

# What are the real risks in superannuation funds and how well are these addressed by regulatory requirements?

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## INTRODUCTION

It is very good to have the Colloquium focus on the topic of risk in superannuation as this is a topic which, somewhat surprisingly, has not been well explored in the literature or at conferences or colloquia in the past. While some aspects of risk have been addressed, often only some of possible and actual risks are addressed. Even more surprisingly in official documentation there is not always a clear exposition of the type of risks that the prudential and other regulatory arrangements in Australia are seeking to address in regard to superannuation.

This lack of a clear exposition is in part due to the regulatory regime in Australia having sometimes been developed on a reactive basis rather than a more principle based approach. In other cases the principles relied on have been not altogether compelling and/or those advising on the appropriate regulatory approach have not been clear on what risks they were addressing or needed to address.

Risks are inherent in the operation of any superannuation fund. There are risks from the point of view of the member, risks from the point of view of the trustee or fund administrator, and risks from a regulatory or government perspective. In regard to some risks there is a commonality of interest in identifying and then avoiding or mitigating the risk concerned, and this makes it more likely that action of some kind will be taken.

However, more problematic are those risks where one party's downside risk is an opportunity for another party. For instance, given the tax advantages applying it is possible that both fund members and employers might seek to use superannuation tax provisions for purposes that were not intended.

What benefits a fund provider may not benefit a fund member. Accordingly it is in the public interest that there is a minimum level of security for fund members and that good practice in management of funds is either encouraged or required.

## A POTTED HISTORY OF REGULATION OF SUPERANNUATION

Historically, the prudential framework for superannuation rested broadly on the principles of trust law supplemented, as and when appropriate, by controls in the Life Insurance Act (for retail products), certain aspects of the corporations law, and the income tax legislation. Not too surprisingly, given the lack of clearly delineated member rights in many cases, the existence of trustee and employer discretions, and the costs of litigation there was not much evidence of action being taken to deal with various risks or to enforce the rights of members.

With the move to superannuation being more of a member

right as the result of award superannuation, there was a need for a new supervisory regime and controls. Accordingly, in 1987 the Government introduced the Occupational Superannuation Standards Act. This prescribed operating standards that superannuation funds were required to meet in order to be eligible for superannuation tax concessions.

The OSSA operating standards covered vesting of superannuation benefits, the preservation in most cases of benefits to age 55, equal representation of employers and employees on trustee boards of funds with more than 200 members, and the requirement to lodge annual returns with the Insurance and Superannuation Commission certifying compliance with the income tax and other relevant provisions. This was the beginning of regulatory arrangements specifically addressing the risks in superannuation. While there was not any explicit reference to the risks being addressed, the measures appeared to focus on providing some degree of member protection against mismanagement of funds. The measures also helped prevent abuse of the tax concessions applying to superannuation, such as obtaining access to funds prior to retirement or some other legitimate condition of release.

With the mandating of superannuation contributions in 1992 also came enhanced prudential supervision of funds. The Superannuation Industry (Supervision) Act effectively replaced the OSSA legislation from 1 July 1994. The legislation defined the duties and responsibilities of trustees, improved disclosure requirements, increased the role of auditors and actuaries, and introduced more direct enforcement powers for the Insurance and Superannuation Commission. Again, while there was no specific analysis of the risks being addressed the measures focussed on reducing the risks associated with the management of superannuation funds.

## THE WALLIS COMMITTEE INQUIRY

The prudential regulation of superannuation and other financial institutions was the subject of consideration by the Wallis Committee in The Financial System Inquiry Final Report in 1997. This report was unusual amongst reports to government in that it identified factors which the authors of the report considered would drive future changes in the industry. A number of structural changes to the finance sector were predicted. Demand side changes were considered likely to flow from an ageing population structure, and a time poor labour force that increasingly would increasingly demand value in price terms.

