters of all trustees are male and over 50 years old. Some trustee directors stay in office a long time and others are trustees of more than one fund. So what rules should there be around qualifications, length of time in office, multiple trusteeships and selection processes for trustees?

The Panel believes that APRA and the boards themselves should give more scrutiny to factors such as the size of the board or length of tenure for directors. However the Panel does not believe there should be legislative requirements in relation to these.

Reliance on outsourcing

The first issues paper explained that in many cases, trustees engage third party experts to perform a large number of the functions of the fund. Have funds struck the right balance between internal and external expertise?

The interim report warns that trustees must be vigilant that they do not become so reliant on the outsourced service provider that they become unable to assess the provider's performance adequately.

Conflicts of interest and duty

The first issues paper questioned how trustees who are associated with a service provider manage the conflict that arises between the interests of members and their own or associated interests? What should the rules be where a trustee has a relationship (by way of employment, directorship or ownership) with a fund service provider?

The interim report explains that under current law, only the trustee of the fund is a fiduciary and bear obligations to fund members and beneficiaries. The report questioned whether fiduciary obligations ought to be imposed more broadly on service providers.

The Panel notes the recommendation of the Ripoll inquiry that financial advisers be required to act in the 'best interests' of their clients.

Complexity

The first issues paper was pondering whether the complexity of the superannuation system creates its own governance problems. If so, what are some examples? Are there any governance requirements that are no longer necessary or impose costs that outweigh intended benefits?

The Panel indicates that it wishes to use this Review and the Henry Review to settle a stable policy framework for superannuation that can last for years and prevent constant change in the legislation.

The Panel does not favour the establishment of a single pension fund regulator.

Consolidation of funds

The first issues paper questioned whether trustees of small funds should be obliged to take steps to merge the fund in the pursuit of economies of scale in the long-term interests of members?

The Panel stopped short of recommending any forced consolidation of smaller pension funds. However it did put forward a possible requirement for smaller funds to justify why merging or increasing scale would not benefit members.

3. Items that the Panel has decided not to pursue.

The following ideas and issues have been “shelved” by the Panel:

- ↳ government-directed investing
- ↳ prescribing adoption of the UN Principles for Responsible Investment (UNPRI)
- ↳ the “tilt toward equities” issue
- ↳ the “portfolio rebalancing” issue
- ↳ restrictions on stock lending
- ↳ new standards-making power for APRA
- ↳ tendering of all service provision agreements.

You may want to refer to the report for further details: http://www.supersystemreview.gov.au/content/downloads/clearer_super_choices/Clearer_super_choices.pdf.

Source

Australian Government, Review into the Governance, efficiency, structure and operation of Australia’s superannuation system, Clearer Super Choices: Matching Governance Solutions, 14 December 2009.

Mallesons Stephen Jaques, Cooper Review releases preliminary report on governance, 15 December 2009.

Cooper Review releases phase 3 issues paper

The government has released for public consultation an issues paper dealing on structure, being phase three of the Cooper Review.

Submissions on the Cooper Review’s third issues paper on structure of superannuation funds are due back by 19 February 2010.

Preliminary recommendations will be released in April-May 2010.

When the Review talks about the ‘structure’ of the industry, it means the way in which superannuation is organised, being comprised of a number of unique sectors and products.

Some of the key issues relating to structure (not including SMSFs) raised in the paper include:

Defined benefit funds

Should there be stricter funding standards set out in part 9 of the Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations) so that there is greater protection for members and so that APRA could have a direct role in working with the employer to remedy the deficit?

Should actuarial reports be required more frequently than every three years? Should a mechanism be provided under the SIS Act with a view to protecting members’ benefits against employer sponsor insolvency?

As employers have a particular interest in defined benefit funds, should trustees of defined benefit funds (or sub-plans) be required to have employer representatives on their boards (assuming that equal representation is not otherwise required for that trustee board)?

Are there other examples of legislation in recent years which has resulted in problematic application for defined benefit funds?

Small APRA funds

Why have small APRA Funds (SAFs) proven so much less popular than SMSFs? Why do SAF members choose these vehicles over SMSFs? What are the additional trustee responsibilities in managing SAFs and how are the risk management frameworks in place appropriate for managing the risks of governing multiple SAFs? Do SAFs offer advantages for the retirement income system by comparison with SMSFs or other APRA-regulated funds? Are there structural impediments to their take up? If so, what are they and how could they be removed?

Retirement Savings Accounts

Could RSAs be enhanced by removing the capital guaranteed nature of the product and allowing any prudentially regulated entity to provide an RSA? What would be the advantages and disadvantages of an enhanced version of this product playing a larger part in the superannuation system?

Approved Deposit Funds

Do ADFs serve any residual purpose? In the interests of simplification, should this institutional class be closed to new members and the capacity to create new ones removed?

Public sector

Should the Government accept the choice architecture model proposed in the Review's Phase One — Preliminary Report, there would need to be discussions between the Commonwealth and the States about the implications, if any, for exempt public sector schemes.

Compulsory or voluntary insurance

Should the minimum level of cover required in a default fund (or a 'universal fund' under the choice architecture model) be tailored to other factors such as family situation and financial circumstances? Should the amount of cover be maintained or indexed, presumably with the cost of cover increasing with age, or should a constant insurance fee be applied with the insured benefit decreasing with age?

Should all members be able to opt out of insurance? Should funds be permitted, for example, to offer life insurance as an opt-in default for young, single members? Should commissions be payable on default fund life insurance? If so, why?

Should default funds also be required to offer TPD cover in addition to death cover?

What are the drivers of a fund's proceeds ratio? Are there ways that death and TPD insurance could be provided more cheaply to members? Are the apparently wide variations in proceeds ratios between fund types explained solely by occupational, socio-economic and demographic factors?

