# 3. Superannuation regulation: basic issues

## Introduction

3.1. This chapter considers what regulatory controls are necessary for superannuation schemes. It outlines the main arguments for and against regulatory intervention in the financial system, and explains how those arguments are relevant to superannuation. It discusses the increased reliance on privately funded superannuation, which is a feature of the Commonwealth's retirement incomes policy, and why this requires a greater level of prudential supervision than currently exists. It outlines the essential elements and objectives of the proposed regulatory regime and considers whether there are other options to protect the interests of members, such as insurance to guarantee benefits, or to protect against negligence or fraud.

## Government intervention in the financial system — Campbell Committee

3.2. The case for government intervention in the financial system in general was thoroughly investigated by the Committee of Inquiry into the Australian Financial System.[1] It identified six possible reasons for intervention

- to promote efficiency
- to promote diversity of choice
- to ensure competitive neutrality
- to promote stability of the financial system
- to promote the macroeconomic stability
- to achieve social objectives.[2]

The Committee concluded that there is a clear justification for government intervention where it is necessary to ensure free, fair and competitive markets.[3] It also endorsed a limited role for government intervention to safeguard the underlying stability of the financial system. It did not support intervention in the financial sector to achieve economic policy purposes, nor did it support intervention for the purpose of achieving social objectives.

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1. See Campbell Committee *Report*.
2. Campbell Committee *Report* para 1.8.
3. Campbell Committee *Report* para 1.80.

## Government intervention — superannuation

### *Background — new superannuation policy*

3.3. *Voluntary superannuation.* Until the announcement in the 1991–92 Budget speech that superannuation would form a 'vital part' of the Commonwealth's retirement incomes policy, superannuation was simply a voluntary form of saving for retirement. The funds invested came principally from the discretionary savings of investors. The only features distinguishing superannuation from other collective investments were that a contribution to a superannuation scheme could not be withdrawn at will[4] and that substantial tax concessions were available.[5] Superannuation was encouraged as a form of saving by tax concessions, but these were of benefit only to those who could afford to save in this way. They did not have the effect of bringing everyone into superannuation schemes.

3.4. *Award-enforced superannuation.* In the 1986 National Wage Case the (then) Conciliation and Arbitration Commission made provision in the National Wage Case principles allowing for agreed superannuation improvements not exceeding the equivalent of 3% of ordinary time earnings of employees. In 1987 the Commission determined that it would continue to certify agreements or make consent awards concerning superannuation, and would also be prepared to arbitrate on superannuation where negotiations and conciliation were exhausted. Award superannuation has been implemented progressively since the 1986 and 1987 National Wage Case decisions and many more people have become members of superannuation schemes.

3.5. *Superannuation and retirement incomes policy.* The decision by the federal Government in 1991 to introduce the Superannuation Guarantee Levy (SGL), and to increase gradually the level of compulsory employer funded superannuation contributions from 3% to 9% of employee earnings, has transformed superannuation. Instead of depending on the implementation of awards, employer contributions will be enforced through the levy. Superannuation will

4. Although prior to the introduction of standards relating to preservation, many superannuation benefits were more easily accessible.
5. The earnings of complying superannuation schemes are now taxed at 15%. Until 1 July 1988 they were tax free. For most other collective investment schemes, earnings are taxed in the hands of the investor at the investor's marginal tax rate. It is acknowledged that other collective investments, for example, insurance bonds, also attract tax concessions. In general these concessions are not as large as those applying to superannuation schemes, although capital gains and profits of gold produces were tax free, like the earnings of superannuation schemes.

no longer be a voluntary collective investment used by a minority of the workforce to supplement their publicly provided tax financed pension. It will now be an integral part of retirement incomes policy, a policy which aims to

> encourage people to save for their retirement so that they can enjoy a higher standard of living than would be possible by reliance on the age pension alone.[6]

It is not intended, however, to replace entirely the tax funded pension with employer or employee financed superannuation. Unless the level of compulsory employer contributions under the SGL legislation is increased, superannuation will remain a supplement (albeit a significant one) to the pension.