On the supply side, developments in technology were seen as providing channels for financial services delivery, with physical location of customers and suppliers becoming less important. Financial industry cost and pricing structures were seen as being under challenge. Technology was

seen as allowing new entrants to compete by offering specialised services without the need for extensive physical representation. Non-traditional competitors such as telecommunications and electricity groups, retail organisations and software companies were seen as likely as successfully offering financial products.

These strategic visions fed into the regulatory regime that was proposed. There was considerable emphasis on a regulatory framework that had its focus on conduct by market participants and disclosure of information. The pricing of risk rather than detailed regulatory intervention was seen as the way to go. A one regulator fits all approach was also advocated, with less emphasis on differences in treatment between different types of financial product, particularly as convergence in financial products was forecast.

However, there were some compromises in the recommendations of the Report. While the reasoning of the report supported prudential supervision of deposit taking institutions in order to minimise potential problems of system instability, acceptance of the need to regulate insurers and particularly superannuation funds was more grudging. There is evidence that at least some of the Inquiry members would have preferred even less emphasis on consumer protection through prudential supervision, with a preference for more market based solutions based on disclosure. The then regulator, the Insurance and Superannuation Commission, went to some effort to argue the case for continuing prudential supervision of superannuation. ASFA also supported this case.

Subsequent developments reinforced the political need for prudential supervision of superannuation. As Ian Harper, one of the members of the Wallis Committee put it in 2007, “the single event that most confounded the Wallis vision was the failure of HIH Insurance, Australia’s largest financial and commercial collapse. From the perspective of establishing a new regulatory regime, HIH could not have occurred at a worse time. Wallis wanted APRA to be a ‘light touch’ regulator, bringing over from the Reserve Bank its “tea and biscuits” tradition of moral suasion plus an economist’s aversion to heavy-handedness in regulatory intervention. ASIC, on the other hand, was always intended to be an enforcer”.

This account by one of the main players at the time makes it clear that the Wallis Committee intended that the main way of dealing with risk was to be through disclosure and regulation of market conduct. As events unfolded this clearly was not enough.

It could be argued that the strategic vision of the Wallis Committee was well up with standard of some other common strategic visions of the business world in the mid-1990s -it was not very good. Investments made in the regulatory structure in line with this vision did not pay off as well as they might have, just as a number of business investments based on such visions in the private sector failed or underperformed. How many financial services kiosks do you find in supermarkets these days?

As well, the supposed principle of consumers bearing the ultimate risk following adequate disclosure did not hold up very well with the collapse of HIH and FAI, and the Commercial Nominees debacle in the superannuation sector. The political and practical reality is considerably removed from some of the theory in the Inquiry report. As one of the Committee members has put it, the tolerance for risk has been less than expected.

## APRA LICENSING OF TRUSTEES AND FUNDS

Despite being three and a half years in the making, the policy objectives behind superannuation trustee licensing are not easy to identify in detail. In broad terms, improving the safety of superannuation has been the stated reason for such reforms, so in essence it should have been about dealing with risks. However, the initial October 2001 Superannuation Working Group (SWG) Issues Paper had little discussion of what was meant by “safety”.<sup>1</sup> The SWG’s Final Report to Government in 2002 did summarise general concerns expressed by the Australian Prudential Regulation Authority (APRA) about certain conduct in the industry, but did little to analyse their significance or how the safety reform proposals, including licensing, would address similar issues in the future.<sup>2</sup> The SSAA’s Explanatory Memorandum did finally refer to the failures of Commercial Nominees and general insurer HIH as well as “public concerns about the prudential framework governing superannuation”.<sup>3</sup>

In essence, the context of the reforms illuminates the genesis of such policy. The failure of general insurer HIH in March 2001 while on APRA’s watch appears to have been a critical event. As Dr John Laker, the current Chairman of APRA, then indicated in a speech to the Institute of Chartered Accountants in December 2004, at that time APRA’s history was a brief and, alas, a troubled one. The failure of HIH was a major blow to APRA.<sup>4</sup>

Accordingly, in the light of HIH, and to a lesser degree, Commercial Nominees, political and bureaucratic pressure

<sup>1</sup> *Options for Improving the Safety of Superannuation Issues Paper*, Commonwealth Treasury, 2 October 2001.