Self-insurance

Is it in members' best financial interests for certain superannuation funds to continue to be allowed to self-insure death and TPD benefits? Should defined contribution funds ever be allowed to self-insure death and TPD benefits?

Is there any reason that defined benefit funds (and sub-plans) shouldn't be allowed to self-insure death and TPD benefits so long as actuarial advice is obtained on the funding needed and APRA is satisfied as to the financial strength of the employer? Would this lead to costs savings for employers and members?

Income protection

What is the right approach here?

Other pooling ideas

Given the apparent cost of life and TPD insurance to the superannuation sector as a whole, are there more radical ways to address the need for super fund members to have life insurance? How could super funds create sufficient risk pools to be able to underwrite such insurance themselves?

Super in post-retirement phase

Should more be done to address financial risk in retirement, rather than just longevity risk? Alternatively, should more be done to ensure that post-retirement assets are not invested too conservatively?

Would a similar system in Australia increase the attractiveness of guaranteed annuities for retirees?

What else can be done to improve the availability of retirement income stream products in the Australian market (such as indexed annuities and deferred annuities)?

Collective pension schemes

Is there room for another model in Australian superannuation, being a model that sits in between the defined benefit model on the one hand and the defined contribution model on the other? Is such a model viable in the face of an ageing population?

Should it be mandatory for trustees to manage pension assets separately from accumulation assets? If not, why not? If yes, what are the specific benefits that would be derived and what additional costs might be incurred? Should there be limits to ensure member level diversification in order for income streams to be paid as required?

Security of super

What, if any, additional measures should be adopted to enhance the security of superannuation funds? What is a suitable definition of fund failure? Do we need a super guarantee corporation or other statutory insurance to cover a fund failure?

Impact of superannuation fraud and theft

What are the areas of greatest vulnerability of superannuation funds to fraud or theft? How is the industry best protected from systemic risk arising from a loss of confidence in the security of retirement savings?

Use of superannuation for criminal purposes

Should rollovers to SMSFs be designated services for the purpose of the AML/CTF Act? What mechanisms could be established to inhibit the repatriation of criminally obtained funds from overseas into an Australian SMSF under the guise of extraordinary foreign investment returns?

Indigenous Australians

Are there ways in which the superannuation system could better accommodate the needs of indigenous Australians?

Women

Excluding issues of adequacy resulting from broken workforce participation and lower average incomes (which fall within the scope of the Henry review) are there specific issues which disadvantage women in their interaction with the superannuation industry? If so, how could these be addressed?

Are there other clearly identifiable groups for whom specific provision could and should be made within super?

Allocation of members to default funds: role of industrial awards

Is the industrial relations mechanism the best way to allocate employees to a default superannuation fund? If not, what other mechanisms might be adopted to improve outcomes for members?

Dispute resolution

Would there be value in the creation of a specialist superannuation court under Commonwealth legislation? Possible roles for such a court could include:

- ↳ consideration of trustee proposals to facilitate mergers of funds where complex member;
- ↳ rights issues were involved;
- ↳ legacy product rationalisations;
- ↳ power to give directions to trustees seeking determination of complex issues; and
- ↳ resolution of disputes with regulators.

Risk-sharing

Currently, the investment risk in the accumulation phase of superannuation rests mostly with the individual. Should the Government assume some of this risk, given that it largely underwrites both investment risk and longevity risk in retirement by way of the age pension?

Should the Government provide some additional certainty to alleviate individual anxiety in volatile financial markets? How could this be offered without representing an undue burden on the Budget?

Should the structure of superannuation include some defined benefit features, rather than solely an accumulation approach? Who could underwrite the defined benefit component?

Could default funds be required or encouraged to incorporate an investment fluctuation reserve into their default investment option, so as to allow a more aggressive investment approach without a commensurate increase in volatility?

How might they address free-riding, where individuals select a fund after its investment reserve had been built up?

How costly would it be to administer a scheme whereby entitlement to share in reserve distributions vested progressively over a period of, say, five years?

Capital requirements

Given the important societal role that superannuation plays and the significant operational risks that all trustees must manage, as a matter of protection for members, should capital be required for all trustees of super funds other than SMSFs?

If so, what sort of risk factors ought to be considered in setting capital requirements? What amount of capital should be required? Should a public offer trustee without capital of its own be able to continue to rely on an approved guarantee or the fact that its custodian may have the \$5 million capital backing? Should a custodian be required to have the minimum capital requirement in its own right, rather than being able to continue to rely on an approved guarantee? Currently, the same \$5 million is required for the custodian whether they are being relied upon by one trustee or many. Should the capital required for custodians be related to the number of fund trustees that rely on that custodian in meeting the trustee's capital requirements, and the assets they hold?

Source of permanent capital

Would it assist super funds to be able to create a listed entity or entities which could hold Longer-horizon assets, such as infrastructure, providing permanent capital for such investments?

Legacy products

'Legacy products' are drivers of increased cost and operational risk throughout the financial services industries. To what extent are they a problem in superannuation? What measures can be taken to facilitate elimination of legacy products (and movement of legacy members) without material disadvantage, in circumstances where a successor fund transfer might not be available?



Innovation

Is there any reason why super funds shouldn't be able to compete in the 'reverse mortgage' market (as this seems peculiarly compatible with the retirement income function of super funds)?

Are there any specific impediments at present to super fund trustees developing new product offerings? If so, what are they?

Please refer to the issues paper for further information: http://www.supersystemreview.gov.au/content/downloads/structure_issues_paper/Phase_3_Structure.pdf.

Source

Australian Government, Review into the Governance, efficiency, structure and operation of Australia's superannuation system, Phase three - Structure, 14 December 2009.

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