*Should there be greater intervention in the provision of superannuation?*

3.6. Retirement incomes policy is intended to achieve a public purpose — higher retirement incomes — by requiring the use of a private delivery system — investment in superannuation schemes. The compulsory nature of the investment gives government a special interest in the success of those schemes. The more successful superannuation investments are, the less resort there will be to publicly funded old age pensions. Conversely, if the returns on superannuation investments are diminished, through incompetence, negligence or fraud, people may have to be provided for unexpectedly from tax revenue. So long as superannuation remained a voluntary private investment decision, there was no need for the prudential supervision of superannuation to be any greater than that applying to collective investments generally. The question for the Review is whether, and if so, to what extent, these policy changes should result in a greater degree of government intervention in the operation of superannuation schemes.

*Failure of superannuation schemes*

3.7. *Nature of the risk.* Investors in superannuation schemes generally face three types of risks: liquidity risk, institutional risk[7] and investment risk. The first two types of risks are firm specific. Liquidity risk relates to the ability of a scheme to meet its short-term financial obligations. Institutional risk concerns the risks faced by members of a scheme that their scheme will fail, that is, its assets will be insufficient to meet its obligations.[8] These risks operate in particu-

6. Treasurer's press release No 73, 20 August 1991.
7. It is recognised that the term institutional risk is more commonly used to refer to the probability that a firm in which an investor has invested cannot meet its financial obligations, or that its assets are insufficient to meet those obligations, even after liquidation. It is not used in that sense in this chapter.
8. This is particularly relevant for members of defined benefit schemes.

lar ways for superannuation. The fact that all employers are liable to contribute for their employees reduces significantly the liquidity risk of superannuation schemes. The regular contributions by employers (and employees) should provide a constant cash flow for superannuation schemes. On the other hand, there is an increased institutional risk faced by most members of superannuation schemes because they generally have no choice as to which scheme they join and are generally a member of one scheme at a time. Investment risk is the risk taken by members of superannuation schemes that the investments made by their scheme will fluctuate in value.[9]

3.8. *Risk of failure — non-diversification.* Most employees are only able to join one scheme. This exposes them to a significant degree of institutional risk (that is, the risk that the scheme of which they are a member will fail). This risk is more significant for them because it is their only scheme.[10] The lack of choice of superannuation scheme facing most superannuation scheme members is considered further in chapter 12.

3.9. *Effect of failure — impact on federal budget outlays.* If a scheme's assets are dissipated by dishonest, negligent or simply inefficient management, a future generation of taxpayers, who will already have paid once through tax revenue foregone due to tax concessions granted to superannuation schemes, will have to pay again through the social security system to provide pensions and other support for the members of the depleted scheme. Such an unexpected increase in social security outlays would have serious long term implications for the Commonwealth. Unlike an unexpected increase in unemployment, where the number of recipients will recede as the level of employment improves, these beneficiaries would require social security for the rest of their lives, as they will have no opportunity to rebuild their retirement savings.

3.10. *Effects of failure — political impacts.* The former members of a depleted superannuation scheme may have expectations (however unrealistic) that the Commonwealth, having forced them into a superannuation scheme, is responsible for their retirement savings and, consequently, should be required to make good the loss. The reaction of depositors in the Farrow group of building societies and the OST Friendly Society in Victoria indicate the kind of expectations people may have and their likely reaction should their superannuation schemes suffer a similar fate. The risk that members of a depleted superannuation scheme may demand recompense from the Commonwealth is heightened by two factors

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9. This is particularly important for members of accumulation schemes.
10. It is acknowledged that an employee who changes jobs will have a series of ETPs which may be held in a variety of ADFs or DAs, thus reducing the degree of his or her institutional risk.

