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Financial System Inquiry

Submission

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INTRODUCTION

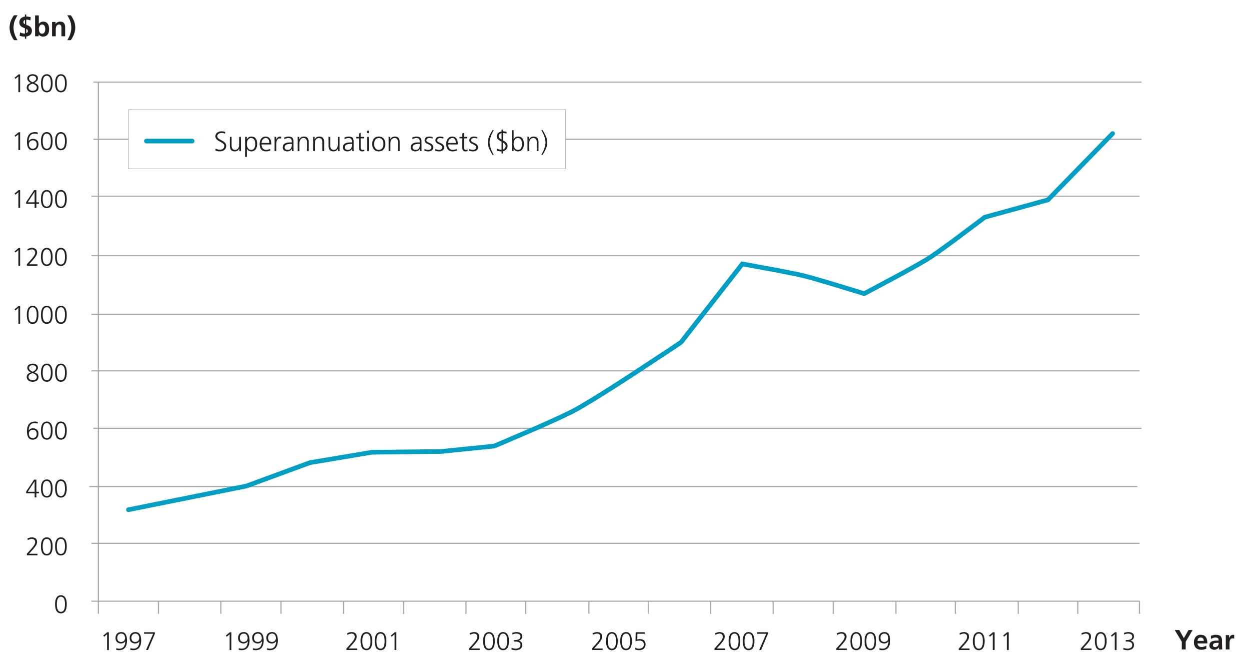
Australia has a three-pillar retirement system made up of:

- a mandatory contribution (made by employers), which is currently 9.25 per cent of wages, and gradually increasing to 12 per cent by July 2019
- voluntary contributions, many of which receive tax or other incentives
- a government means-tested Age Pension commencing at age 65 for men (64 and a half for women) but increasing to age 67 for both men and women from 2017.

All three elements have been, and continue to be, subject to change.

The result is a unique, if complex, superannuation system, which is rated amongst the highest-performing pension schemes in the world. And, as a significant participant, the superannuation system will be positively impacted by improvements in the efficiency and competitiveness of the Australian financial system.

Figure 1: Superannuation assets in Australia ($bn)



Source: APRA.

The Australian superannuation pool is one of the largest in the world, and will continue to grow for decades to come. It will become increasingly important to the goal of providing Australians with adequate income in retirement, and the impact of superannuation on the financial system and the economy will increase as a result. The pool of superannuation funds is expected to quadruple within 25 years; Treasury estimates suggest that assets held within superannuation will rise to around $6 trillion by 2037, about 145 per cent of gross domestic product (GDP).

Of all superannuation assets, Australians bear the investment risk on around $1.6 trillion through their defined contribution (DC) superannuation plans and, using Rice Warner and APRA estimates, we can say that roughly $1 trillion of these assets are chosen by the investor – through a self-managed superannuation fund (SMSF), through choice driven by a relationship with a financial planner, or through the investor's own decisions.

HISTORY OF SUPERANNUATION

1960
The Commonwealth Government introduces the 30/20 rule.

1961
Super funds exempt from tax if they held required amounts of Commonwealth Bonds. Commonwealth control of super funds by use of taxation power is firmly established.

1965
High Court upholds Commonwealth's ability to control superannuation fund investment by use of taxation power.

1967
The first industry fund, the Stevedoring Fund is established.

1972
Only 32 per cent of workers covered by superannuation.

1973
The government establishes the *National Superannuation Committee of Inquiry*, by Hancock.

1976
The Hancock Inquiry recommends a partially contributory, universal pension system with an earnings-related supplement.

1979
Fraser Government rejects the recommendations of the Hancock Inquiry.

1984
The 30/20 investment rule is abolished.

1985
Renegotiation of the Wages Accord identifies superannuation as a key issue.

1986
Labor and the ACTU succeed in seeking a universal three per cent of wages to be paid as superannuation contributions.

1989
The Government's 1989 retirement income policy statement establishes a policy in Australia based on the Age Pension and private superannuation.

1991

Employers required to make super contributions on behalf of their employees under a new system to be known as the Superannuation Guarantee (SG).

1992

The Labor Government implements the SG, which extends retirement savings to 72 per cent of workers.

1993

The World Bank endorses Australia's three-pillar system for the provision of retirement income as world's best practice.

1996

Superannuation surcharge introduced by Coalition Treasurer Peter Costello in the Howard Government's first budget.

1998

Australian Prudential Regulation Authority established as the lead superannuation regulator.

2003

- Superannuation surcharge reduced from 15 per cent to 12.5 per cent.
- Government co-contribution for low/middle-income earners introduced.
- 90 per cent of employed persons have employer provided super.

2005

- Abolition of the Superannuation Surcharge.
- Choice of Superannuation Fund take effect.

2008

Labor's first Budget contains details of a review of taxation – "Australia's future tax system", to be chaired by Dr Ken Henry.

2009

- A review is announced into the governance, efficiency, structure and operation of Australia's super system – to be headed by Jeremy Cooper.
- Limit on concessional contributions reduced.

2010

Stronger Super reforms announced in response to the Cooper Review.

2012

Legislation passes increasing SG from 9 to 12 per cent in increments from 2013 to 2019.

Table 1: Estimated MySuper assets by market segment (as at June 2013)

Market segment	Pre-retirement assets			Retirement	Total market	
	Choice	MySuper		Choice	All	MySuper
	$ million	$ million	%	$ million	$ million	%
Not-for-profit						
Corporate funds	9,621	54,521	85	3,661	67,804	80
Industry funds	45,397	257,248	85	27,034	329,678	78
Public sector funds	28,696	162,608	85	54,272	245,576	66
Total not-for-profit	83,714	474,377	85	84,967	643,058	74
Commercial funds	202,967	103,903	34	158,632	465,503	22
Self-managed super funds	258,672	-	-	248,528	507,200	-
Total superannuation market	**545,353**	**578,281**	**52**	**492,128**	**1,615,761**	**36**

Source: Rice Warner.

Recommendations

ASFA sees this Financial System Inquiry as an opportunity to make recommendations in two key areas: regulation and the financing of the Australian economy.

Our recommendations are based on the overarching theme that, as the system is compulsory and funded by taxpayers, it must be regulated to ensure that it delivers the retirement outcomes framed by public policy and that all monies are invested in a prudent manner.

Regulation

Of the developments in the superannuation and financial sector since Wallis, the most significant is the rise of fund members making their own investment decisions. We now have two large pools of money within the system: one pool with SMSF investors and the other with APRA-regulated collective investment vehicles. We also have a growing pool of post-retirement monies. The system has also evolved from one where the standard superannuation product was a balanced diversified fund; we now have many diverse products being offered to consumers. We also have a wider range of service providers which perform various functions within the system.

These developments mean that we need to re-assess the current framework and to determine how to address gaps, issues and emerging trends that prevent the efficiency and competitiveness of the superannuation industry. In this submission, ASFA highlights the need to:

- acknowledge the impact of the rise of individual decision making and how that applies to a high duty of care on retirement monies
- identify and address emerging regulatory and consumer protection gaps and overlaps due to structural and participant changes
- identify any systemic risks across all three pools of money (pooled, SMSF, retirement), both separately and collectively
- respond to the increasing linkages between superannuation and other parts of the social security and tax systems
- assist future retirees looking for a wider selection of income stream products by removing impediments and promoting innovation and competition in the market
- anticipate any regulatory requirements for the growing globalisation of regulation and the global movement of people pre and post retirement

- address inconsistencies in the application and methodology of the funding of regulatory oversight and regulation
- focus on the needs of the developing electronic payments system
- enable effective and transparent competition within the industry
- put in place a framework that provides incentives for the purchase of income stream products as well as develop an appropriate governance framework.

Funding

Our submission is based on an overarching principle with respect to superannuation investments. This principle is that the primary purpose of superannuation is to provide income in retirement. While incentives may help to maximise the economic impact of superannuation capital, directing investments into particular assets or investments classes has the potential to move away from that purpose. Market forces will determine that capital will flow where it is most valued. This obviates the need for any specific interventions mandating asset allocation of superannuation fund investment strategies, as this is an invitation for poor performance and lower returns.

