FSC FINANCIAL SERVICES COUNCIL

Ms Melissa Bray
Senior Adviser
The Treasury
Canberra ACT 2600

4 November 2012

Dear Ms Bray

FSC SUBMISSION – SUPERANNUATION LEGISLATION AMENDMENT (FURTHER MEASURES) EXPOSURE DRAFT 2012

Thank you for the opportunity to provide a submission on this exposure draft.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 members who are responsible for investing $1.8 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Please find our submission enclosed. We look forward to discussing the contents with you. I can be contacted on 02 9299 3022.

Yours sincerely

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SENIOR POLICY MANAGER

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FSC SUBMISSION – SUPERANNUATION LEGISLATION AMENDMENT (FURTHER MEASURES) BILL 2012

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1. SCT

Subection 14(6A) of the *Superannuation (Resolution of Complaints) Act 1993* (Cth) (**SRC Act**) currently prevents the Superannuation Complaints Tribunal (**SCT**) from dealing with a member's complaint about a decision of a trustee relating to the payment of a benefit because of total and permanent disability unless the complaint is made within 2 years after the trustee's decision.

The Exposure Draft contains an amendment to extend the period within which the SCT can hear a complaint lodged to the following:

(a) In the case of a person who, before the trustee made its decision, permanently ceased particular employment because of the physical or mental condition that gave rise to the claim for disability benefit—4 years after the trustee's decision;

(b) In any other case—6 years after the trustee's decision.

The FSC believes the timeframes proposed in the ED are too long.

The amendment is based on a recommendation of the Super System Review which found that time limits for lodging complaints to the SCT were out of alignment with related time limits for making claims through the courts. However, the FSC believes it incorrect to compare time limits for SCT complaints to with the timeframe for court claims.

This is because time limits for court claims are measured from the time of the event. In the context of total and permanent disablement claims, the period for a court claim would be measured from the time the person became totally and permanently disabled.

As there is no legislated time limit within which a member must lodge a claim with a trustee for total and permanent disablement benefits, the period between time of the event and time of claim can be lengthy in some cases. Accordingly, an extension of the period to lodge a complaint with the SCT results in a significant time period between date of event and date of complaint to the SCT – potentially much greater than that permitted in relation to court claims.

We believe that the adoption of this recommendation is likely to create the potential for increased incidence of fraudulent and non-genuine complaints and could increase premiums for all members.

Further, the ‘longer tail’ of potential liabilities under this timeframe will be particularly problematic where there is a change of insurer. Increasing the timeframe to up to six years of a member from the date of the trustee's decision will also create difficulties in forming a retrospective view of the member’s ability to work and the ability of insurers and claimants to obtain retrospective medical reports. This is in addition to the limitations of accessing employer and medical records after such a long period.

We recommend the SRC Act be amended to extend the timeframe during which the SCT is able to hear complaints relating to claims that have been lodged with the trustee to within three years of the date of the trustee's decision.

Such an amendment will address a situation where a member is entitled to workers’ compensation benefits for period of 2 years (which is typically the case). We believe this is an appropriate compromise that benefits consumers without adversely affecting premium costs.

2. DUAL REGULATED ENTITIES

Introduction

It is common in the financial services industry for a body corporate to act as both an RSE licensee (that is APRA regulated fund as an RSE licensee, i.e. an APRA regulated superannuation trustee) and also licensed (with ASIC) as a responsible entity.

Currently, the body corporate's activities as:

(a) an RSE licensee are governed by the RSE licensing rules in the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) and (in many cases) the Australian financial services licensing rules in the *Corporations Act 2001* (Cth) (**Corporations Act**); and

(b) a responsible entity (**RE**) are governed by the managed investment scheme and Australian financial services (**AFS**) licensing rules in the Corporations Act.

In those situations where the trustee of a superannuation fund holds both an RSE licence and an AFS licence, section 912A of the Corporations Act exempts the trustee from the following obligations as the holder of an AFS licence:

(a) the obligation to have available adequate resources (including financial, technological and human resources) to provide the financial services covered by the AFS licence and carry our supervisory arrangements; and

(b) the obligation to have adequate risk management systems.

The Exposure Draft proposes amendments relating to (among other matters) resource and risk requirements for certain **dual** regulated entities. Dual regulated entities which are entities which are both an RSE licensee (that is APRA regulated as an RSE licensee, ie an APRA regulated superannuation trustee) and also licensed (with ASIC) as a responsible entity.