<sup>2</sup> *Final Report of the Superannuation Working Group*, Commonwealth Treasury, 28 March 2002.

<sup>3</sup> Explanatory Memorandum, *Superannuation Safety Amendment Bill 2003*, House of Representatives, 27 November 2003.

<sup>4</sup> Speech by Dr John Laker, “APRA – Growing in Strength”. Given to the Institute of Chartered Accountants in Australia, 8 December 2004.

grew for a response. The HIH Royal Commission began in August 2001 under justice Neville Owen and the aforementioned Superannuation Working Group's Inquiry into the Safety of Superannuation began a few months later in October 2001.

This parallel process led to the licensing of superannuation funds. Views held within Treasury and APRA about a need for consistent regulation across product classes were dominant, which led to calls for trustee licensing, mandatory capital requirements and a raft of other prudential requirements and powers. Fortunately, the strong lobbying efforts of ASFA helped stave off capital requirements for non-public offer funds in the eventual regime.<sup>5</sup>

There was also a renewed expectation from the Commonwealth Government, post-HIH Royal Commission, for APRA to be, in the words of Justice Neville Owen, "more sceptical, questioning and, where necessary, aggressive".<sup>6</sup> A bolder, better-resourced and more empowered APRA was expected to make its mark in all areas of prudential regulation, including superannuation.

It was in this context that the Commonwealth Government made its decisions that a package of safety of superannuation initiatives was required.

## THE THEORY AND LANGUAGE OF RISK DESCRIPTION

Moving from the pragmatic and political responses to risk within the superannuation sector, a number of analysts have provided an exposition of the theoretical framework that is relevant. For instance, in their December 1999 World Bank paper, Roberto Rocha, Richard Hinz and Joaquin Gutierrez group together the risks that regulators of pension/superannuation funds seek to manage into three major classes;

- i) investment risk
- ii) agency risk, and
- iii) systemic risk.<sup>7</sup>

**Investment risk** contains both diversifiable risk and market risk. Diversifiable risk is risk that can be mitigated through a sound diversification strategy – or else through restrictions on the holding of illiquid assets and very risky assets. Market risk is the exposure of members to the vagaries of the market. The long holding periods for superannuation funds have a tendency to mitigate some risks in this area.

**Agency risk** is where the interests of the persons operating or regulating the fund diverge from the interest of fund members. The legal and financial complexity of superannuation, combined with a lack of member knowledge of these complexities, generate an imbalance of information that can disadvantage members and create opportunities for incompetence, misuse or outright fraud and theft by plan providers and/or their service providers. Agency risk can also include operational risk, where administrative or computer systems may prove inadequate or fail.

**Systemic risk** is where the possible failure of a financial institution threatens confidence in the sector or the economy as a whole. Traditionally, this has been of greatest concern in the banking sector, where a failure of a major bank can have a ripple effect throughout the economy that threatens economic stability.

The current Australian regulatory regimes seeks to address a number of these risks. For instance, agency risk is addressed through licensing, "fit and proper" tests for responsible officers and formal outsourcing arrangements. However, experience suggests that managing agency risk through things such as licensing and a "fit and proper" test may have its limits. While a "fit and proper" test may keep out the truly ignorant or avaricious, how it will keep poor judgement or fear of failure in check may be another matter!

Whether the safety reforms even seek to address investment or systemic risk is open for debate. Existing requirements in SIS guide trustees towards a diverse and liquid investment strategy. The safety reforms further formalise investments decision-making, primarily through the risk management documentation, but do not dramatically change how trustee actually invest. Systemic risk appears well outside of the reform's frame of reference and indeed has seen little debate generally in Australia. This may be an issue worth future consideration. In fact recent APRA and government comments have indicated their desire for superannuation funds to take into account the possibility of liquidity pressures as a result of members shifting funds following negative investment returns. Fortunately to date such pressures do not appear to have emerged.

