

31 March 2014

Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001



By email: fsi@fsi.gov.au

Dear Sir / Madam

Financial System Inquiry

The Law Council of Australia welcomes the opportunity to respond to the Financial System Inquiry.

I am pleased to enclose a submission prepared by the Superannuation Committee of the Law Council's Legal Practice Section.

The Committee would welcome the opportunity to discuss the submission further. In the first instance, please contact:

- Ms Pam McAlister, Chair, Superannuation Committee on 03 9623 5040, or pam.mcalister@mercero.com
- Mr Luke Barrett, Chair, Legislation and Policy Subcommittee on 03 9910 6145, or luke.barrett@unisuper.com.au

Yours sincerely

A handwritten signature in black ink, appearing to read "M Hagan".

**MARTYN HAGAN
SECRETARY-GENERAL**



Financial System Inquiry

Financial System Inquiry Panel

31 March 2014

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Executive Summary

This submission focuses on items 1.3, 2.3 and 3.3 of the terms of reference for the Financial System Inquiry and, in particular, the impact of regulatory developments in the Australian financial system on issues such as the availability and innovation of financial products in the superannuation industry, and potential impacts which regulatory developments may have on the allocation of capital by superannuation funds.

The manner in which regulatory reform is undertaken can have positive and negative impacts on the financial system. If handled well, the overall quality of regulation can be improved, policy ends can be achieved more effectively, and industry participants will have greater certainty as to what is required. These factors in turn have positive implications for overall rates of compliance and the associated costs of implementation.

In recent years, however, several sub-optimal trends have been observed in the regulatory reform process, particularly in relation to the superannuation space.

- Consultations have not always been undertaken or structured as effectively as might otherwise have been the case.
- Complex reforms have been implemented in a piecemeal fashion through 'tranches', which creates 'blind-spots' for industry when endeavouring to understand how particular aspects of a reform program will interact with other aspects which are in the pipeline.
- Regulatory relief is sometimes provided too late to be of meaningful utility resulting in various inefficiencies, including loss of management time, unnecessary out-of-pocket expenditure on compliance work and loss of business opportunity.
- Some reforms have effectively been rolled out by media announcement in the first instance.
- Subordinate / ancillary requirements have been introduced which conflict with more fundamental legal requirements and which potentially impede product innovation and product offerings.

Suggestions that superannuation funds be required to invest in particular sectors – for example, infrastructure, venture capital and corporate bonds – similarly have potential to conflict with more overarching legal duties, such as the duty to make investment decisions in the best interests of members.

The financial system would benefit from structured and disciplined approaches being adopted throughout the regulatory reform process and by ensuring that laws are fair, equitable and demonstrably clear. An outworking of this is that subordinate requirements ought not to conflict with more fundamental legal obligations or be applied in a way which has this effect indirectly. Product innovation should not be discouraged by regulation except where there is a deliberate policy justification for doing so. For example, it is generally accepted that superannuation regulations give rise to constraints on product innovation, especially in the pension space and the design of longevity products.

Introduction

1. The Law Council of Australia welcomes the opportunity to respond to the Panel's inquiry into the Financial System.
2. The Law Council of Australia is the peak national representative body of the Australian legal profession; it represents some 60,000 legal practitioners nationwide. [Attachment A](#) outlines further details in this regard.
3. This submission has been drafted for the Law Council by the Superannuation Committee (the Committee) of the Legal Practice Section.
4. The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. The Committee makes submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

The need for a structured approach to regulatory reform

Sub-optimal trends in regulatory reform

5. In recent years, our Committee has observed a trend towards sub-optimal approaches being adopted by the Australian Government, Treasury and regulators when undertaking financial services regulatory reform.
6. This leads to periods of unnecessary uncertainty within industry, unnecessary compliance-related costs, and imperfect regulatory requirements which could more efficiently achieve their policy objectives.
7. Several trends which we have observed in the financial services space – specifically, within the superannuation industry – are summarised below. These trends provide examples of how the financial system might be regulated more efficiently in future.
8. Ultimately, it is our view that Government, Treasury and regulators should adopt a more structured, coherent and co-ordinated approach when implementing regulatory changes which will impact the financial system, including when consulting with stakeholders on those proposed changes.