That said, we note that there are several areas where impediments could be removed and funding needs could be better matched with the risk and return objectives of superannuation investors. These are:

- to reassess the ways in which we require pooled superannuation funds to manage liquidity risk, potentially exploring innovative solutions to this issue. For example:
  - » considering some regulatory relaxation of the liquidity requirements in products that are mainly invested in by younger members with longer investment horizons
  - » looking at whether product disclosure statements could explicitly lengthen redemption terms to allow pooled funds greater exposure to less liquid assets
  - » exploring the potential for liquidity limits to be based on some historical assessment of the behaviour of members' redemptions over time
- to ask state governments and other infrastructure developers to be more flexible in the structuring of funding and financing of infrastructure projects to better match the risk and reward preferences of superannuation investors. For example, to follow the NSW Government approach of seeking superannuation funding after the initial development risks have been mitigated.

CHAPTER ONE

The superannuation environment

The superannuation environment

1.1 Where have we come from?

In 1997, the Wallis Inquiry was established to examine the outworking of the deregulation of the Australian financial system, which had been underway since the early 1980s. In particular, its remit was to make recommendations on the nature of the regulatory arrangements that would best ensure an efficient, responsive, competitive and flexible financial system. By this time, compulsory superannuation – in the form of the Superannuation Guarantee – had been in place for around five years, although superannuation in the broader sense had been operating for some decades.

Although firmly established, in 1997 superannuation represented a fairly small part of the financial system as a whole, with assets totalling around $321 billion, or 37 per cent relative to GDP. In the following 16 years, the system has grown substantially with compulsory and voluntary contributions, combined with compounding returns, driving the growth of superannuation assets to in excess of $1.8 trillion, and the ratio of super to GDP rising to over 100 per cent of GDP. This means that, since Wallis, growth in superannuation assets has tripled that of Australia's GDP growth.

Superannuation was not a key concern for Wallis. Rather, it was considered a part of the system that needed to be sensibly incorporated in the context of larger scale adjustments to the philosophy and implementation of financial system regulation. Wallis noted, however, that:

> *"Compulsory superannuation has seen a greater share of household assets shift from capital certain investments, such as bank deposits, into market linked investment classes. A growing proportion of the nation's financial wealth is being invested in superannuation and the level of risk being directly borne by households is increasing."*

The recommendations and the underpinning regulatory philosophy that emerged from Wallis, however, would be key in shaping the superannuation industry over the next decade and a half.

The release of the Wallis Report cemented an evolving philosophy, first catalysed in 1979 by the Fraser Government's rejection of the Hancock Inquiry's recommendations. This philosophy was that superannuation should be privately funded, and that the investment risk of assets held within superannuation should not be borne by the government. The final Wallis Report advocated greater superannuation choice for members, alongside other recommendations including an increased need for disclosure and the separation of the regulation of public-offer superannuation funds from self-managed superannuation funds (SMSFs). Under the heading of 'Promoting Increased Efficiency', Wallis also recommended harmonising the regulation of collective investments and public-offer superannuation funds.

In 1986, the introduction of three per cent award superannuation through the Wages Accord meant that many workers who had not previously had access to retirement benefits through their workplace began to have money set aside for retirement. The cost of these contributions was, effectively, funded by the worker and that money, generally, was not being contributed towards a defined benefit (DB) scheme run by their employer or the government. Rather, the money was invested in a defined contribution (DC) scheme, where members would receive the full profits, and also wear all of the losses from their investments.

A 'paternalistic' approach, where the employer was responsible for the retirement experience of their employees was gradually disappearing for a number of reasons. Firstly, the employment patterns of individuals were changing. It was no longer typical for an employee to remain with one organisation for their working life, which meant issues regarding the transfer of post-employment benefits were emerging. Secondly, the credit risk associated with the DB plans provided by employers was significant. Employees were exposed to the risk of their corporate superannuation plan being mismanaged, or the default of obligations under the plan if the organisation went into liquidation. As Australia faced recessionary times, this issue was very real. Thirdly, and perhaps most importantly, many employers were no longer willing to bear the liability to the DB scheme on their balance sheet. These same issues with DB schemes are now emerging globally.

In the period since Wallis, the vast majority of DB plans have closed, either altogether or to new members. Some offered

their members incentives to shift their balances from a DB scheme to a DC scheme to remove the liability from the employer and shift the investment risk of their superannuation benefits to the member. As Figure 3 shows, the number of corporate superannuation plans has declined significantly since 1997. Where corporate funds have closed, the members and assets, in most cases, have moved to retail or industry funds rather than any formal mergers occurring.

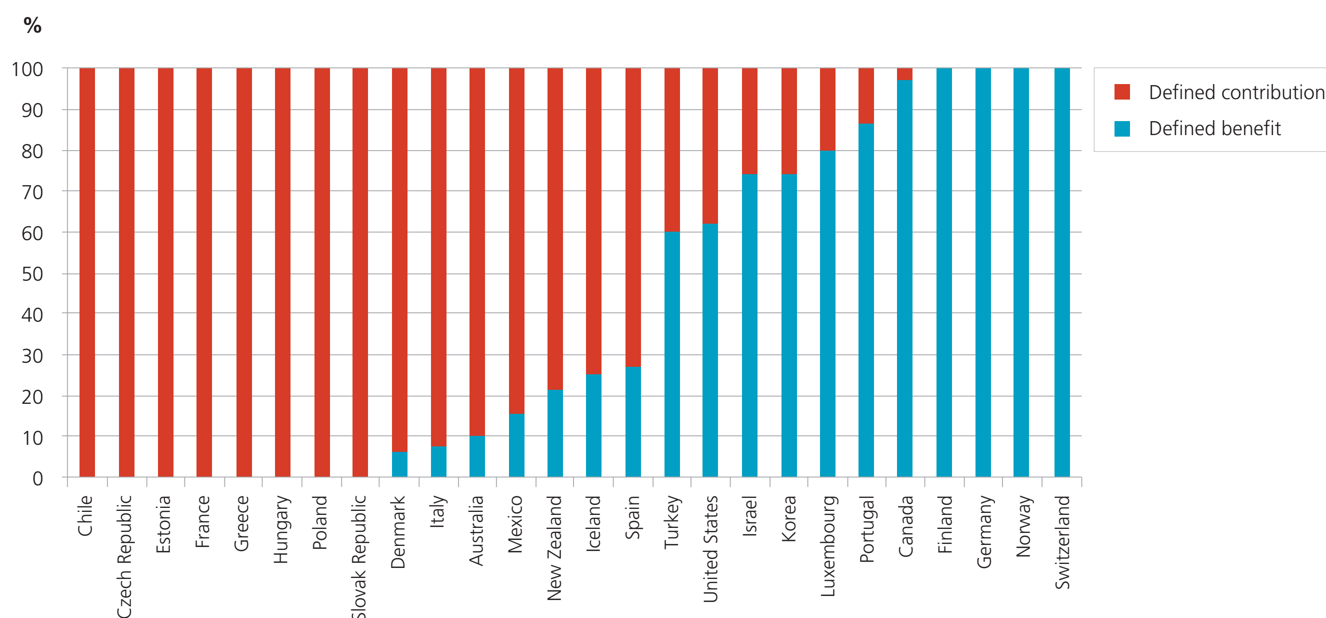
Defined benefit (DB) plans are pension benefits provided by an employer or sponsor. The employer or sponsor promises a regular income benefit on retirement that is calculated using the employee's salary, their tenure of service, and their age. DB's are not directly related to investment returns. In the OECD, 18 countries have DB plans provided by the government and private occupational schemes are mandatory (or effectively mandatory) in the Netherlands, Switzerland and Iceland.

Defined contribution (DC) plans are those where contributions are paid into an individual account for each member. The contributions are invested and the returns on the investment – either positive or negative – are credited to the individual's account. On retirement, the balance of the account is used to support the member in retirement, sometimes through the purchase of an annuity that then provides a regular income. DC plans are compulsory in 10 OECD countries.

While problematic in many respects, DB schemes do have one key advantage over DC plans in that they seamlessly manage the transition from working income to retirement income. Therefore, their demise has created an unintentional gap in our superannuation system, which poses a key challenge for future public policy around superannuation: how do we ensure that the lump-sum benefits of superannuation are sensibly converted into an income stream or capital source that can finance an individual's needs during retirement, for the whole of their retirement? This issue is discussed further in Section 2.2.

Today, almost 90 per cent of Australia's superannuation funds under management (FUM) are invested in DC schemes. This is relatively high compared to many advanced countries, including the United Kingdom, Canada and the United States and, when considered alongside the relative immaturity of the Australian superannuation scheme, perhaps explains the greater weighting to equities in the Australian pension market, relative to our global peers. The share of superannuation fund assets that are in DB schemes has remained around 10 per cent since 2005, after declining over the previous decade (RBA, 2011). We note, however, that the liabilities to members across DB schemes in Australia are somewhat higher than this data suggests, because many public sector schemes are partially unfunded.

Figure 2: asset shares of different pension fund types (%)



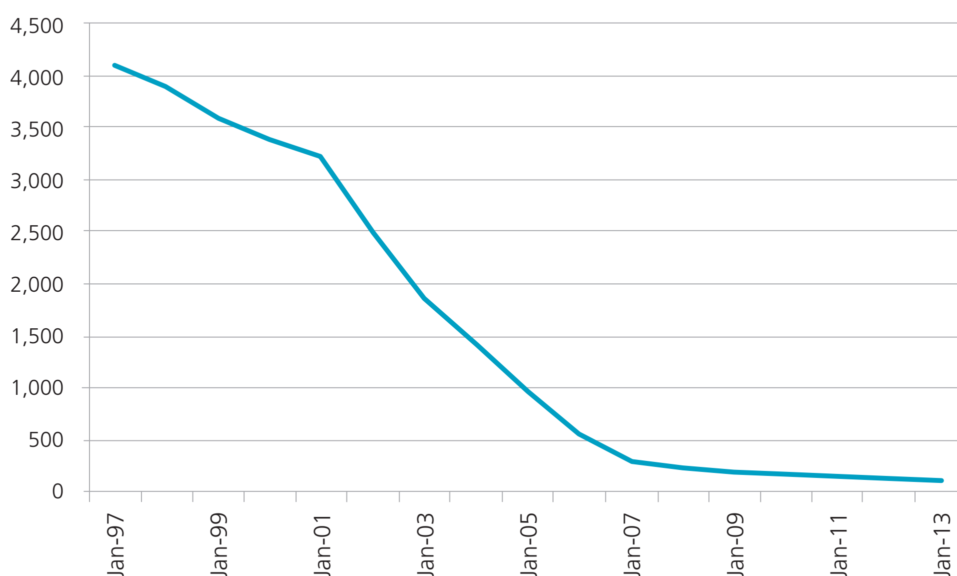
Source: OECD Pension Markets in Focus, 2012.