Christopher Daykin, the United Kingdom Government Actuary, in a 2002 paper<sup>8</sup> explored in further detail the risks that can apply to members of defined contribution (accumulation) pension or superannuation schemes. Some of these risks fit within the World Bank descriptive framework but Daykin also

<sup>5</sup> "A safer superannuation system"; Press Release from Minister for Revenue and Assistant Treasurer Senator the Hon Helen Coonan, "Safety of Superannuation a priority for reforms", 28 October 2002.

<sup>6</sup> HIH Royal Commission Final Report, p. 221.

<sup>7</sup> Roberto Rocha, Richard Hinz and Joaquin Gutierrez, "Improving the Regulation and Supervision of Pension Funds: Are There Lessons from the Banking Sector?", The World Bank, Washington DC, 1999

<sup>8</sup> Christopher D. Daykin, *Risk management and regulation of defined contribution pension schemes*, ISSA Seminar for Social Security Actuaries and Statisticians, Moscow, July 2002.

identified some additional risks. These latter risks are not always recognized or well recognized. One of the reasons for this is that some risks are attached to the regulators and legislators who are entrusted with the roles of administering and setting the rules for how superannuation funds deal with risk.

In addition the fact that a risk exists does not necessarily mean that anything, or anything much, should be done about it. This is because avoidance of some risks brings about avoidance of substantial potential benefits as well. Certainty or near certainty generally comes at a significant cost. In these circumstances the appropriate treatment of the risk might be no more than disclosure and/or understanding of the risk concerned. This is often, but not always, the case in regard to investment type risks.

### Investment risk

Within the general class of investment risks Daykin identifies some important sub-sets of risk. Within investment risks these include:

- **Market risk**, where the value of investments in an individual superannuation account may fluctuate and suffer significant falls in value in adverse market conditions (and considerable increases in value in favourable market conditions).
- **Economic risk**, where real rates of return on investments may prove unsatisfactory because of rampant inflation or poor economic growth rates (running a superannuation scheme in Zimbabwe would be problematic at the moment).
- **Default risk**, where investments made by a superannuation fund may default or lose value as a result of financial problems within the issuing company.
- **Hedging or mismatching risk**, where fund members may be exposed to the impact of unhedged positions in options or other derivative instruments or might be invested in instruments with an unsuitable risk or duration profile with respect to the position of the fund member.

Each of these sub-categories of risk deserves some attention in the Australian context.

### Market risk

The last five or six years in Australia has clearly demonstrated that the value of investments backing individual accounts can fluctuate. While outcomes have varied between funds and between investment options within funds, the general pattern has been one of considerable fluctuations.

Table 1 provides average return figures for recent years as reported in the ASFA Long-Term Return Study which is published each November in *Superfunds* magazine. Fluctuations between years between positive returns

approaching 20% in one year following by a negative return of between 5% and 10% have occurred in the past.

Investment returns for the financial year 2007-08 at the time of writing this paper were not known, but were on average likely to have been negative for most funds. Based on preliminary information returns ranging from negative 10% or 12% to around zero seemed the probable outcomes for most individuals in balanced portfolios. An average of around negative 5% or 6% appears likely. Higher negative figures generally apply to those funds with more growth assets in their investment portfolios.

The figures in Table 1 are for typical balanced, default type portfolios. Such investment portfolios attempt to mitigate risk through making use of a range of assets and asset classes. However, as the pattern of returns in the table such a strategy while it can mitigate investment risk, it in no way eliminates investment risk. This is particularly the case in those years, such as 2007-08 when there is a "perfect storm" for investment returns. More specifically, in the last financial year many asset classes experienced negative returns, investment speak for fund investments being worth less than what they were bought for.

Share prices were down both in Australia and in just about all overseas jurisdictions, including those economies in which overseas investments are generally made by Australian financial institutions. Both listed and considerable unlisted property fell in value. Some would argue that there were even greater falls in the market value for at least some unlisted investments than was recorded in fund accounts. However, this is difficult to prove or disprove in the absence of actual sales of such investments. The holders of such investments also point to the capital value of an investment being linked to the income stream that it generates. In the case of many infrastructure related investments that income stream may demonstrate considerable stability and certainty.