- it will have effectively endorsed superannuation as the preferred mechanism for retirement savings and forced people into superannuation schemes
- most individuals will only be members of one scheme at a time which denies them the protection available to other investors through diversification of their portfolio across institutions.[11]

*Conclusion*

3.11. ***Intervention justified.*** The Review is satisfied that government intervention in the provision of superannuation services is justified, not only for the general reasons endorsed by the Campbell Committee but also to ensure that scheme members are offered an adequate and appropriate level of protection for what may be a significant component of their post-retirement income. In IP 10 the Review identified the following three goals for regulatory intervention in collective investments.[12]

- To promote commercial stability and efficiency in capital raising and in long term investments. This involves establishing competitive neutrality between similar investments. It aims to ensure that the regulations imposed enable collective investment schemes to operate efficiently and effectively.

- To ensure that the legal framework harmonises with the regulation of similar investment vehicles. This goal is closely allied to the first. It is designed to ensure consistency in the regulation of conceptually similar investment opportunities. In the case of superannuation it is important that, subject to the special policy considerations flowing from the compulsory nature of superannuation and its role in the retirement incomes policy, its regulation be consistent with the regulation of collective investments generally.

- To ensure that there is appropriate protection for investors and beneficiaries. This involves adequate information being made available to investors and potential investors so they can make realistic assessments about their investment opportunities. It also involves ensuring that promoters, trustees and investment advisers meet minimum standards

11. This issue must be distinguished from the issue of diversification of investment across asset classes, but see fn 10.
12. IP 10 para 2.21.

of competence and integrity. It requires that investors have an appropriate input into the conduct of collective investment schemes. This is particularly important in the case of employer related superannuation.

These goals are equally applicable in the context of superannuation.

3.12. *Prudential supervision.* Prudential supervision is a series of measures directed at redressing market imperfections in a particular industry. A major way that it does this is by prescribing standards that participants in the industry must observe. It is not a substitute for the assessment of risk by individual investors. Rather, it aims to make it easier for investors to make accurate assessments of the risks involved. For example, by establishing minimum disclosure requirements, a system of prudential supervision can avoid the need for excessive duplication of basic information search costs and provide investors with a proper and reasonable opportunity to measure and assess risk. There is already a level of prudential supervision in operation, and the Review is satisfied that it represents an appropriate way of intervening.

## Insurance

### *Why consider insurance?*

3.13. *Requiring insurance.* Another way of intervening is to arrange for the risk of loss, which regulation is designed to prevent or minimise, to be insured. The Review notes that the Commonwealth has indicated that, in intervening, it does not propose to control investment generally, or to guarantee superannuation benefits to scheme members against the impact of adverse market movements or poor commercial decisions.[13] The risk of failure will continue to lie with the superannuation scheme members.[14]

3.14. *Structure of the industry.* There are over 120,000 superannuation schemes. Close prudential supervision of the superannuation industry by the regulator alone is prohibitively expensive. Even if supervision were tightened up and a regulator established with the full powers and the right approach to its functions, there would still be gaps, and there would still be potential for failure. The Review gave consideration to whether, given the importance of superannuation for public policy, the risk of failure should be insured. Two kinds of insurance were considered. The Review explored whether it is feasible to establish an insurance system to guarantee the benefits provided by superan-

13. Treasurer's press release No 73, 20 August 1991; Treasurer's statement, paper 1 para 10.
14. Treasurer's press release No 73, 20 August 1991; Treasurer's statement, paper 1 para 7.

nuation schemes to their members against loss caused by failure of the scheme, however the failure arose. The second option is more limited. It may be possible to provide insurance against loss due to fraud or negligence. The cost of either option is a key consideration.