Table 2: Risk distribution by superannuation fund type

Type of risk	Defined benefit	Defined contribution
Investment	Employer	Employee
Inflation	Employer/employee	Employee
Longevity	Employer	Employee
Market timing (temporal)	Employer	Employee
Accrual (portability)	Employee	DC plans are portable
Vesting	Employee	Employee
Employer insolvency	Employer/employee	DC plans always fully funded
Salary replacement risk	Employer	Employee
Fiduciary/legal risk	N/A	Employer

(Broadbent, 2006).

Figure 3: Number of corporate superannuation funds in Australia



Source: APRA.

Alongside the reduction in the number of corporate superannuation funds, we have seen two other significant structural shifts in the superannuation landscape. These are: firstly, a reduction in the number of superannuation players in the market; and secondly, the extraordinary growth in SMSFs.

As corporate funds have closed or consolidated, so too have the number of other larger players in the superannuation industry. The number of not-for-profit industry funds has reduced by more than two-thirds from 176 funds in 1997, while the number of retail funds has also decreased by around 50 per cent. This is largely the result of mergers, as players have looked to increase scale to help drive operating efficiencies. There are many examples of this occurring, including the merger of AMP with AXA Asia, Health Super with First State Super and AGEST with AustralianSuper. AustralianSuper has been involved in more than 15 mergers.

While the number of corporate funds and retail superannuation providers has reduced, the number of products have not necessarily followed suit. Across 10 of the largest providers, there are 135 separate products, each of which will offer a range of different risk and return options.

Table 3: Number of products within selected retail superannuation trusts

Trust name	Number of products
AMP Retirement Trust	7
AMP Superannuation Savings Trust	10
Asgard Superannuation Account	19
EquitySuper Master Fund	12
IOOF Portfolio Service Superannuation Fund	19
MLC Superannuation Fund	6
Oasis Superannuation Master Trust	22
OnePath MasterFund	15
Suncorp Master Trust	14
The Universal Super Scheme (MLC)	11

Source: SuperRatings.

Further, the assets held on master trust and wrap platforms have also increased markedly. Data provided by Chant West has $376 billion in assets held on these platforms. This compares to $306 billion managed by industry funds.

Table 4: Structure of the Australian superannuation industry (as at June 2013)

Fund type	Number	AUM ($b)	Members (milion)
Retail – master trusts	72	305	8.2
Retail – wraps	38	71	0.4
Industry	53	306	11.3

Source: Chant West.

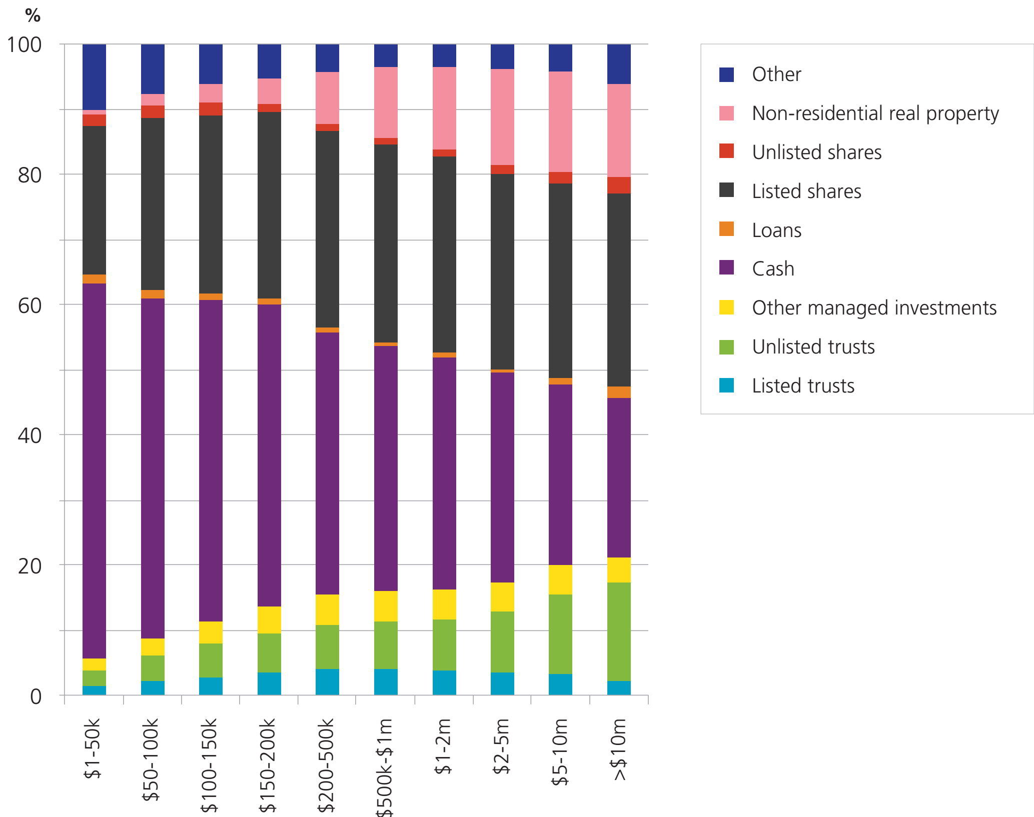
While the number of large superannuation funds has been reducing, the number of small funds, more specifically SMSFs, has been rising at a rapid rate (refer Figure 5). It is not likely that this phenomenon was expected in 1997 when the recommendations of the Wallis Inquiry were being finalised.

The rise of SMSFs cannot be easily ascribed to one, or even two specific reasons. While our research indicates that some members want to feel more in control of their assets than possible, or perceived to be possible, through an institutional fund framework, there are many other reasons cited for the rise in SMSF numbers including:

- lower management fees, actual when the SMSF is large and perceived at lower levels of FUM
- effective tax management of investment income, including no capital gains tax when a member moves from accumulation to pension phase
- loss of confidence in collective investments following the GFC
- aggressive marketing of SMSFs.

The data shown in the graph on the next page shows that, across all SMSFs, cash (including term deposits), listed shares and non-residential real property are the most popular assets for SMSF trustees to invest in. Institutional funds have responded to this pattern by introducing standalone options for term deposits and offering individual shares on their investment menu, in an attempt to retain would-be SMSF holders.

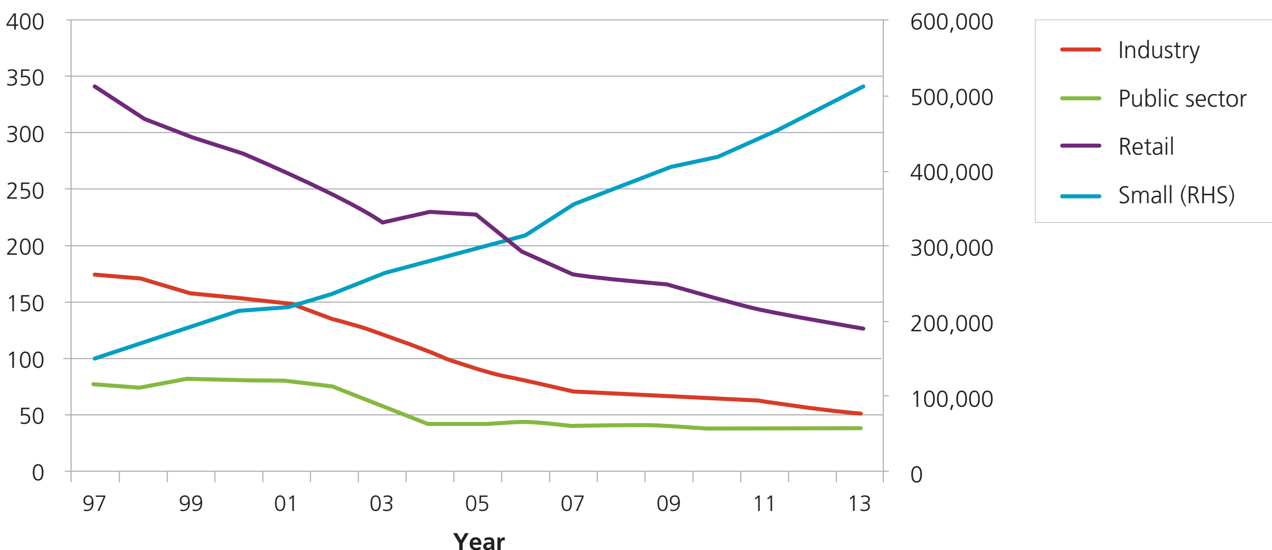
Figure 4: SMSF asset allocation by size of fund (as at December 2012)



Source: ATO.

While the absolute number of APRA-regulated superannuation funds is quite large – more than 300 in total as at end December 2013 – the holding of assets is concentrated. Australia's largest 20 superannuation funds, in combination with SMSF accounts, control around 70 per cent of all superannuation assets. The residual 30 per cent of assets are managed by 180 large super funds (those with assets greater than $50 million) and a further 110 or so smaller super funds. Outside SMSFs, around 80 per cent of new contribution flows go to just over 20 funds.