Higher interest rates would normally be expected to increase investment returns to those holding debt instruments. However, while this may be true for newly purchased debt instruments, in most instances superannuation funds will already have large holdings of fixed interest securities. With an increase in interest rates in the economy the capital value of fixed interest securities falls in order to bring their yield into line with market rates. This detracts from would otherwise be a stabilizing influence on returns.

The only unequivocally positive factor for returns in 2007-08 was the higher interest rates available for cash at call. However, generally only 5% or 6% of fund assets are in cash. Also of some assistance has been continuing strength in company profits and dividends in the case of many companies. This has led to funds having substantial franked dividends even though the capital value of shares in the companies concerned have fallen.

Table 1:1 Year – Real Rates of Return Year ending			
Year ending 30 June	Average fund return	AWE increase	CPI increase
1963	11.3	2.6	0.0
1964	13.6	5.4	0.7
1965	-8.7	7.3	4.2
1966	8.4	4.8	3.4
1967	12.0	6.9	2.6
1968	41.4	5.8	3.8
1969	8.3	7.5	2.5
1970	-1.5	8.4	3.0
1971	2.4	11.2	4.7
1972	20.6	10.2	7.2
1973	0.1	9.0	5.7
1974	-14.5	16.2	13.2
1975	8.7	25.4	16.5
1976	21.3	14.3	13.0
1977	7.3	12.5	13.8
1978	15.5	9.9	9.5
1979	13.9	7.7	8.2
1980	37.5	9.5	10.2
1981	17.1	13.9	9.3
1982	-2.8	14.6	10.5
1983	26.4	11.4	11.4
1984	14.2	7.2	6.9
1985	21.5	6.8	4.3
1986	32.0	6.4	8.4
1987	31.5	6.9	9.4
1988	1.0	5.8	7.3
1989	10.0	7.3	7.3
1990	11.2	7.3	8.0
1991	9.4	5.9	5.3
1992	10.6	2.8	1.9
1993	11.5	2.5	1.0
1994	8.8	2.8	1.8
1995	7.9	3.7	3.2
1996	10.5	3.0	4.2
1997	18.9	2.7	1.3
1998	8.7	3.8	0.0
1999	8.6	2.5	1.2
2000	13.3	2.5	2.4
2001	5.6	4.4	6.0
2002	-4.9	4.9	2.9
2003	-1.6	4.7	3.1
2004	13.8	4.9	2.2
2005	13.1	3.7	2.4
2006	15.1	5.4	3.2
2007	14.1	4.8	2.9



## **Economic risk**

This is a risk that does not currently attract much attention in Australia, perhaps because governments have become relatively successful (at least in recent years) at dealing with such risks. Monetary and fiscal policy settings have been set at levels which mean that inflation has generally been kept within the 2% to 3% range per year, and unemployment rates are at relatively long term lows. However, you only have to go back to the 1970s to find a number of years where double digit investment returns were more than outpaced by growth in prices and wages, with a string of negative real returns.

Perhaps the most important task for governments in dealing with investment risk in defined contribution funds is to manage the economy in such a way that levels of inflation and unemployment are kept at acceptable levels. The success of recent governments in Australia achieving this should be acknowledged.

## **Default risk**

In general superannuation funds in Australia have been remarkably successful in dealing with default risk in the investments that they make. They have achieved this through a combination of diversification and careful selection of counterparties. In the case of large superannuation funds the counterparties in regard to fixed interest securities are usually sovereign countries or very substantial companies.

That said, default risk has not always been dealt with well in some Self Managed Superannuation Funds (SMSFs). Over the last year or two there have been losses incurred in such funds because of losses in debentures and unsecured notes issued by companies such as Westpoint. A number of such funds have also suffered losses because they transferred shares to a stockbroker such as Opes Prime in order to facilitate various transactions. While the legal consequences of those transfers are still being considered by company receivers and liquidators and may be subject to legal proceedings, what happened reinforces the need for all trustees to consider the implications of what would happen if a counterparty to a transaction they have entered into runs into financial problems.