The proposal under the ED is to remove the current exemption for these dual regulated entities from having to meet the Corporations Act resources and risk management requirements applicable to responsible entities (essentially, ASIC's requirements). As a result of these proposed amendments:

(a) the obligation to have available adequate resources would apply to the body corporate in relation to its activities both as an RSE licensee and as a responsible entity; and

(b) the obligation to have adequate risk management systems would also apply in relation to activities both as an RSE licensee and as a responsible entity, except to the extent that a particular risk relates solely to its activities as an RSE licensee.

The exposure draft proposes a start date of 1 July 2014 to remove the exemption. That is, the ED proposes that from 1 July 2014 entities which are both an RSE licensee (regulated by APRA) and a responsible entity (regulated by ASIC) would need to meet both APRA and ASIC's financial resource requirements.

Consistency of application

We recognise the challenges faced by APRA and ASIC in developing the various capital proposals and achieving a level of consistency and coordination. This is made particularly difficult due to their different mandates of prudential supervision and consumer protection, and their responsibility for only certain segments of the industry.

For example, ASIC has recently introduced a "revenue" based capital formulation for managed investments, APRA is seeking to introduce a "FUM" based capital formulation to cover wealth management activities within a conglomerate groups (known as "Level 3" proposals – deferred until 2014) but superannuation funds have no prescribed capital formula (as per latest draft prudential standards).

Accordingly, it means is that a super fund which manages its own investments (increasingly the case), may be outside the capital requirements that apply to competitors and at an advantage vis-à-vis fund managers who are also required to hold a prescribed amount of liquid capital by ASIC. This gives rise to regulatory arbitrage.

Given these challenges, we believe that it is critical that prior to any significant proposals being finalised, including this amendment, that they are considered by the Council of Financial Regulators with a view to determining their effect on competition and financial stability.

For example, many of our members have indicated that the removal of the exemption effectively doubles the capital reserve that must be held against their RSE and RE businesses – this may be somewhat onerous in light of new operational risk reserve requirements. Also, in some cases, the RSE Licensee invests into the schemes operated by the same entity as RE. To

avoid double-counting, the capital requirements in respect to those activities of the RSE Licensee/RE should be as applicable to the RSE Licensee alone.

We recognise and appreciate the Government's rationale for removing the existing exemption in order to address the gap in regulatory coverage that may exist for certain REs. However, there are unintended consequences that may flow from this decision without consideration of how APRA and ASIC's capital regimes operate alongside each other.

We do not believe this to be the Government's policy intent, which is seemingly to instead address situations where REs may be able to take address the potential for regulatory arbitrage.

We recommend that Treasury, APRA, ASIC and industry work consultatively to develop a risk-based holistic framework for determining the approach to capital across the wealth management industry that is applied consistently.

This is particularly important given the government is yet to consult on an approach to developing a holistic framework. Until the government (and the relevant agencies) formulate a co-ordinated approach to capital requirements across dual-regulated (and conglomerate) entities, we are of the view that amendments may be necessary.

We recommend the legislation should stipulate that the same assets can be held as a capital reserve against the APRA and ASIC requirements. This will ensure that conglomerate wealth management operations are not unduly burdened by segregated capital requirements in the absence of appropriate consultation between government and the regulators. Entities will be subject to the higher charge of the RSE or RE requirements and the existing gap in regulatory coverage will be closed.

The resulting increases in capital charges that will occur if these recommendations are not adopted may be significant. They will not be the result of any increase in risk, but rather is the result of a lack of co-ordination between government and government agencies charged with supervising RSEs and REs.

We further recommend that this measure commence on 1 July 2015 to provide an adequate transition period.

3. OTHER MEASURES

Contributions paid to a MySuper product

The *Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2012* (**Tranche I**) will insert a new section 29WA into the SIS Act to make it a strict liability offence for contributions in relation to which no member direction has been given to be applied to a product that is not a MySuper product of the fund [1]from 1 January 2014.

The test in Tranche I is found in s29WA(2), being whether the member had given an "***election in writing that the contribution is to be paid into a specified choice product***". The ED amends this test, so that the treatment of the contribution will instead depend on whether the person has given a "***direction in writing that the contribution is to be invested under one or more specified investment options***".