Figure 5: Number of funds by type (as at December 2013)



1.2 Interconnectedness with the financial system

At the time of Wallis, the focus was on banks, insurers and capital markets, largely due to their scale in the financial system. However, with the growth of superannuation assets and the consolidation of players within the superannuation industry, there are now significant and complex linkages between superannuation and other parts of the Australian financial system.

- **Banks:** superannuation is heavily invested in the banking sector. Firstly, as deposit holders in Australian deposit taking institutions (ADIs) such as banks and building societies, and secondly, as holders of bank equity. As of December 2013, superannuation funds had invested about $217 billion in deposits accepted by banks. A further $22 billion was invested in the bonds of financial corporations (bank and non-bank), and $159 billion invested in the equity of financial corporations (bank and non bank). This means a total of around $398 billion of superannuation funds are invested in Australia's banking sector, representing 22 per cent of total superannuation (ABS). This is an important source of liquidity for Australian banks and it reduces the need for them to source wholesale funding from overseas (Levine).

- **The Australian Securities Exchange (ASX):** superannuation funds hold a substantial portion of Australian shares by market capitalisation and this relationship has grown over time. The ASX estimates that the proportion of Australian equities held by superannuation funds grew from 8.5 per cent in 1998 to 16.5 per cent in 2007 (ASX 2007). Based on the latest available data, ASFA estimates that direct holdings of shares by superannuation funds accounted for around 33 per cent of the total ASX market capitalisation as at January 2014.

- **Insurance companies:** superannuation relationships continue to be key to the business model for life insurance companies, with around 50 per cent of annual in-force premiums linked to superannuation services either through a superannuation fund, or a financial adviser (Rice Warner)).

- **Managed funds:** superannuation funds are the largest contributor to managed funds. As at the December quarter 2013, superannuation funds accounted for 78 per cent of all consolidated assets in managed funds, with public unit trusts, life insurance funds and other funds comprising the remaining 29 per cent (ABS 2013). Recognition of the opportunities created by the growth in funds under management has driven significant global interest in establishing and building funds management operations in Australia. The size of the domestic industry, together with the availability of a highly skilled, multilingual workforce, a strategically-advantaged time zone, and access to world class infrastructure, have proven critical factors in the decision by global investment houses and service providers to establish operations in Australia.

- **Service providers such as administrators and custodians:** as the size of the superannuation market has increased, so too has the reliance on the services of third-party providers such as custodians. Of the $4 trillion custodian market in Australia, $1.1 trillion assets are held on custody on behalf of not-for-profit and retail superannuation funds (Rainmaker). Administrators already manage the pension payments for much of the system's retirement assets, and the size of pension payments out of superannuation accounts will only increase as the system matures.

- **The broader payments system:** the payments system is the plumbing through which around $125 billion in contributions were made in 2012-13 and the means by which transfers of money are effected from one superannuation fund to another when a member changes their active fund.

1.3 The impact of changes in technology

Over the past decade and a half, technology has moved at a surprisingly rapid pace. This technology shift has been particularly evident in the rapid uptake of mobile technology: tablets and mobile phones. Most sectors of the economy have been affected by this change, for example, the impact of online shopping on the retail sector. The combination of computational speed and the ready access to vast amounts of data means that data-intensive processes that were once uneconomic or unwieldy are now easily managed.

Financial service providers are adjusting to this new environment by offering an online experience to their customers. For example, nearly all banks now offer online personal banking services, many of which are accessible via mobile or tablet devices.

While many superannuation funds offer a similar online experience, fund-implemented technology solutions for receiving superannuation contributions have, at least until recently, focused on delivering a bespoke solution for each individual fund. While this delivers benefits to the individual fund, such solutions have provided limited productivity gains for employers who are often required to deal with multiple funds. This has led to the rise of clearing house service providers, who offer a better service to employers than that which is offered by the funds. However, in order to increase efficiencies further, a single industry-wide technology solution could be developed using the smart application of technology. At present, no such system exists.

For superannuation providers, there are four key client groups, who each have unique challenges when it comes to dealing with them electronically:

- those making contributions on behalf of superannuation fund members (generally employers)
- superannuation fund members themselves
- providers of insurance services to funds and their members
- providers of investment and custodial services to funds.

As discussed previously, the general approach has been for individual funds to develop and implement their own bespoke electronic solutions. For contributions, the focus of these solutions was to link the banking system payment transaction with the associated data describing the purpose of the payment. While this approach 'solves' the problem from the superannuation provider's perspective, from the client's (contributing employer or member) perspective it only solves the problem of communicating with that superannuation entity and not the other superannuation entities with which it also needs to interact.

Similarly, with the other three groups, where electronic interactions occur, they do so under bespoke solutions.

Additional challenges with the existing system include the limited amount of data that can be sent with a payment and flaws in the inter- and intra-bank processes for dealing with the data. In particular, for employers, the shift from paying contributions to a single fund of their choice to multiple funds under multiple payment arrangements has created administrative complexity.

Since 1998, the superannuation industry has endeavoured to standardise the process for interactions between employers and funds with respect to contributions, and between funds with respect to the rolling over of superannuation benefits.

Technological advances have largely removed the need for people to deal face to face. The increasing move to electronic transactions, and particularly to the electronic and remote initiation of transactions, is not without its risks. One such risk is the increasing prevalence of cyber-crime.

In establishing the SuperStream transaction network, particular attention has been paid to requiring the encryption of data as it moves from gateway to gateway to prevent the interception and alteration of this data. Connections between originating parties and the gateway network, and the gateway network and end points have login code and password protection. However, where transactions are passed through a chain of players, the overall security strength must be

measured by the strength of the weakest link in the chain.

Identity theft is also a growing concern in the superannuation industry due to the increasing size of member account balances. The problem is exacerbated due to the new member enrolment process for those being enrolled by an employer into the employer default fund. For these members, a fund receives no member-completed documentation. While there are some protections offered under the new arrangements as a result of SuperStream (for example, use of the ATO's SuperTick service to validate the member details against the ATO's records of taxpayers), the process remains open to fraud.

1.4 Legal and governance structure

While corporate superannuation funds have become a smaller part of the superannuation industry, they have left their legacy in the legal structure under which all superannuation funds now operate. Most superannuation funds today are structured as trusts, following the pattern established by the earlier employee sponsored pension plans. The directors of these trusts have a fiduciary obligation to members by virtue of the trust structure in which they operate, but also through legislation which looks to provide more certainty around the roles and responsibilities of the trustees than would be the case if the system were to rely on the judicial interpretation of Australian Trust Law. This provides considerable efficiency and equity gains because disputes relating to superannuation trust arrangements are not required to be determined through the judicial system.

The statutory obligations of superannuation funds, which are set out in the *Superannuation Industry (Supervision) Act 1993* (the *SIS Act*) as well at tax legislation and the *Corporations Act* amongst other legislation, allow effective regulation of the superannuation industry, and have provided government with the opportunity to ensure that superannuation meets the long-term needs of Australians. In combination with the control of public policy relating to superannuation – as determined in the 1960s – government is able to balance protecting the interests of Australians invested in the compulsory superannuation system, with the impact on the public purse of the Age Pension arrangements.

The purpose of superannuation assets meeting retirement income objectives is set out in legislation. Under the *SIS Act*, a superannuation trustee is responsible for formulating an investment strategy that has regard to the whole of the circumstances of the fund. While not restricting the investment universe, this requires superannuation funds, including SMSFs, to operate according to the 'sole purpose test' with the retirement income objective paramount. In particular, Section 62 of the *SIS Act* requires that a trustee of a regulated superannuation fund must ensure that a fund is maintained for the core purpose of providing benefits after a member's retirement. The sole purpose test does clarify that certain kinds of investments are regarded as inconsistent with the government's superannuation policy objectives, including lending funds to a member of a super fund or investing in an asset that is not on an 'arm's length basis' and specific restrictions are placed on investing in 'in-house assets'.

As part of the *SIS Act* legislative framework for superannuation, a superannuation fund trustee is also required to:

- ensure that investments are diverse and that the super fund is not exposed to risks from inadequate diversification
- manage the liquidity of a fund's investments to meet expected cash flow requirements
- have regard to the risk involved in making, holding and realising the investments, as well as the likely return from the investments meeting fund objectives
- justify and document how all investments made under an investment strategy are consistent with that strategy and the safeguards, if any, that will be used to enable both the objectives of the strategy and the requirements contained in the investment covenant to be met.

In February 2001, APRA provided further clarification on its interpretation of the *SIS Act* outlining a set of principles in a superannuation circular. The principles state that a trustee should exercise care when considering investments to ensure that the provision of retirement benefits for members is the overriding consideration behind the investment decision. "However, the situation may arise where a properly considered and soundly based investment provides 'incidental' advantages to members or other persons which could suggest that the fund is maintained, in whole or part, for an improper purpose." The principles go on to describe that "such incidental advantages would not necessarily, in isolation, amount to a breach of the sole purpose test". For example, "investment in a well-researched and commercially sound project might incidentally create employment opportunities for members; and it is open to trustees to develop features of their fund which add value to, or differentiate it from, other funds."

There has been little focus on the concept of 'incidental advantage' in the broader debate about fiduciary duties. However in the context of a legislative environment that does not restrict investment, there is no legislative and regulatory restrictions that have for instance prevented the development of traditional forms of ethical investment, so long as investments are made for the purpose of providing retirement benefits.

1.5 How has superannuation performed?

In international comparisons, Australia's retirement incomes system has consistently been ranked favourably compared to other countries. As early as 1993, the World Bank endorsed Australia's three-pillar system for the provision of retirement income as world's best practice. This was supported by the 2012 Mercer Global Pension Index, which ranked the Australian system third out of the eighteen countries assessed, noting that it has a "sound structure, with many good features" (Mercer, 2012).