Fortunately these counterparty problems have not been experienced to any noticeable extent with larger superannuation funds. Professional investors generally will only transfer legal title in assets to entities such as custodians who have substantial capital backing and are well managed.

## **Hedging**

Superannuation funds in Australia are not much into options or derivative instruments. This is in part due to regulatory arrangements limiting the ways that fund assets can be

charged against a liability. It is also because funds usually obtain their desired degree of exposure to various investment risks (and returns) through primary investment instruments. Active involvement in options and derivative markets is also hard work and not for the faint hearted and often does not sit well with how superannuation fund asset allocations are assembled.

One traditional exception has been the hedging of the currency risk in regard to exposure to international investments. Such hedging is generally used to mitigate currency risk rather than to seek enhanced returns. As well, over time funds have tended to hedge less as the net impact of currency hedging over an extended period can be negative as wins and losses cancel out but transaction costs and fees continue.

Funds also make use of hedge funds, and accordingly can end up with some indirect exposure to derivatives and hedging. However, usually such investments make up only 2% to 3% of fund assets, and typically make use of "funds of hedge funds" in order to diversify risks.

Some Self Managed Superannuation Funds have begun to make greater use of installment warrants following legislative changes late last year which authorized such financial instruments following doubts raised about the prohibition on borrowing by funds on the use of such products. While traditional installment warrants used to purchase shares do not raise significant concerns about risk exposure, some newly developed products do raise questions of whether an unsuitable risk or durational profile is involved given the characteristics and interests of the SMSF members. A review of the legislative provisions relating to installment warrants is currently being undertaken by the government.

## **Agency risk**

There also are a range of risks that could be loosely described as agency risks. Some of these risks attach to those directly running superannuation funds, while others attach to those supervising or even setting the regulatory framework for such funds.

## **Management risk**

That the managers of a superannuation scheme prove incompetent or criminal in the management of investments or otherwise is one of the primary risks that prudential regulation of the sector seeks to address.

One approach is to detect any such mismanagement and then bring about a remedy of the situation, or at least punishment for those responsible and compensation for those defrauded. This was the approach primarily adopted prior to APRA licensing of trustees. In essence practically anyone could set up a non-public offer fund, but once such a



fund was in place the trustee had responsibilities.

The other approach to managing the risk of bad or incompetent trustees is a licensing regime. Since July 2006 all fund trustees (other than SMSFs) need to be licensed by the regulator, APRA. To get an APRA licence, superannuation funds need to have policies dealing with adequate resources, outsourcing and risk management.

Trustees are required to have both a Risk Management Strategy and a Risk Management Plan. These are required to contain sufficient information to enable the reader to understand in general terms how the trustee identifies, monitors and manages the risks to its own operations and those of the entity for which it is trustee, respectively. Actual risk management processes are not expected to be detailed within the respective documents. Breaches of the risk management regime are notifiable events to the regulator. Clearly, identifying and managing risk is a core part of keeping an APRA licence.

Importantly, trustees also have to demonstrate that they both individually and collectively they are “fit and proper” persons to acquire a licence from the regulator and to maintain this competence on an on-going basis. This requires all individual trustees to submit to police checks, character references, identification of necessary skills and establishment and adherence to minimum training requirements.

There also can be risks for both funds and members in the distribution of superannuation products and in the provision of advice. In Australia ASIC has the responsibility for the administration of Corporations Act provisions relating to both disclosure and the provision of advice. This includes licensing, where appropriate, product providers and advisers.

### **Fiscal risk**

A classic fiscal risk is where the government changes the rules for the taxation of pension fund investments thereby reducing the effective rate of return on the pension fund.

While hopefully this risk is relatively low at the moment, there is the Review of Tax and Transfers currently in process. ASFA in its submission to the Review will be addressing any potential fiscal risks for funds and fund members.