Sub-optimal consultation

9. Our Committee endeavours to participate in almost every consultation process concerning superannuation regulatory reforms. In recent years, this task has proved to be challenging when comments have been sought from industry unexpectedly and without adequate time to properly consider the reform and to provide detailed feedback. Increasingly, the time-frames for submissions on exposure draft legislation and other consultations have been cut short – in numerous instances, this might be as short as a handful of days. Further, there are often several consultation processes being conducted over the same period. In some instances, it has been apparent that the body undertaking the consultation process has not allowed itself adequate time to properly consider the feedback being sought – for example, when legislation has been introduced within several days of the closing date for receipt of submissions. These factors discourage genuine participation in the consultation process. In some instances, industry has been left wondering whether its feedback was considered at all or, if it was, why identified problems have not been addressed.

10. In contrast, the approach taken by the Australian Prudential Regulation Authority (APRA) in recent consultation processes (for example, in relation to the prudential standards) provides a sound model that could potentially be adopted more broadly by Government, Treasury and regulators. In our experience, the positive aspects of APRA's approach to consulting with industry are:

- (a) reasonable advance notice is provided as to when reforms will be released for comment;
- (b) reasonable timeframes are allowed for providing comments (typically one month or longer);
- (c) reasonable timeframes are allowed for the comments received from industry to be analysed;
- (d) written reports are released to industry to summarise common themes and significant issues identified through the consultation process and to explain how those issues are to be addressed or why they have not been addressed; and
- (e) there is typically a second round of consultation to collect feedback with regard to changes made as a result of the first round of consultation.

Use of tranches and piecemeal reforms

11. One of the more challenging aspects of consulting with Government in recent times (for example, on the "Stronger Super" and "MySuper" reforms) has been the introduction of the legislative reform in separate (and sometimes overlapping) "tranches". It is difficult, perhaps even impossible, for affected parties to provide comprehensive feedback on proposed changes when they do not have access to all of the relevant details regarding a measure or suite of measures.

12. Industry views on the one tranche of reforms may well change (for better or worse) once details of subsequent tranches become known. The use of tranches also creates a risk that a program of related reforms may be interrupted by a change in Government or some other event which shifts the Government's focus. Earlier tranches which might always have been intended to be modified or clarified by subsequent tranches could potentially be 'orphaned', left on the statute books without being joined by their related tranches. Further, from a practical perspective, advisers and compliance staff experience significant difficulty in ascertaining the state of the law when it is necessary to refer to multiple tranches of legislation, particularly where later tranches amend earlier ones. This adds to compliance costs and creates a risk of inadvertent non-compliance. The Committee considers that the making of legislation in 'tranches' is an undesirable approach to law making that should be avoided.

Reform through announcements

13. As a general principle, Governments should govern through legislation and legislative instruments and not through announcements. When changes to the superannuation system are announced, as a general principle, they ought to be promptly followed by the relevant legislation (or by an exposure draft or bill). Under rule of law and Parliamentary sovereignty principles, it is unreasonable for industry to be expected to begin implementing reforms that have merely been announced, not knowing for certain when or whether the announcement will be enacted by the Australian Parliament. Inevitably, uncertainty leads to additional cost that is ultimately borne by members. It is also unreasonable that members of the community should have to plan

and manage their affairs in such a critical area without having certainty as to the rules that apply.

Relief and clarification provided too late

14. In recent times, there have been a number of instances where supposed regulatory relief has provided little by way of real relief due to the regulatory relief being formalised too late in the process.
15. Regulatory reforms often pertain to processes which will affect hundreds of thousands of customers and clients in the case of large financial services organisations. As a practical matter, substantial system changes and substantial volumes of documentation may have to be prepared in order to comply with regulatory changes, especially where these affect the way in which financial services organisations interact with their client base.
16. The lead-time required to take these steps can be significant, in the order of weeks or months depending on the extent of the changes. Organisations like superannuation funds do not have resources sitting idle, so all work needs to be scheduled having regard to other business priorities and the available resources.
17. For all these reasons, the practical deadline for commencing implementation will always be significantly earlier than the regulatory deadline for achieving compliance.
18. In the absence of formal relief, prudent superannuation funds and other financial services organisations have found themselves in the unenviable position of having to choose between (a) commencing implementation, in case relief is not forthcoming, even if they lack detail as to what must be done or (b) doing nothing, but risking non-compliance in the event that relief (even rumoured relief) is ultimately not forthcoming.
19. A recent example is the relief from the obligation to include MySuper product dashboards with periodic statements. Although relief had been rumoured to be forthcoming, this was not ultimately confirmed until mid-December 2013, only a fortnight prior to the legislative commencement date. By this time, some superannuation funds had already commenced their implementation work and, when the relief was ultimately confirmed, the costs incurred in doing that work were thrown away.
20. In the same way that commencement dates ought to allow for reasonable transition periods, Government and regulators should ensure that regulatory relief is provided a reasonable period ahead of the commencement date.