While globally acknowledged as a leading pension system, Australia does not operate to a standard model. It is neither a standard DB nor DC market. In its survey, Mercer referred to Australia as a hybrid model, but even this term does not do justice to the unique nature of the Australian superannuation system. It has components of 'compulsion', of 'choice' and of 'defined contribution' but is not any one of these alone. So while international comparisons are useful, there is a limit to the relevance these comparisons.

OECD roadmap for the good design of defined contribution pension plans – Australia's scorecard

	A well-structured defined contribution superannuation system should:	Score out of 5	ASFA assessment
1	Have coherence between accumulation and retirement phases	3	Regulatory and tax environments between the accumulation phase and retirement phase of an Australian's life are significantly different. However, good transfers to allocated pensioners and TTRs.
2	Have long contribution periods	5	Compulsory superannuation for all working Australians and advantageous tax arrangements promote participation.
3	Provide incentives for participation	5	Taxation arrangements incentivise contributions.
4	Promote low-cost retirement savings instruments	4	MySuper regime supports low-cost default plans.
5	Appropriate range of risk and return options and default options	5	Australian super funds have provided a range of risk/return options for many years.
6	Consider lifecycle options deemed as appropriate for default options	5	Many super funds have life stages defaults. A large number have adopted a lifecycle approach as their MySuper default.
7	Encourage the purchase of annuities to cover longevity	2	Some tax issues. No positive incentive over higher alternatives.
8	Promote the supply of annuities and cost-efficient competition in the annuity market	2	Low demand for annuities and many providers have abandoned this product line.
9	Develop appropriate information and risk hedging instruments to help manage longevity risk	1	Still some way to go.
10	Promote financial literacy	3	Mixed scorecard. ASFA has undertaken financial education initiatives. However, there is still evidence of a limited understanding of risk and reward trade-offs across investment products.

LOW — MEDIUM — GOOD — HIGH — VERY HIGH

Rating	Criterion
1	Help manage longevity risk with appropriate information and risk-hedging instruments
2	Promote supply of annuities and cost-efficient competition in the annuity market
2	Encourage purchase of annuities to cover longevity
2	Coherence between accumulation and retirement phases
3	Promote financial literacy
4	Promote low-cost retirement savings instruments
5	Appropriate range of risk and return options and default options
5	Lifecycle options considered appropriate for default options
5	Incentives for participation
5	Long contribution periods

The OECD, through its roadmap for the good design of defined contribution pension plans (as approved and endorsed by the OECD working party on private pensions in June 2012), has provided a useful benchmark against which to assess Australia's defined contribution pension scheme.

As the box on the previous page shows, overall our superannuation system rates well against these internationally recognised criteria. Indeed, ASFA assessed the Australian superannuation system as meeting five of the ten criteria to a high or very high level. Those criteria where Australia could be seen as not meeting the highest standard include the provision of post-retirement products and the coherence of the accumulation to retirement phases of investment. These themes are picked up in Section 2.2, which sets out ASFA's ratings against the criteria. For members, superannuation's performance can be measured by its ability to provide a reasonable level of capital growth over the accumulation years and a sustainable income stream through retirement. In superannuation, where funds are set aside for the long term, the emphasis should be on the long-term returns that are achieved. Shorter term fluctuations in valuations are usually the cost a long term investor pays for better long term performance. As a consequence, most default funds for entry level members, where investors assets will be squirrelled away for their retirement, some 50 years away, will hold a greater proportion of growth assets to improve the probability of a better investment outcome.

The financial performance of a private pension system is vital to its adequacy. Stronger returns lead to higher accumulations at retirement for the same contribution. Australian superannuation funds have delivered returns well above inflation over the long term.

Table 5: Investment returns to June 2013

Time horizon	Fund returns	Real returns	
years	% p.a.	vs AWE	vs CPI
10	6.8	2.4	4.0
15	6.0	1.4	3.1
20	7.2	2.7	4.5
25	7.9	3.3	4.8
30	9.7	4.6	5.8
35	10.8	4.7	6.0
40	10.3	3.1	4.5
50	10.0	2.7	4.5

Source: *Superfunds*.

The data is for funds with growth assets in the range of 60 per cent to 80 per cent, which is representative of the average default investment arrangement.

These returns are ultimately reflected in retirement incomes. Mercer (2012) suggests that replacement rates – the percentage of final salary that a member receives as income in retirement – for median income earners are a key determinant of the overall performance of a retirement incomes system. The OECD recommends a target replacement rate of 70 per cent of final earnings (OECD, 2009). Similarly, in assessing the adequacy of international pension arrangements, Mercer (2012) gives the highest scores to countries with replacement rates between 70 per cent and 100 per cent.

Currently, the gross replacement rate (including the Age Pension) for median income earners in Australia is approximately 60 per cent (OECD Pensions at a Glance, 2013). This replacement rate is slightly above the OECD average. The Australian Government has published figures with higher replacement rates but these are not consistent with the methodology used by the OECD in its international comparisons. For an individual on 1.5 times average earnings, the OECD estimates a replacement rate of 39.4 per cent for Australia, somewhat below the average for the OECD countries of 48.4 per cent.

> *The current "three pillar" retirement income arrangements have led to higher retirement incomes than under previous systems. In particular, the superannuation system, and the superannuation guarantee is providing a significant boost to retirement incomes and will help maintain retirement incomes at a level that would otherwise not occur.*
>
> *(Source: Treasury, 2009.)*

CHAPTER TWO

Regulatory policy recommendations

Regulatory policy recommendations

Chapter one sets the scene for the policy recommendations provided in this chapter.

Current superannuation regulatory philosophy is driven by the fact that the system is mandatory, taxpayer-funded and reduces the burden of the Age Pension on current and future governments. The resulting philosophy is to ensure that retirement outcomes are maximised to increase the rate of self-funded retirees, and taxpayers receive value for money. That is, the tax incentives provided within the superannuation system delivers a better result for the economy than they would in other vehicles or consolidated revenue. Additionally, money saved for retirement needs to be used for retirement purposes only.

Whilst there have been continuing changes to the regulation of the superannuation system and industry, the overall regulatory framework is still fundamentally based upon the traditional structure of a superannuation provider. That is, a standalone trust with only a few investment options and a trustee board. This assumption is no longer valid, as outlined in Chapter one.

Going forward, regulatory philosophy and framework must have the flexibility to respond to the significant changes that are occurring, and will continue to occur. By far the biggest driver of the need to change the regulatory approach is the increase in the availability of choices for individuals in relation to their superannuation and the continued growth in individual decision making pre and post retirement.

Tax incentives promote savings in the system. Over the long term, this policy initiative will prevent the blow out of liabilities for the government that would otherwise occur under a universal Age Pension system. We have seen this problem emerge in other economies. Having foregone tax revenue in the form of incentives, it is reasonable for the government to expect that recipients of these incentives invest their money in a manner which is consistent with supporting their long-term retirement needs for income.

In order to get the balance between consumer protection and choice right, the following regulatory philosophy should be applied:

- at the whole-of-system level, there should be monitoring in place to ensure that the super system is delivering against its retirement objectives. This means that the regulatory framework that governs the superannuation system supports public policy in relation to retirement
- at the product and service provider level, oversight is required to ensure that they are meeting their obligations with respect to delivering retirement outcomes
- at an individual level, choice should be encouraged within a framework where the ability to invest in an unregulated environment is limited. This will ensure that the system delivers the overarching retirement outcomes objectives, by putting parameters around risk-taking and providing consumer protections.

While there are a myriad of regulatory challenges for super, four main gaps within the current regulatory framework:

- it does not cover all structures, products and entities that are now part of the system
- the superannuation pool is now so large that it requires a regulator to look at issues and, particularly, risks, across the whole system
- it has not kept pace with the rise in individuals making choices and the resulting range of structure options
- there are impediments to developing post-retirement products and the requirements for the drawdown phase need to be further developed.

We have addressed the first three points in section 2.1. The last dot point in relation to post-retirement is covered in section 2.2.

In reviewing these issues, we believe it is too early to determine whether or not we should change the 'twin peaks' model. The remit of APRA and ASIC should be reviewed in the context of the highlighted issues. Over time, it may be considered that a specialist superannuation and retirement regulator is appropriate. The growing complexity of retirement incomes policy may also drive a decision to implement a centralised government policy agency as the connection with other health and age care public policy areas grows. In our view, however, it is important to understand the regulatory gaps and challenges, and agree on those before we tackle the framework at the regulator level.

2.1. Regulatory framework

Of the developments in the superannuation and financial sector since Wallis, the most significant is the rise of fund members making their own investment decisions. We now have two large pools of money within the system; one pool with SMSF investors and the other with APRA-regulated collective investment vehicles. The system has also evolved from one where the standard superannuation product was a balanced diversified fund; we now have many diverse products and platforms being offered to consumers. We also have a wider range of service providers which perform various functions within the system.

These developments mean that we need to re-assess the current framework and determine how to address gaps, issues and emerging trends which prevent the efficiency and competitiveness of the superannuation industry. In this submission, ASFA highlights the need to:

- Acknowledge the impact of the rise of individual decision making
- Identify and address emerging regulatory gaps and overlaps due to structural and participant changes
- Identify any systemic and regulatory risks across the two significant pools of money (SMSF and pooled) as well as the growing third pool of retirement monies
- Respond to the increasing linkages between superannuation and other parts of the social security and tax systems
- Assist future retirees looking for a wider selection of income stream products
- Anticipate any regulatory requirements for the growing globalisation of financial services
- Address inconsistency in the way regulation and oversight is funded and the funding calculated
- Focus on the development of the superannuation payments system
- Ensure effective and transparent competition within the industry.

2.1.1. The rise in individual decision making

One of the biggest changes since Wallis has been the rise in individuals making their own choices. These choices have included which superannuation provider they use, what structure they invest in (for example, SMSF or pooled fund), the products they use, their investment allocations, even down to which individual shares they wish to hold in superannuation. This increase in choice has spanned both the accumulation and drawdown phases. The detail of how this is played out is provided in Appendix A.