An interesting bit of history is that ASFA was established as a response to fiscal risk. In 1961 the then government introduced the 30/20 Rule, which required superannuation funds and life insurance companies to hold specified minimum holdings of government bonds. This requirement continued until 1984. Its abolition was a long term project for ASFA, one that was ultimately successful.

A more recent change was the introduction of the tax on contributions and fund earnings which took effect on 1 July

1988. While at the time the impact of the introduction of the tax on fund earnings was downplayed with the claim that imputation credits could be used to largely eliminate any earnings tax liability, currently the earnings tax contributes many billions of dollars of tax revenue to the government every year.

### **Regulatory risk**

Amongst other things this includes the regulator failing to identify incipient problems with a superannuation management company or, at the other extreme, decide to withdraw authorization for a company or trustee to provide superannuation services.

Examples of both have occurred in Australia in the relatively recent past. Commercial Nominees, an Approved Trustee under the old licensing system for public offer funds, is a case in point.

On the other hand some thousands of superannuation funds, mostly corporate funds, recently shut up shop because of the relatively onerous licensing requirements that have been introduced. While the regulator would argue that the licensing requirements are appropriate one of the consequences of the new regime was that in the absence of applying for a license these funds had their authorization in effect withdrawn.

Other regulatory risks include both the direct and indirect costs of regulation becoming excessive relative to the benefits of regulation. Some regulated entities complain from time to time about the regulator or regulators not understanding how markets actually work. However, such complaints tend to be universal around the world and are more a certainty than a risk.

“Regulatory contagion” is a sub-set of regulatory risk. There is some evidence that regulatory arrangements appropriate for one form of financial institution are then proposed for other types where they may not be appropriate. Examples include proposals for capital reserves of some type for accumulation superannuation schemes on the basis that other prudentially supervised entities such as banks and life insurance companies require such capital.

### **Political risk**

Daykin describes political risk as the government interfering in the operation of the superannuation system. Examples of this include sequestering assets, reducing contribution requirements, directing investments towards social or political objectives without regard to whether the returns are economic.

One might think that in the Australian system such risks are minimal, but we do have relatively recent examples of

the superannuation surcharge and (even more recently) the proposed arrangements applying to non-residents. Of course the surcharge is now abolished (at least for new contributions) and the non-residents superannuation proposal is under active review by the government following some spirited commentary from the sector and employers. However, the fact that both major political parties could contemplate a 100% tax on certain superannuation benefits indicates that there are some political risks for the sector, at least in regard to fund members not considered to be politically significant. Being a non-resident, and by definition not an Australian voter, is not helpful in regard to having your rights preserved.

However, the strong community support for the current superannuation system means that political risks are relatively limited in scale. For example, the government has specifically excluded the tax exemption for superannuation benefits taken by persons aged 60 and over from a taxed fund from the review of tax and transfer provisions that recently commenced.

Similarly governments in Australia are very careful when talking about superannuation fund investment in areas such as infrastructure or affordable rental housing to emphasise that funds will not be required to invest in such areas. Rather, proposals hinge on the provision of incentives (tax or otherwise) and the removal of any impediments to investments.

### **Systemic risk**

While the World Bank classification of risk includes systemic risk, this has not been a significant issue to date in Australia. This is partly because even the largest superannuation provider only has a 2% or 3% share of the total market and there are some hundreds of large superannuation funds and nearly 400,000 SMSFs. The failure of one fund is both unlikely and unlikely to have any impact on the system as a whole. This is reinforced by compensation arrangements being available to deal with any losses due to fraud or theft in the system.

Recently both the regulator APRA and the Minister for Superannuation have raised the question of whether funds have sufficient liquidity to support transactions associated with members switching funds in response to their fund reporting negative investment returns. Holding higher cash returns and emphasising the longer term for investment returns are ways of mitigating this risk.

While the regulator will continue to monitor the situation, systemic risk does not appear to be a big issue for the sector. This is because most funds will continue to receive strong cash inflows of employer contributions, and there is little evidence of fund members switching between funds because of low returns. Preservation requirements severely limit the

ability to withdraw funds from the superannuation system. Funds are able to deliver on their investment promise, as that promise in the case of accumulation funds puts most of the risk on the fund member.