Shifting status of regulator opinions and issues of inconsistency

21. Traditionally, laws and regulations have been made by Parliament and enforced by regulators. While regulators may express views on how they interpret and intend to enforce particular laws and regulations, traditionally these views have ultimately just been opinions. As such, while these opinions may affect conduct within the financial services industry, they do not necessarily influence what the legal position actually is as a matter of law.
22. In more recent times, APRA has been given powers to make prudential standards with regard to various parts of the financial system. These prudential standards have force of law, but are not drafted with the precision which one would typically expect of legal requirements. This in itself leads to uncertainty within industry and creates potential for inefficiencies – for example, compliance costs which are incurred in taking actions

which may or may not actually be required, or legal costs incurred in an effort to ascertain what is in fact required to comply.

23. The financial system has entered a new regulatory paradigm in which a regulator can create mandatory requirements and then enforce its own requirements. In this new paradigm, a question arises whether statements by regulators as to what was intended by a particular regulatory requirement should be given more weight than traditionally may have been the case.
24. From a strictly legal perspective, it may be that statements made by regulators as to how particular requirements should be interpreted do not carry any more weight than before.
25. However, it has become a commercial reality that statements by regulators are indeed given greater weight by many industry participants. This potentially introduces further regulatory uncertainty and volatility to the financial system, since statements and opinions may be expressed by regulators relatively informally – for example, through answers to ‘frequently asked questions’ published on websites or in verbal discussions. Uncertainty arises when these statements and opinions are inconsistent with a strictly legal interpretation of a regulatory requirement.
26. In the new paradigm, there are three species of regulatory certainty, each of which is important.
27. It is important to ensure that there is consistency in how regulatory requirements are interpreted and enforced by regulators. It is important that interpretations adopted by regulators be consistent with what the legal position genuinely is. For example, it would be concerning if interpretations were published with the intention of varying what the legal requirements actually are.
28. It is also important, when enforcing regulatory requirements, that the same interpretation be consistently applied across all industry participants.
29. Further, it is important that the various interstate offices of regulators all adopt a consistent position.
30. In recent times, there have been anecdotal reports of each of these types of inconsistencies emerging.

Disproportionate impact of incidental and subordinate requirements

31. In recent times, a trend is starting to emerge within the superannuation sector which is seeing relatively minor, incidental and subordinate requirements having a disproportionate impact on business and investments in a way which conflicts with more fundamental legal obligations.
32. For example, APRA now requires superannuation funds to provide data relating to the rate of investment return which is being targeted, and the asset classes in which a strategic decision has been made to invest.
33. These are essentially data collection and reporting requirements. The requirements are highly prescriptive and require the data to be calculated in a particular way by using particular methodology. In providing this information to the regulator in the prescribed way, it is a simple fact that the data provided does not convey an accurate portrayal of how the superannuation fund actually approaches its business. If this

were the extent of the issue, there would be no particular concern from a legal perspective.

34. However, there is now also a statutory obligation for the information in product disclosure statements to be aligned with the data which is provided to APRA.
35. Prudent superannuation funds are concerned to ensure that they do not mislead or deceive their members by disclosing information which does not accurately portray how the fund is being managed. The law is relatively clear that funds must give members information which is consistent with what has been given to APRA. Funds are therefore under pressure to fundamentally change the way they manage their investments, simply so that their investment objectives and strategies are the same as those which the regulatory requirements compel them to provide to APRA.
36. Investment objectives and investment strategies are therefore being impacted by what is essentially a template or form which has to be completed and sent to the regulator on an annual basis.
37. In a similar fashion, this is impacting product innovation. MySuper products are currently required to disclose their 'return target' by reference to CPI and this is in turn driving superannuation funds to target investment objectives which have been defined by reference to CPI, even though this may not be the kind of investment objective which is actually currently being pursued. This requirement will potentially be expanded to other superannuation products as well. As such, the data collection requirements are creating impediments to the development of products which pursue different (or more innovative) kinds of investment objectives.
38. Similarly, the requirement to disclose investment strategies in a particular way and using particular terminology will potentially be an impediment to the adoption of innovative strategies which do not 'fit' the template which has been prescribed by the regulator.
39. The other issue which this creates is the potential for these reporting and disclosure requirements to conflict with the fundamental duty for trustees to formulate investment objectives and investment strategies in the best interests of members.
40. As a general proposition, we submit that ancillary and subordinate requirements (for example, data collection requirements) should not conflict with fundamental statutory duties and ought not impede product innovation or compel significant changes to how financial services organisations manage their businesses or investments.