Of superannuation assets, Australians bear the investment risk on $1.62 trillion through their DC superannuation plans. Using the Rice Warner estimates, we can say that roughly $1 trillion of these assets are chosen by the investor, through an SMSF, through choice driven by a relationship with a financial planner or accountant, or through the investor's own decisions. It is probably fair to say that Wallis did not fully anticipate the extent of growth in DC superannuation which would occur in the next decade and a half. It is even less likely that Wallis would have anticipated the alacrity with which people would embrace self-managing their super.

The emergence of choice, together with the rise in the different ways you can invest your superannuation, means that we need to consider the regulatory philosophy and how it applies across all the methods by which superannuation is invested.

In dealing with this issue, we first need to ask the question: is there the same duty of care across all superannuation monies, regardless of how they are invested?

ASFA believes there is the same duty of care and that the duty is to invest in such a way as to deliver the required retirement outcomes. This means the government does have a role in protecting the retirement wellbeing of its people, through ensuring that their superannuation investments are well managed and invested in such a way as to promote the likelihood of delivering a reasonable retirement outcome. In today's world of individual choice, this is challenging because the products in which people invest and the investment risks they take are very diverse. Further, the system is taxpayer-funded and there is a government imperative to reduce the cost of the ageing population on the public purse.

In 1997, investment in superannuation was done mainly through a diversified fund, which had a trustee fiduciary obligation to make sure the investor's interests were looked after. APRA was set up to monitor and oversee that the trustees met their obligations. Conversely, those who invested directly were likely to be doing it outside super, or with the help of a financial planner, and therefore needed to make sure that the information upon which decisions were made was clear, accurate and managed scrupulously. Investment in superannuation is now not only through a diversified fund, but via many different wrap accounts and platforms, as well as through SMSFs into both regulated and unregulated products.

Accordingly, ASFA recommends that where superannuation members have chosen their own investment strategy (through an SMSF, a wrap platform, or a master trust menu, with or without a financial planner), there needs to be some benchmark duty of care that ensures this investment is appropriate for retirement, in order to be eligible for tax incentives.

2.1.2. Emerging regulatory gaps

The regulatory approach needs to be adjusted:

- to ensure consumer protection gaps are identified and addressed as appropriate
- to create regulatory efficiency of implementation whilst ensuring consistency of regulation and limiting regulatory arbitrage.

A review of the regulatory framework is made even more crucial because the compensation is different between a) a superannuation investor within an APRA-regulated fund who suffers a loss as a result of the failure of that fund and b) an SMSF trustee who selects a related product for their SMSF portfolio. The compensation available to each fund member reflects the fact that APRA regulated funds are prudentially supervised and SMSFs are not. Reflecting this, APRA regulated funds pay a higher supervisory levy than SMSFs, and there is a financial compensatory levy mechanism in place for APRA-regulated funds.

Consumer protection gaps

Across the various investment superannuation structures and opportunities, there are different oversight and consumer protection arrangements. Individuals who are bearing the investment risk on their superannuation investments should be able to make decisions that are appropriate for their own financial circumstances and reflect their personal risk appetite. They should also expect the same level of protection across the different ways in which they can make these investments.

While the level of protection needs to be consistent with the investment risk taken by the investor, it is vital that:

- regardless of the choice of vehicle and the way superannuation and retirement monies are invested, the regulator is able to 'follow the money' through underlying investment vehicles to ensure it is invested as disclosed
- all investors have access to consumer protection arrangements including consumer dispute resolution bodies.

The table below highlights some of the current regulatory differences:

Table 6: Consumer choice, regulatory oversight and consumer protection

Consumer choice	Low ———			High
Category	**APRA-regulated super funds**		**Non-super**	**SMSF**
	Diversified options under trustee	**Other wrap and master trust options**	**Managed investment schemes**	
Responsibility for decision to invest	Trustee	Trustee/member	Individual	Members (also trustees)
Responsibility for investment decisions	Trustee	Responsible entity	Responsible entity	Responsible entity
Prudential regulation (by APRA)	Yes	Yes	No	No
Consumer protection (by ASIC)	Yes	Yes	Yes	Yes
Redress and compensation against fraud/theft	Yes, through industry-levied post-funded scheme if the entire fund fails.	Yes, through industry-levied post-funded scheme if the entire fund fails.	No. May seek redress for misconduct by the Australian Financial Services Licence.	No compensation schemes for SMSFs. May seek redress for misconduct by the AFSL holder.

Source: Department of Treasury, ASFA.

In the scenario where the member has exercised no choice, the fiduciary oversight is very high. For MySuper products, the trustee is effectively asked to stand in the shoes of the member and make a decision about their investments. Similarly, where a member chooses an investment option that is not the default, say, for example, another diversified product, which has a strategic asset allocation and objectives approved by the trustee, there are still very onerous requirements on the trustee to ensure that the investment governance process is sound. These requirements are set out in the *Superannuation Industry (Supervision) Act 1993* (SIS) and regulations and the APRA Prudential Standard SPS 530.

Once the member choice moves beyond these diversified options, the oversight of the investments, even within superannuation, effectively becomes the remit of ASIC, rather than APRA, even though APRA still has regulatory obligations with respect to these assets. Here, members may be investing directly into the underlying investment strategy of a stand-alone product offered by an external fund manager. The superannuation trustee's control is mainly focused on whether or not to include the option, on the superannuation platform. The responsibility for ensuring the interests of unit holders of the Managed Investment Scheme (MIS) are met sits with the responsible entity (RE). There is a significant difference in the investment governance required from a superannuation trustee – regulated by APRA – versus the RE of a managed investment scheme – regulated by ASIC.

While Wallis recommended the harmonisation of the regulatory treatment of managed funds investments inside and outside superannuation (recommendation 89), this has not occurred. The fiduciary responsibility and regulatory oversight across direct investments, SMSFs, platform investments and superannuation investments has evolved to be quite different. However, it is still important that there is a high level of regulatory power so that the money can be 'followed', no matter what the investment vehicles is. At this time, it is not clear whether ASIC or APRA, or even the ATO have this responsibility across all superannuation structures.

This notion can be extended to how far consumer protection should be applied to the assets and products invested in by SMSFs. For example, ASFA has previously advocated that consumer protection be increased in relation to SMSFs by mandating that asset classes such as investment property and limited recourse loans only be provided through licensed financial planners. This enables SMSF trustees to have access to industry and consumer dispute resolution bodies.

Uneven and inefficient regulatory burden and scope for regulatory arbitrage

Today, the number of entities supervised by APRA and products that are regulated by ASIC is considerably larger than it would have been when the various responsibilities were mapped to APRA and ASIC in 1997. Over the past 16 years, we have also seen a rise in regulation by other regulatory agencies with a broader remit than just the financial services sector or superannuation. Examples include AUSTRAC (anti-money laundering) and the Office of the Australian Information Commissioner (privacy).

As a minimum, ASFA recommends:

- regulation should be principles based rather than rules based so that it is flexible enough to apply to various structures and promote innovation
- an assessment should be carried out of the cost/benefit impact of any regulation or standards on different structures
- consistent application of regulation in order to remove the opportunity for regulatory arbitrage
- that relief powers for regulators are broad.

The framework of the regulation of superannuation post-Wallis has been focused on the specific needs and responsibilities of regulators. The introduction of MySuper is a good example. This regulation has been applied at a product level and has involved substantial effort on the part of the industry and all related service providers. The full public benefit is yet to be determined. Should the regulation prove to be ineffective, for whatever reason, in the first few years of implementation, the time delay before sensible, necessary changes can be made is years, rather than months. In a fast-moving market, this is not conducive to market efficiency.

‘One size fits all’ legislation may, on occasions, have an inconsistent and possibly unfair impact, given the diversity and complexity of superannuation structures. One of the fundamental duties of a superannuation trustee is to act in the best interests of members and, as such, it is a sub-optimal outcome if complying with the legislation leads to outcomes where members are worse off. Further, strict compliance may cause a trustee to incur costs, or face risks, which are considerably in excess of those which would be necessitated by complying with a slightly modified provision, while still achieving substantially similar policy outcomes. These costs are usually borne by the investor.

It is important to note in this context that ASIC has considerable powers to exercise relief where legislation has had an adverse effect. This includes: unintended consequences, inappropriate scope and ambiguities that necessitate clarification or to grant transitional relief.

In ASFA’s submission to the Parliamentary Joint Committee on Corporations and Financial Services on the *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Bill 2012* dated 17 January 2013, we considered it important that the exemptions and modification power in the SIS legislation be extended. Part 29 of the *SIS Act* empowers APRA to grant exemptions and make modifications to specified provisions of the *SIS Act*.

We consider it important that the exemptions and modification power in SIS be extended to empower APRA to exempt classes of trustees, or individual trustees, from full compliance with any SIS provisions or to modify how the SIS law applies, subject to any conditions which APRA may impose. This would have the protection of being administered by APRA, while having the flexibility to accommodate specific circumstances.

2.1.3. Systemic risk

Currently, there is no system-wide view of superannuation available to a regulator or public policy maker. There is:

- no aggregate data on superannuation investments across the whole super pool
- no clear visibility of the significant role of other parties such as: administrators, custodians, clearing houses and gateways
- no high level view by a single regulator to monitor the whole of the system given we have two significant pools of money (SMSFs and pooled funds) and an emerging third pool of retirement assets.

The strong performance of Australia during the GFC and the role that superannuation funds were able to play in stabilising markets has been noted earlier, as has the generally unleveraged nature of superannuation investment; and its naturally longer investment horizon, which encourages investors to think of investment returns over a period of 10 years or more. These characteristics help provide stability to the financial system in times when investors with leverage or shorter-term objectives are in crisis. However, as the system matures, the level of short-term liabilities in the form of benefit payments, which our superannuation providers will be expected to deliver, will increase significantly. While there is expected to be far less leverage in the system than in, say, banking, the liquidity profile of superannuation providers will become increasingly important. At the moment, cash flows into the aggregate superannuation market exceed benefits paid. In years to come, the reverse will be the case and with that shift, liquidity risks will increase.