As outlined in previous submissions, the FSC and its members have serious concerns over the current drafting in that it will create a significantly wider application than "default members". According to the 2010 statement: "(t)he standards that a MySuper product must meet will be set out in legislation and enforced by the Australian Prudential Regulation Authority (APRA). Funds that do not operate as default funds, such as self managed superannuation funds (SMSFs) or choice products, will not have to comply with these additional standards."

Similarly, the Regulatory Impact Statement did not countenance the inclusion of members in 'choice products'. It repeatedly refers to "default members":

The stated policy and RIS considered "default members" to be those defaulted into superannuation arrangements through employment arrangements and not members in "choice" superannuation funds (or products) where an active election, i.e. completion of a PDS, had been made.

Therefore, we do not believe it is appropriate to either;

a) transfer member balances to MySuper which are invested due to a choice of fund decision, i.e. where an individual may have a defaulted balance within a specifically elected a 'choice product' through the completion of PDS (see or

[1] [1] Due to the effect of s29WA(2), the applicability of s29WA is questionable where the fund does not offer a MySuper product. Our view is that s29WA does not apply in circumstances where the fund does not offer a MySuper product.

submission on Further MySuper and Transparency Measures dated 3 October 2012 regarding section 20B) or

b) apply the contributions to MySuper for members who have specifically elected a 'choice product' through the completion of PDS as potentially captured under Schedule 1, item 44, paragraph 29WA(1)(c) and item 46, subsection 29WA(4)

We believe limiting the application of MySuper to "default members" enrolled through employment arrangements reflects the Government's MySuper policy objectives.

If a member has actively chosen their product or fund then it is reasonable for this money to be treated as 'choice' and it is unreasonable for the Trustee through the application of this regulation to override that decision.

Our recommendation is to word any references to the application of these rules as being applicable only to "standard employer sponsored members".

Where a trustee has not received a direction as to the investment option a contribution is to be invested in (in whole or part), that part of the contribution for which no explicit direction has been received must be paid to a MySuper product of the fund. This narrows the circumstances in which trustees will be able to apply contributions to products that are not MySuper products. For further see the Tranche IV explanatory memorandum 6.31-6.33 in the attached PDF.

The issue with the amendment to s29WA(2) contained in the ED is that it will require trustees to perform member level attribution. For choice/personal superannuation products, our members will be required to effectively confirm for all members with a balance in the product's default option whether or not these members have "ticked the box" on the application form and were not "defaulted" into that option (regardless of the fact that nearly all of these members will have made an active investment selection eg. to invest in that product).

Recommendation: That s29WA does not apply in circumstances where the member does not already hold a MySuper product within the fund.

Statements of advice

Currently, s947D(1) of the Corporations Act imposes quite onerous requirements for what is referred to as replacement financial product advice. It requires a provider of financial product advice that recommends a client replace a financial product with another financial product to include certain requirements in their statement of advice (**SoA**), including:

- charges for the disposal of the current product and those that will or may be imposed on the new product;
- the benefits that the member will lose; and
- information about any other significant consequences of acting on that advice.

The ED contains an amendment to section 947D(1) to extends this requirement to a situation where:

- a MySuper product and the investment options of a choice product are offered to members within a single financial product; and
- financial product advice is provided to a person to switch from a MySuper investment option to a choice investment option.

This is despite the fact that such a change might not ordinarily be expected to be the cancellation and issue of a new financial product and might otherwise have been advised on the basis that this was simply an investment allocation within the one product.

Recommendation: Retain the existing section 947D(1) of the *Corporations Act 2001* (Cth).

Transfer of accrued default amounts in defined benefit funds

The requirements relating to the transfer of accrued default amounts in item 7 of Schedule 6 of the Superannuation Laws Amendment (Further MySuper and Transparency Measures) Bill 2012 (Section 29SAA) are flawed and in some cases, from 2017 onwards, it will be impossible for some RSE licensees to comply.

The concern relates to new accrued default amounts which arise after 1 July 2017 in a defined benefit fund which has offered a MySuper product for some time.

In a defined benefit fund, accrued default amounts can arise at any time when a member's lump sum defined benefit is crystallised (generally resulting from the member leaving the employer's service).

This is because, at this point, the member ceases to be a defined benefit member and the crystallised defined benefit will (unless the member has given already given the trustee instructions as to how the amount is to be invested) become a default amount attributed to a member who is not a defined benefit member and so fall into the definition of accrued default amount.