The duty to make investments in the best interests of members

41. As alluded to in the previous section, trustees of superannuation funds have a fundamental duty to make investments in the best interests of their members, having regard to all the relevant circumstances of their fund. This is a common law duty and a statutory obligation under superannuation legislation.
42. Caution is therefore warranted before introducing requirements which conflict with this fundamental duty.
43. The previous section gave examples of how relatively incidental and subordinate requirements are indirectly cutting across the fundamental duty to make investment decisions in the best interests of members.

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44. Any proposal to compel superannuation funds to invest a proportion of their assets in infrastructure, corporate bonds, venture capital (or indeed in any other asset class or sector) would have real potential to conflict with this fundamental duty in a more direct way.
45. Arguments are sometimes put that there is some ‘social contract’ under which superannuation funds are obligated (for want of a better word) to invest for the ‘good of the nation’ as quid pro quo for perceived concessional tax treatment. This is, of course, entirely a policy argument, as there is no such obligation in any legal sense of the word. In any event, investments can be made in infrastructure, venture capital and corporate bonds (and in any other asset class) either domestically or offshore. We note that even under the most generous version of the ‘social contract’ argument, the argument would not seem to justify compelling trustees to invest in offshore infrastructure.
46. There has been some public speculation that a ‘Government liquidity facility’ may increase the appetite of superannuation funds to invest in unlisted infrastructure, by alleviating any concerns that increased holdings of illiquid assets may jeopardise the ability of the fund to process transactions. The general rule and perception is that superannuation funds can never borrow. In essence, the idea therefore seems to be that superannuation funds may be more willing to invest in unlisted assets if they are provided with comfort that they would be able to borrow in the event of a liquidity shortfall, in order to continue processing transactions.
47. In this regard, we note that s 67 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) already includes an exception to the general prohibition against borrowing. The section already permits superannuation funds to borrow an amount equivalent to 10% of the fund’s assets for up to 3 months if necessary to pay benefits to a beneficiary. Given the existence of this flexibility, we therefore query whether a Government liquidity facility would have the degree of impact which is being posited. Most funds manage their investment programs so as to minimise the likelihood of ever needing to rely on the s 67 exception. It would seem reasonable to assume that most funds would similarly manage their investment programs so as to minimise the likelihood of ever needing to draw on a Government liquidity facility either.

Regulatory impediments to pension product innovation

48. Earlier sections of this submission noted how aspects of the regulatory framework are influencing – or impeding – product offerings in terms of their investment objectives and investment strategies.
49. This section provides an overview of how the current regulatory requirements potentially impede product innovation in the pension space. There will no doubt be other submissions made to the Inquiry which explore these issues in greater detail.
50. The SIS Act and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (“SIS Regulations”) (collectively the “SIS Legislation”) regulate the various types of benefit that may be paid by a superannuation fund.
51. For a retired member, who has reached preservation age, the benefit can usually be paid in any one or more of the following forms:
- (a) one or more lump sums
 - (b) one or more pensions

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- (c) the purchase of one or more annuities.
 - (d) Broadly speaking, there are two types of pensions:
 - (i) **Account based pensions:** These are pensions paid from an account maintained for the member, with the member retaining control over how the account is invested, the frequency and amount of pension payments from the account (subject to statutory minimum payment requirements), including the ability to make withdrawals as and when required. It also involves the member bearing the investment risk and the risk that the account may run out before the member dies.
 - (ii) **Non account based pensions:** These are pensions paid for the life of the retiree.

52. The majority of post-retirement products offered in the superannuation system are account-based pensions.

53. However, the average lifespan of Australians is likely to increase over the next 50 years. With this increasing lifespan comes the greater risk that the lump sum retirement will be exhausted before the retiree ultimately dies. This is known as longevity risk.

54. While longevity risk is not new, the potential for the risk to be realised has grown as a result of the following factors:

- (a) the increase in life expectancy;
- (b) the increase in self managed superannuation funds which do not have the ability to provide pensions that are complex and expensive to provide;
- (c) the reduced number of defined benefit funds, corporate superannuation funds and public sectors superannuation schemes offering pensions; and
- (d) the removal of tax incentives for those taking pensions.

55. The Committee submits that there is a relative lack of diversity in the products available to address longevity risk in the Australian superannuation market. It is submitted that there are a number of legal and regulatory reasons for this.