Most low returns come from the investment option chosen rather than the fund selected. Finding another fund which gives a higher likelihood of an improved return for a like investment portfolio is not an easy task, possibly not a feasible task.

### **Other risks that the World Bank did not say much about**

The World Bank analysis is comprehensive, but it does not cover every relevant risk. Some other important risks for fund members are longevity risk and for funds reputational risk.

#### **Longevity risk**

In Australia most members are in accumulation funds and are not required to purchase annuities at the time of retirement. Very few do purchase annuities following the abolition of social security means testing concessions for annuities. Current and prospective improvements in life expectancy also highlight the financial risk to fund members of their savings running out before they die, or the member cutting back excessively on consumption and leaving an excessive account balance on their death.

My paper for the 2007 Colloquium addresses these longevity risk issues and possible responses by fund members and funds.

#### **Reputational risk**

As the dominant institutional investors in the Australian economy and as major players in the financial system superannuation funds run the risk of damage to their reputation on a range of fronts. Some of these criticisms can be for perceived rather than actual defects in management of superannuation funds. Often the issue will be completely unexpected so the management of the risk is more about crisis management than risk avoidance.

A recent example of reputational risk was in regard to stock lending. Superannuation funds came in for assorted criticism, not generally well based, on the grounds that stock lending is used to support short selling by hedge funds and the like, thereby supposedly destroying value in certain shares.

This criticism has eased off as share prices have bottomed out, and as it has become clear that the companies which had significant falls in share prices had problems greater than hedge funds being interested in them. The interest came from their fundamental problems rather than being the cause.

There have also been flurries of criticism of superannuation funds for supposedly investing in the wrong sort of companies, such as tobacco or alcohol companies. For example, the Australian Capital Territory government was subject to such criticisms in regard to the investment practices of the superannuation provision account that it maintains. Its response to this reputation risk was to establish a *Review of the Application of the Environmental, Social and Governance Principles to Territory Investment Practices*. Following the receipt of the report of the review in June 2007 the ACT Government has adopted the United Nations Principles for Responsible Investment.

There also is an Ethical Public Sector Superannuation Schemes Inquiry currently being conducted by the Economic and Finance Committee of the South Australian House of Assembly.

### **Socially Responsible Investment and Environmentally Sustainable Investment**

Going forward these issues will become increasingly important for superannuation fund trustees. The introduction of emission trading arrangements in Australia will provide both risks and opportunities for superannuation funds given that there will be impacts on share prices and economic activity from such arrangements. Dealing with the financial and investment implications of climate change will also be a risk management exercise for superannuation funds.

### **Adequacy**

The issue of how much is enough in retirement and whether current superannuation and retirement income settings will deliver adequate retirement savings is something which has been given considerable attention, including in papers presented to the Colloquium in previous years.

Although raising the issue in detail again has some attractions, for the purposes of this paper it is fair enough to just say that there is a significant risk that current retirement savings settings will not generate adequate retirement incomes for a substantial proportion of future retirees. Hopefully this risk will be addressed in the near future by adoption of a variety of policies. Amongst other things, ASFA has suggested the introduction of soft compulsion for higher superannuation contributions, enhancement of the co-contribution, facilitation of benefit projections and provision of advice on issues such as contribution rates, and development of uniform assumptions for benefit calculators.

## **CONCLUSIONS**

Regulatory requirements in Australia are reasonably good at dealing with many of the traditional risks associated with the operation of superannuation and pension funds. These include investment risks, operational risks, and even the largely non-existent systemic risks.

Superannuation arrangements are less good at dealing with some other risks. These include the financial risks of longevity in retirement, the adequacy of retirement income more generally, reputational risks for superannuation funds (including in regard to non-core features or operations of funds, and the possible risks of climate change and emissions trading arrangements.

Political and regulatory risks can also be challenging for a regulated entity to deal with, as in some instances regulation is the problem rather than the answer.