3.15. *Retirement income insurance systems overseas — ERISA.* Some countries have voluntary supplementary pension schemes with an associated safety net,[15] whereas others have mandatory pension schemes with an associated safety net.[16] The best known example of voluntary supplementary funds pensions combined with an insurance scheme is in the USA, where many schemes are insured by the Pension Benefits Guarantee Corporation (PBGC), an independent corporation established under the *Employee Retirement Income Security Act 1974* (USA) (ERISA).[17] ERISA only provides a safety net for defined benefit schemes.[18] In return for the payment by a superannuation scheme of a variable fee of between $US16 and $US50 for each member, the PBGC guarantees the payment to members of their basic benefit, that is, the normal retirement benefit which would have become vested in the employee under the terms of the scheme, up to a maximum monthly pension payment.[19] The PBGC will pay a benefit to members of a single employer sponsored scheme only if the scheme has been terminated on one of a number of specified grounds including that the employer sponsor is placed in liquidation.[20] In the event of such a termination the employer is liable to the PBGC for the unfunded liability of the scheme and special rules apply if the amount owed exceeds 30% of the net worth of the employer sponsor.[21] It was necessary to amend the original legislation[22] to provide for specific instances where a superannuation scheme could 'terminate', because of the presence of moral hazard. Employers were deliberately underfunding superannuation schemes and then voluntarily winding up the schemes, thereby requiring the PBGC to pay the difference to the members. Interestingly, this problem has not been as predominant where the employers contributed to a multi-employer plan.[23] In a multi-employer plan, several employers combine to offer a multi-employer superannuation scheme. These schemes pay a lower, flat, insurance premium of $US2.60 a member.[24] The conditions under which the

15. US, Canada, Germany.
16. In Sweden, supplementary contributions are required by collective agreements between the employee's union and the employer's union not by legislation.
17. ERISA s 4002
18. The PBGC does not insure accumulation schemes.
19. In 1990 this was $US2164.77. The rate is adjusted each year in line with inflation.
20. ERISA s 4041(c)(2)(B)(i).
21. ERISA s 4062(b)(2)(B).
22. *Omnibus Budget Reconciliation Act, 1987* (USA).
23. Multi-employer plans are administered separately from the single-employer plans: Ippolito *The Economics of Pension Insurance* 14.
24. Coleman *Primer on ERISA* 57.

PBGC will pay a benefit are also restricted. It will only act in the event that all the assets of the scheme have been depleted[25] or all the employers have withdrawn from the scheme.[26] This form of co-insurance reduces the moral hazard problems that are associated with single employer schemes. In addition, the level of benefit guaranteed by the PBGC to employees covered by multi-employer schemes is relatively low. No portion of the benefits under these schemes is guaranteed until the scheme has been in effect for five years and the maximum benefit paid by the PBGC is $US20 a month for each year of service.[27] Thus an employee with 30 years service would only receive $US600 a month.[28]

*Arguments in favour of insurance*

3.16. *Lower cost.* No matter how extensive the supervisory framework, losses will occur. The importance of superannuation for retirement incomes policy means that the impact of such losses must be minimised. A universal insurance scheme would spread the burden of these losses across the industry. It is argued that an insurance scheme is the most cost effective way of protecting the interests of the members of the schemes, decreasing the total cost of supervision and increasing the profitability of funds. This is because it is argued that the lower cost of reduced prudential controls more than offset the cost of the insurance scheme.

3.17. *Protection for poorly diversified investors.* Insurance can also provide protection for poorly diversified investors.[29] This is particularly important in the context of superannuation, where most employees are only a member of one superannuation scheme at a time.

3.18. *Protection against runs.* If contributors are entitled to transfer their membership from scheme to scheme, the chance of a run increases. Investor confidence in schemes, therefore, becomes more important. The fact that a scheme has insurance will promote investor confidence. This will reduce the likelihood of runs.

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25. Formally the employer's liability ceases upon the plan's adoption of an amendment to the effect that no further credit may be given to participants in the fund: ERISA s 4041A(a). Under the *Multiemployer Pension Plan Amendment Act 1980* (USA) the employer is liable to meet unfunded liabilities, so the PGBC is not liable until the fund has exhausted this source of funds. See Coleman *Primer on ERISA* 60.
26. ERISA s 4041A(a)(2).
27. Domone *ERISA The Law and the Code* 58–59.
28. cf $US2164.77 for members of single employer sponsored schemes.
29. Again, diversification is here used to mean diversification across institutions, rather than diversification of investments across asset classes and risks.

*Arguments against insurance*

3.19. *Cross subsidisation.* It is said that a compulsory insurance scheme may be inequitable for some schemes. First, those who behave in a responsible manner will be subsidising those engaging in excessive risk taking. Furthermore, those members who are willing to accept more risk for a higher return will be paying an implicit insurance premium (in the form of a lower earnings rate) for insurance they don't want. This argument needs to be weighed against other public policy purposes in relation to superannuation.