It will be critical to be able to estimate the size of different exposures in the system in order to assess the systemic market risk that such concentrations may create. Currently, we have no overarching collection of data on investments that sit within superannuation. While data collection across APRA-regulated funds has increased considerably, the ATO is not at this time able to provide the same level of information on SMSFs. As such, aggregate data across the whole system which would be useful for public policy makers is not available. Without this data, it is difficult to assess the extent of any of the risks emerging in the system.

There may be no large concentrations of exposures across the superannuation industry today, but over coming decades, we expect changes in technology and increases in investment choices to result in larger amounts of money moving faster. With this comes the potential for systemic risk.

Related to this is the potential exposure to a single counterparty providing longevity risk mitigation in the Australian market. As post-retirement products develop, and much-needed annuity and income-stream style products are taken up in the market, it will make sense to have visibility of the extent of system-wide counterparty risk to the issuers of these products and control this if necessary.

Further, with the rise in funds under management and mergers of third-party service providers, we are building up concentration risk exposures to key partners, such as custodians and administrators. The failure of any one of these would present issues for their superannuation fund clients. At present, each superannuation trustee is responsible for managing the risk of their outsourced service providers. A time may come when the system-wide exposure to any one custodian or any one administration company is very high. While assets may not be at risk, their failure to deliver services may have a significant short-term impact on the economy and on those Australians waiting for their regular benefit payments to be made.

2.1.4. Connectivity to social security and the tax system

Over the coming years, there will be an increasing interaction of retirement income policy with tax and social security policy and systems. Accordingly, it will be important to understand all of the structures and relationships relating to the retirement income industry. Critical to all of this is striving to ensure the interoperability of the various systems used to store and report data, including achieving consistency in the use of terminology format of data storage and transmission, and security protocols.

2.1.5. Post-retirement products

Later in this chapter, we will explore how to respond to the ageing and longer-living Australian population. It will be very important that an appropriate legislative and regulatory framework is established before the post-retirement product market is further developed.

While superannuation funds are able to provide account-based pensions; life offices are able to provide annuities; and defined benefit funds can provide a lifetime pension; there is scope both to improve the flexibility of the pension standards in the SIS regulations and the tax and social security treatment of various pensions, in order to facilitate product innovation and competition in this space.

Further, it would be desirable to see the extension of the MySuper concept, which currently only applies to members in the accumulation phase, to the retirement or drawdown phase. In particular consideration should be given to streamlining a member's transition from accumulation to drawdown, including the possibility of members being entitled to automatically receive an account-based income stream in retirement, which they can opt out of at any time.

2.1.6. Globalisation

Increasingly, there are rules and regulations affecting private pensions and superannuation that involve extra-territorial or international application.

Extra-territorial measures include the FATCA legislation of the United States of America. While superannuation funds in Australia have largely been carved out from the coverage of the FATCA provisions in regard to reporting to the US tax authorities, US citizens are subject to reporting and tax requirements on their interests in Australian super funds.

International accounting standards also impact on how superannuation funds are required to report their financial accounts and how companies report any defined benefit liabilities in regard to fund members. International agreements have also led to extensive domestic legislation containing reporting requirements for superannuation funds and other entities in regard to anti-money laundering and counter-terrorism financing.

International harmonisation will continue to increase, which will impose its own challenges as countries globally move to protect their revenue base and allow for the global movement of funds.

Basel III capital adequacy arrangements directly impact on banks and deposit-takers but they have implications for superannuation funds given their impact on the interest rates that can be offered to various depositors. APRA-regulated superannuation funds, regarded as wholesale investors, are paid a lower interest rate on deposits with banks, reflecting the higher level of capital adequacy required relative to deposits made by households and SMSFs.

While there are merits in international consistency in regulation, ASFA considers that Australia should have a strong voice in international and bilateral negotiations in regard to any laws or agreements that impact on superannuation funds and other financial institutions. Policies developed in the context of circumstances in other countries, which may differ markedly from Australia, should not necessarily automatically be applied to Australia. There should be scope for international requirements to make allowance for the specific circumstances of superannuation funds in Australia.

We also may see in coming decades an increase in the number of retirees who would like to live abroad, and may want to take their pension with them, as opposed to receiving payments from Australia. We may also see a greater number of overseas retirees looking to move to Australia.

A current example of this phenomenon is the two-way movement between Australia and New Zealand. There are also arrangements that allow for the transfer of pension benefits from pension schemes in the United Kingdom, but no equivalent arrangements to allow transfers from Australia to the United Kingdom. This is becoming an issue that is receiving increasing international attention with, for instance, moves to bring about pension portability between countries in the European Union.

While a less pressing problem for our financial system, we believe that any changes in current policy should be made with an eye to the likelihood of increasing global mobility of retirees. Flexibility in arrangements and consistency with global pension regulations will be important to ensure that our financial system is well set up for these changes ahead.

2.1.7. Cost sharing

Implementing public policy and providing regulatory oversight requires funding and should be borne equitably by all participants. Currently, the operations of APRA, ASIC, the ATO, and other regulators, are to some extent, all drains on the public purse. In some instances, this cost is offset in part by levies on the supervised entities. For example, some superannuation entities regulated by APRA are levied through means of an APRA supervisory levy for their regulation. SMSFs pay an annual fee to the ATO. In other cases, the cost of the regulation is borne on the national balance sheet by all taxpayers.

Finding a sensible way to ensure that costs are borne where the benefit is incurred is a challenge for the financial system.

APRA-regulated superannuation entities currently contribute to the cost of regulation via an annual supervisory levy. More recently, APRA regulated entities also contributed a levy to fund SuperStream. ASFA is on record for raising two issues with this levy:

- the methodology used to calculate the levy was based on funding prudential regulation not the funding of a system-wide transaction payments system and was therefore applied inequitably only to pooled vehicles
- due to legislative limitations, regulatory arbitrage occurred as this type of levy could not be applied to SMSF vehicles.

These costs are ultimately borne by Australian superannuation members of APRA-regulated entities, in the form of higher fees, that is, lower net returns on products. In a 'user pays' system, the contributors of these levies to government should have transparency over the manner in which these fees are spent and the efficiency of the way in which this is done. Currently, the only transparency around the breakdown of spending is provided through reviews by the Australian National Audit Office and the occasional Senate Estimates hearing. In our view, this is not sufficient. It would not be considered to be best practice if applied to the reasonableness of any other regulatory impost.

The superannuation industry strongly believes that levies should be directed to cover areas where risks are greatest; we encourage regulation on a system-wide basis. This does not, however, remove the obligation for the regulators to provide detail on what they are doing and how much the various exercises cost. Further, it would seem reasonable to provide the industry with a forward-looking program of review, which would scope the areas to be assessed and considered over, say, a three-year period.

We also note that there is some inconsistency between the applications of levies across the financial services sector; it is not clear what the policy is around self-funded or public-funded oversight and regulation. APRA-regulated superannuation funds contribute to the cost of industry regulation by APRA; SMSFs pay a supervisory levy to be overseen by the ATO. Managed investment schemes are not levied for the oversight of ASIC. The policy around 'who pays', 'user pays' and who gets paid in the event of a system failure or a product failure due to fraud or theft should be considered consistently across the whole financial services industry. This review might also consider the benefits AFSL holders receive through this process and the costs which should perhaps be applied to this sector of the industry.

2.1.8. Systemic risk in the superannuation payments system

Technology has been driving change in the financial system for many years. However, our approach to how the financial system operates and how it is regulated has not changed to the same degree. The speed of change we are observing requires us to think about the flexibility and adaptability of the system, to ensure that it can change dynamically with new opportunities and developments.

The administration side of superannuation payments sits with the ATO. For example, the ATO is now responsible for administering the SuperStream process. Given the size of the superannuation system and the risks associated with payments made from it, we should consider whether a higher level oversight is required. In particular, we would see this oversight or the agency responsible for it:

- supporting, and facilitating the development of technology solutions to efficiency constraints. Initiatives such as the low value payments system being developed through APCA (the NPP) would be actively supported
- providing regulatory support for technology initiatives that deliver economic benefits to individuals, which recognise the rise of the individual in society and which provide consumer benefits and safeguards. The regulatory framework should support technology developments in the area of transaction initiation and document delivery
- facilitating the development of 'whole of industry' solutions to industry-wide problems through the resolution of the funding issues where a whole industry benefits from an initiative and where the potential for free riders would be a barrier to development. In the superannuation industry, this would include a broadening of application of the APRA Supervisory levy and the ATO levy on SMSFs
- ensuring that the regulatory framework does not create significant barriers to entry such as to prevent the market entry of micro/niche players who may be able to drive new, more efficient solutions
- requiring legislators to adopt technology neutral language. Requirements such as evidencing things 'in writing' do not facilitate the adoption of new technologies
- recognising the internationalisation of the workforce. The mobility of the workforce should be matched by a capacity to transfer workforce entitlements such as superannuation
- supporting industry wide efficiency improvements through the development and mandating of data standards including interactions with insurers, investment managers, and custodians
- considering the degree to which the direct reach of regulators should extend beyond the current regulated entities to entities that provide infrastructure that is fundamental to the operation of the financial services sector.

Currently, the Reserve Bank of Australia (RBA) is responsible for the efficiency and safety of the Australian payments system. Over time, we see significant growth in the size, number and importance of payments made through the payments system via superannuation funds and their third-party services providers. In particular, we believe that the role of administrators and custodians in providing services to superannuation entities will have increasing importance as the superannuation system matures and more benefits are paid to Australians. These third party providers will become important players in the payment system. A coordinated approach between the agency and the RBA would be important in managing these risks.