Existing rules in many defined benefit funds currently result in the automatic allocation of these crystallised benefits to the fund's cash option (or a very conservative option) as it is generally considered unreasonable for a member's defined benefit to suddenly become subject to investment fluctuations on leaving employment. The member would then be advised of the details of their crystallised benefit and be given the opportunity to either transfer their benefit to another fund or change the investment option. Any automatic or compulsory transfer which exposes the member to potential investment losses on the crystallised benefit may not be in the member's best interests.

We note transferring crystallised defined benefits to a MySuper can also result in an increase in withdrawal fees incurred by the member. Currently withdrawal fees for defined benefit members are almost always met from employer contributions rather than reducing the member's benefit. If a crystallised defined benefit is transferred to a MySuper product, a withdrawal fee (assuming one applies in the MySuper product, as is generally expected to be the case) would become payable by the member on subsequent withdrawal from the MySuper. This likely consequence is another reason why the transfer may not be in the member's best interests, particularly where the member wishes to cash their benefit, purchase a pension or rollover to another fund in the short term.

As currently written, the Bill requires the RSE licensee to elect to transfer accrued default amounts arising after 1 July 2017 to the fund's MySuper within 30 days of the fund receiving approval to offer a MySuper (which could be from 1 July 2013). As a crystallised defined benefit arising after 1 July 2017 would be a default amount attributed to a member who is not a defined benefit member, it would become an accrued default amount. Clearly it will be

impossible to achieve such a transfer in the required time frame as the time for transfer would have ended well before the accrued default amount arose.

A similar problem arises where a defined benefit is crystallised shortly before 1 July 2017 although in this case, the transfer must occur by 1 July 2017 (assuming the fund received approval to offer a MySuper more than 30 days before 1 July 2017). In such cases it may not be possible to comply with APRA's proposed requirements of providing members with three months notice of such transfers.

For an accumulation fund, it is unlikely new accrued default amounts will arise in a fund which has offered a MySuper productfor some time. (An exception is through a fund merger and this is covered further in the following section.)

We recommend amending the definition of accrued default amounts to exclude crystallised defined benefits.

Defined benefit member with an additional MySuper account

We understand it is not necessary for any contributions for a defined benefit member to be allocated to a MySuper account. However there will be occasions where a defined benefit member elects a MySuper account (and will therefore be subject to the MySuper fee requirements).

On the other hand, Schedule 2, Item 6 (section 68AA) indicates the MySuper insurance requirements do not apply to a defined benefit member. In other words, it appears it would not be necessary to provide a defined benefit member who also has a MySuper account with opt-out MySuper insurance.

Whilst we support this interpretation, we are concerned with the requirements of proposed Section 29TC(1)(b) which requires all MySuper members to be provided with the same benefits, options and facilities. We assume the express provisions of section 68AA would override the provisions of 29TC(1)(b), however, this is not entirely clear.

Another concern relating to Section 29TC(1)(b) relates to whether the provision of a defined benefit to one or more defined benefit members who are also MySuper members would

require all MySuper members to be offered defined benefits. This would clearly be impractical with employers unwilling to provide such benefits.

We recommend that greater clarification be provided on the insurance requirements for defined benefit members with an optional MySuper account and the the impact of Section 29TC(1)(b) for such members.

Director provisions

Under the current section 55(5) directors are protected from a beneficiary of the fund for loss or damage where they have followed the direction the beneficiary provided that the investment was made in accordance with the investment strategy formulated by the directors.

The *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth) amends section 55(5) from 1 July 2013. Under the new section 55(5):

- Directors will be protected from a beneficiary of the fund for loss or damage only where the trustee have complied with the following covenants that apply to the trustees in relation to the investment made by the beneficiary:
    - all of the covenants (and not just the covenant relating to the formulation of and the giving effect to an appropriate investment strategy); and
    - for a MySuper beneficiary, the new obligations in relation to MySuper.

The tightening up of the existing defence in section 55(5) is likely to raise a concern as directors may only rely on that defence if it has complied with all the covenants and not (as is currently the case) just demonstrating that the investment was made in accordance with the investment strategy formulated by the trustee under a covenant.

Recommendation: Consistently with the Super System Review's recommendation for an investment safe harbour rule, revert to the previous section 55(5) to provide a meaningful "safe harbour" for directors and trustees who have acted in accordance with the entity's investment strategy.