3.20. *Encourages risk taking.* A more significant objection is that insurance may tend to encourage excessive risk taking by members or by the scheme. This is known as the 'moral hazard' problem. It is argued that those who are insured against a certain risk have less incentive to use optimal care to avoid those risks. In the case of insurance against investment risk in particular, this argument suggests that such superannuation schemes would be encouraged to engage in the highest yielding investments, as this is the most economically rational option for the scheme. Given the direct inverse relationship between rates of return and risk, members will therefore have incentives to place their funds in the riskiest investments, that is, the ones most likely to fail. There would be little incentive for members to stop trustees from engaging in such investment strategies, because, if the strategy succeeds, they reap the benefits and, if it fails, the insurer bears the costs, not them.

3.21. *Leads to underfunding.* An additional moral hazard in the case of defined benefit superannuation schemes is the incentive for employers to underfund the scheme. This has been a problem in the USA and was recently addressed by tightening the funding requirements in the 1987 amendments. Underfunding occurs because the insurer, rather than the employer sponsor, is ultimately responsible for any underfunding of such schemes.[30]

3.22. *Insurance less cost effective.* The proponents of prudential supervision argue that it is generally more cost effective in achieving a given level of protection for investors than are systems of insurance, principally because there is a much smaller 'moral hazard' problem. Investors know that return of their investment is not guaranteed. They must, therefore, make use of the information provided to them as a consequence of the prudential supervision undertaken by the regulator to monitor their investment. Promoters too, know that taking excessive risks will cost them in loss of capital.

30. Holland & Sutton 'The Liability Nature of Unfunded Pension Obligations Since ERISA' (1988) 55 *Journal of Risk and Insurance*, 32–58.

*DP 50 proposal*

3.23. In DP 50 the ALRC proposed that a privately funded comprehensive insurance system be established.[31] Comment was sought. The majority of the submissions rejected this proposal.[32] Many focused on the unknown and potentially prohibitive cost of such a scheme. Aside from the cost of funding a scheme such as that established under ERISA, there are additional complications in the Australian context, such as the lack of experience with this type of insurance and an increasing number of accumulation schemes. In order to reduce the moral hazard problem, each premium would need to be based on the riskiness of the fund's own portfolio. This has been very difficult to assess. This was one of the reasons for the development in the United States of a government backed insurance fund associated with ERISA,[33] the PBGC, instead of a private insurance scheme. There is the further limitation that, in Australia, an insurer like the PBGC could only provide cover for defined benefit funds and not accumulation schemes.[34]

*An alternative — negligence and fraud insurance*

3.24. *Introduction.* As superannuation schemes are structured as trusts, there are no capital adequacy provisions like there are in the banking[35] and insurance[36] industries. Capital adequacy requirements can act as a buffer in the event of fraud or negligence on the part of the management to reduce the likelihood of loss to investors. Prudential supervision alone does not provide a guarantee against negligence or fraud. It may be possible to supplement prudential control with insurance to protect funds simply against fraud or negligence. Although there was no specific proposal to this effect in DP 50, it received support during the Review's consultations.

3.25. *Insurance can cover breach of duty.* Negligence insurance provides cover in the event that the scheme operators fail to perform their duty.[37] As the trustees of superannuation schemes are often not remunerated for their work, the deed or other instrument constituting the scheme typically provides that the

31. DP 50 proposal 11.1.
32. eg, National Mutual *Submission* February 1992; Institute of Actuaries *Submission* February 1992; Department of Social Security *Submission* February 1992; BT Asset Management *Submission* February 1992.
33. Ippolito *The Economics of Pension Insurance* 3–5.
34. Although it may be possible to provide cover for accumulation schemes provided the interest to be insured is determinable, such as members contributions in real terms or members contributions plus a minimum earnings rate.
35. *Banking Act 1959* (Cth) s 16.
36. *Life Insurance Act 1945* (Cth) s 19A.
37. This type of cover is presently available through ASFA and one of the major life companies.