Restrictive and inflexible rules

56. The pension standards are prescribed for various types of pensions. These standards are set out in SIS Regulation 1.06. However applying the provisions of SIS Regulation 1.06 to particular products is not at all straightforward.

57. In order for a pension to conform with the standards, it must satisfy each of the characteristics set out in the standard prescribed for that type of pension. It is not possible for a pension to comply partially with the requirements for one type and partially with those for another. In this sense, the SIS Regulations restrict the flexibility of superannuation funds to offer pensions which do not strictly comply with only one set of rules. For example, it is not possible for a superannuation fund to offer a hybrid pension product which provides an account-based pension up to a certain age and fixed income payments from an underlying life policy thereafter.

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58. In order for a superannuation fund to be able to offer a retirement solution to do this, it must offer two different types of pensions with tax consequences for the retiree. The Committee submits that this is excessively restrictive and inflexible.
 59. The pension standards have been amended from time to time and as a result some of the rules are historical and only apply to pensions which have already commenced, and are largely irrelevant to new products.
 60. Further, the legislation does not easily accommodate new pension types, even those which simply combine elements of several of the existing pension types.
 61. The Committee supports the recommendation in the Australia's Future Tax System report for the prescriptive rules in the SIS Regulations relating to income streams to be removed or amended to enable greater flexibility and innovation in the offering of retirement products.

Limited tax incentives for superannuation funds to offer pensions

62. A superannuation fund is eligible for tax exemptions on income earned on fund assets which support liabilities for pensions which comply with the pension standards in the SIS Regulations.
63. However, the tax exemption only applies to assets that are used to meet current (as opposed to future) pension liabilities. This acts as a barrier to the creation of pension products which involve a combination of a currently payable pension and a deferred pension because the underlying assets of the deferred pension do not qualify for the tax exemption.
64. Further, announcements by previous Governments to reduce the tax exemptions provided to pension products (for example, the proposal to tax superannuation pension earnings above \$100,000 a year) undermine confidence and demand for such products, and discourage funds from offering such products.

No tax incentives for taking a pension

65. One of the effects of the "Better Super" changes in 2007 was to overhaul the regime by which retirement benefits were taxed. Prior to the commencement of these changes (1 July 2007), the amount of concessional tax superannuation benefits a person could receive over their lifetime was tested against what was called the "Reasonable Benefits Limits" or "RBLs". Superannuation benefits paid in excess of a person's RBL were subject to additional taxation.
66. A different RBL applied to lump sums and pensions. The pension RBL was significantly higher than the lump sum RBL. In order to qualify for the higher pension RBL, at least half of the superannuation benefit must have been taken in the form of a complying pension or annuity – that is, a pension or annuity that was payable for the life of the beneficiary, or for a term corresponding to the beneficiary's life expectancy (and that met certain other prescribed standards in the SIS Legislation).
67. While there remains a tax exemption on the earnings of assets used to support the payment of pensions, this exemption applies to pension assets generally and is not restricted to complying pensions and annuities as was previously required by the pension RBL.
68. Another potential disincentive to demand for pension products (and, therefore, the offering of such products) is the treatment of pensions under the "assets" and

"income" tests which are used to determine eligibility for the Australian Government's Age Pension. For instance, pensions purchased on or after 20 September 2007 are fully assessed for the purposes of the assets test, which reduces the scope for such members to access the Age Pension.

Potential reforms

69. The Committee submits that in order to address increasing longevity risk in Australia, retirees should have a wider choice of innovative retirement income stream products and that this can only be achieved through, among other things:

- (a) the removal of legal/regulatory barriers (such as complex, restrictive and inflexible pension rules) which impede the creation and offering of retirement products in Australia;
- (b) extending the tax incentives available to superannuation funds to offer innovative retirement income stream products; and
- (c) introducing tax incentives for retirees to taking out pensions.

Attachment A: Profile of the Law Council of Australia

The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its Constituent Bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Large Law Firm Group, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Independent Bar
- The Large Law Firm Group (LLFG)
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of approximately 60,000 lawyers across Australia.

The Law Council is governed by a board of 17 Directors – one from each of the Constituent Bodies and six elected Executives. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive, led by the President who serves a 12-month term. The Council's six Executive are nominated and elected by the board of Directors. Members of the 2013 Executive are:

- Mr Michael Colbran QC, President
- Mr Duncan McConnel President-Elect
- Ms Leanne Topfer, Treasurer
- Ms Fiona McLeod SC, Executive Member
- Mr Justin Dowd, Executive Member
- Dr Christopher Kendall, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.