fund will indemnify the trustee or a member of the trustee board for any loss resulting from negligence. The fund is required to pay for any successful claim made against the trustee.[38] If instead the scheme took out a third party indemnity policy, the insurance company would be responsible for paying any successful negligence claim against the trustee, thus preserving the remaining assets of the scheme.[39]

3.26. *Would there be a moral hazard problem?* The Review has concluded that such insurance is appropriate in the context of superannuation schemes. It could be argued that just as there is a moral hazard problem when insuring against any loss, there is also a moral hazard problem with insuring for negligence, because it provides an incentive for trustees not to perform their duties properly, knowing that neither they nor the fund will suffer financially.[40] After consultations with industry practitioners, however, the Review is convinced that such a problem is not significant. The prudential system can place clear obligations on responsible entities, and insurers are likely to have fewer difficulties in pricing the risks for insurance purposes. The likelihood that a single employer sponsored or industry superannuation scheme will be defrauded by its trustees is not high.[41]

3.27. *Premium calculation.* Negligence insurance is now available commercially. The premiums of such insurance are based on the riskiness of each fund. The evaluation of riskiness includes, among other factors, an evaluation of the size of the fund, the number of members, whether the funds are externally managed and whether prior claims have been lodged. There should be no difficulty with fixing premiums.[42]

3.28. *Recommendation.* It would be desirable to have all single employer sponsored and industry schemes insured against loss due to fraud or negligence. However, the Review accepts that there may be practical difficulties, particularly for the small funds, in meeting such a requirement. The Review strongly recommends that such insurance be obtained by all funds. There should be an obligation on the trustees to disclose to the members whether or not the scheme has this kind of insurance.

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38. This means that often times the fund will have to pay twice: for example, when the trustee negligently pays money out of the fund assets to the wrong beneficiary and then to the correct beneficiary.
39. See Companies & Securities Law Review Committee *Company Directors: Indemnification, Relief and Insurance*. The CSLRC proposed similar reforms to the Corporations Law s 241.
40. Except to the extent of increased premiums.
41. Only if the fraud involved all the trustees would the loss be uninsurable on the basic public policy rule that one's own fraud is uninsurable. Usually the fraud of one trustee will involve the negligence of other trustees and, consequently, be recoverable under a policy covering loss due to negligence.
42. The Review understands that such insurance is available relatively cheaply with $1m in cover costing approximately $500 each year.

3.29. ***Liability and indemnity***. Indemnities for trustees against liability for breach of trust are often included in deeds, particularly where the trustee is not remunerated (as is the case with most superannuation schemes) to reduce what would otherwise be too heavy a burden of responsibility upon them. The trustees of superannuation schemes are often insured against liability. The premium on the insurance policy can be paid out of the assets of the scheme. However, the Corporations Law provides that any attempt to indemnify an officer of a body corporate against a liability that by law would otherwise attach to the officer for negligence, default, breach of duty or breach of trust is void.[43] This may prevent superannuation schemes from paying the premium for trustees from the assets of the fund merely because they are directors of a company. As a result, trustees may be reluctant to incorporate. The Review recommends that the law should make it clear that premiums for negligence and fraud insurance may properly be paid out of the fund.

**Recommendation 3.1: Indemnification of members of boards**

**1. The law should provide that the responsible entity, and the members of the board of management of the responsible entity, for a superannuation fund, an ADF or a PST may not be indemnified out of the fund, ADF or PST for any liability incurred by it or them while acting as responsible entity or member. Failure to comply should be an offence as well as a breach of fiduciary obligations.**

**2. The law should provide that the responsible entity for a superannuation fund, an ADF or a PST must ensure that the annual report for the scheme include a statement whether the responsible entity or the members of the board of management of the responsible entity are insured in respect of their liability to members of the scheme for loss caused by fraud or negligence and, if they are, the prescribed particulars of that insurance.**

**3. Nothing should prevent the payment out of the fund of the costs associated with obtaining insurance for the responsible entity for the fund, ADF or PST or for a member of the board of management of the responsible entity against fraud or negligence.**

43. Corporations Law s 241.