2.1.9. Competition

There is significant competition in the superannuation market as a result of consumer choice. As noted in Chapter one, there are a relatively large number of providers of superannuation products and many individuals choose the superannuation fund that receives contributions on their behalf. Funds compete in terms of both the level of fees that are charged and the characteristics and functionality of the superannuation products that are offered.

However, the existing model is not transparent and contestable in all aspects, particularly in regard to the arrangements applying to industrial awards and default contributions.

ASFA considers that the rules and processes for employers to choose a default fund for their employees should have the following minimum characteristics:

- a clear, efficient and transparent process or processes in which the criteria for a fund being chosen as a default

fund or potential default fund are well defined

- the selection of a default fund for an employee should be based on which fund is most suitable for the employee or class of employees as the focus should be on obtaining the best possible outcomes for employees
- employees should be encouraged to engage with their superannuation arrangements and to make their own choice of fund if they consider that the default fund is not the most suitable fund for them
- any application process that forms part of the selection of default funds should be as simple as possible and generally make use of information readily available to applicant funds and/or already required to be provided by funds. 'Red tape' and any unnecessary costs should be avoided
- any changes to default fund arrangements should be subject to appropriate transitional arrangements that provide an opportunity for employees to exercise choice of fund or to consolidate their superannuation accounts should they wish to do so.

The existing legislated model for default funds in modern awards is contestable in the sense that all providers of MySuper products have opportunities to be considered for selection as a default fund in an award or awards. However, where the employer associations and unions associated with an award have the final say, this in effect restricts the range of funds that might be considered for inclusion in an award.

As well, it is important that regulatory arrangements are such that decisions by employers regarding the selection of a default fund for employees, are not influenced by factors other than those that are relevant to choosing the best fund or funds for the employees concerned.

ASFA considers that if an employer is allowed to choose as a default fund any fund offering a MySuper product then arrangements should be put in place to lead employers to choosing a default fund for employees that is likely to provide the best possible outcomes for the employees.

In this context, there should be prohibitions on employers receiving, and superannuation funds and their associates offering, financial incentives for an employer to choose a particular fund.

Currently in section 68A of the *Superannuation Industry (Supervision) Act 1993* there is a prohibition on the offering of inducements to employers, with a civil action also available to any person who suffers loss or damage as a result.

The general competition law also has provisions that prohibit a business from forcing a customer to also purchase a good or service from a third party or another good or service from the business itself. These anti-competitive behaviours are known as "third line forcing" and "full line forcing".

In order to provide clarity for funds, their associates and employers, ASFA considers that there should be explicit legislative prohibitions on "third line forcing" and "full line forcing" where an employer is induced to select a fund through being offered collateral benefits by an entity which is associated directly or indirectly with the superannuation fund in question.

2.2 Regulatory response to an ageing population

Australia, like many countries, has a significantly ageing population that is living longer. Research also shows that the average retiree is looking for an income stream in retirement particularly in the more active years of retirement. The system then also needs to have the flexibility to convert income streams into payments and deposits for aged care at the more fragile end of retirement.

Unlike the accumulation phase, there is no "default" MySuper equivalent in post-retirement. As people enter retirement, there is a complex maze of tax, social securities and savings interactions, which makes having a default system problematic. Members who make no choice within their fund, are moved into a different tax paying account which may or may not be suited to their retirement needs.

We have identified some modifications to the existing framework which will remove some of the barriers to investment in products such as deferred and lifetime annuities. (Refer Box A below.) However, these are marginal improvements. We are moving from a system in accumulation phase, to a mature pension system, which will ultimately be paying benefits in excess of contributions. We must ensure that Australians are investing more of their retirement savings into sensibly designed post-retirement products. This means adjusting the choices and incentives available to Australians in post-retirement.

Our current system has not resulted in individuals buying post-retirement products in any meaningful way. To date, the tax regime for products that have characteristics that are most suitable to provide an income into old age, has not been appealing enough to generate demand for these products. We can identify some 'tweaks' to the system that may marginally improve this. However, we need to do more if we are to create a pension scheme where individuals retire with an investment that will generate income for their whole retirement and provide some buffer against health care costs.

This may mean an adjustment of the tax arrangements for investments of individuals in retirement. ASFA is not yet in a position to offer the ideal solution to this post-retirement conundrum. We are continuing to consider these issues and working within our industry on potential solutions. However, we know that the key issues that must be considered and addressed in this space are:

- managing the 'free option' of the Age Pension. Today, an individual who runs out of money always has the Age Pension as a fall back. While we fully support a safety net for Australians as they grow older, there needs to be an incentive for Australians not to unnecessarily risk their retirement assets, safe in the knowledge that the Age Pension is available
- that product innovation and competition needs to be enabled. Investment in fixed-income securities is only one way to generate a steady income stream, and it can be argued that the cost of the Age Pension will be higher if all retirees invest in conservative (cash and fixed income) investments. Other investment solutions, including a systematic approach to the drawdown of capital, should be considered. We want to ensure we have the best products developed for our retirees
- the benefit of having a post-retirement-approved product category that is consistently regulated across all product manufacturers and that would receive a consistent tax treatment. This category would include deferred annuities and other eligible post-retirement products that satisfied criteria such as providing income stream into longevity or managing longevity risk
- the relative tax treatment of arrangements on investments which are not 'retirement friendly'
- the tax consideration and treatment of superannuation and retirement incomes in relation to health and aged care costs
- the vexed issue of ways to effectively release equity in the family home.

While there will be difficulties with the implementation of some of these ideas, the risk associated with not implementing some kind of incentive to invest in products that are better suited to generating a retirement income will have far worse implications in the long term for the Australian economy.

Box A: Seven impediments to retirement income stream products

1. SIS regulations

Current SIS regulations are built around the structures of the current style of post-retirement products. This severely limits the scope for innovation and new product development. Regulations should be designed around general principles rather than linked to the structure of existing products.

2. APRA prudential standards on minimum surrender values of longevity products

APRA standards on minimum surrender values make longevity products expensive to manufacture and therefore expensive to consumers relative to other products. Greater flexibility in APRA prudential standards on minimum surrender values would promote innovation in the types of longevity products offered during the deferral phase. An example is the treatment of pooling within products.

3. Means test treatment for longevity products

A longevity product does not have the same characteristics as a bank account at call. The consumer has no access to these funds for a decade or more. It is not logical then that longevity products are treated in the same way as current assets for the purposes of means testing. A full or partial exemption from the asset test of certain longevity products – for example deferred annuities – would substantially increase their appeal to customers.

4. An efficient approval process for longevity products

Currently, providers need to navigate a maze of red tape with separate, and sometimes inconsistent, approval processes from the ATO, APRA, ASIC and Centrelink. Innovation would be promoted by a streamlined single approval process.

5. Better advice on post-retirement products

Increased take up of longevity products will come with better advice and with better education about these products. Post-retirement product advice should be a key feature of the scaled advice operating guidelines being developed by ASIC.

6. Lower taxation of deferred annuities and other longevity products

Current exemptions applied to income from traditional post-retirement income streams do not apply to deferred annuities or similar longevity products. The earnings tax and accrual tax treatment of non-commutable deferred annuities (and similar products) should be amended to ensure a level playing field.

7. SMSFs should be able to purchase deferred annuities

Current SIS provisions only allow individuals to purchase annuities and other similar products. It seems unreasonable that self-managed super funds (SMSFs) should not be permitted to invest in these products.

APPENDIX A

The growth of heterogeneous decision making

The growth of heterogeneous decision making

This appendix covers:

- choice in the accumulation stage
- choice in the draw down stage.

A.1. Choice during the accumulation phase

Full choice is provided to individuals at the superannuation provider level; the product level and the investment level, both pre and post retirement.

In 1991, Paul Keating noted the history of a paternal relationship between the political parties and the aged. "People … had gone about their daily lives with dignity and independence until they … retired. From then on, they have found themselves caught in this absurd relationship with politics, with the political system deciding how they will live and under what conditions." Today's Australian superannuation system is substantially different to the world where the retirement income of individuals was dictated by the policy surrounding the Age Pension system.

A combination of changes in social behaviour, shifts in public policy, and developments in technology have led to a market where consumers of financial services, including superannuation, demand a unique, individual and personal experience. Today's superannuation members are increasingly able to transact with their bank on mobile devices, can move their superannuation assets freely between different types of investments and providers, and are able to access and compare the services and performance of competitor products in any market.

Public policy has supported and driven a philosophy of individuals taking responsibility for providing for their own retirement and for determining the manner in which their future retirement assets are managed. In particular:

- as early as 1979, with the rejection of the Hancock Report, policy makers have rejected a paternalistic, national approach to superannuation in favour of an individual, privately funded approach
- in 1987, the *Occupational Standards Act 1987* prescribed operating standards for the vesting of benefits from employer and employee contributions, with more member involvement in the control of superannuation funds
- in 1996, the *Super for all: Security and flexibility in retirement policy* had greater freedom for employees to choose their fund into which their superannuation contributions would be paid
- in 1997, the Wallis committee reiterated support for choice within the superannuation system
- also in 1997, retirement savings accounts were introduced and were intended to provide a simple low-cost alternative to superannuation fund accounts
- in 2004, superannuation regulations were changed to allow the portability of money between different superannuation accounts
- in 2005, choice of superannuation fund was fully implemented, after a slow passage through Parliament. Further simplifications to transferring money between funds were also announced in the 2006 Budget and were n effect in 2007
- in 2007, tax changes allowed significant cash contributions and transfer of business assets which drove a significant increase in self-managed super funds (SMSFs)
- in 2009, the TransTasman retirement savings portability scheme was announced
- consumers now have more access to different forms of advice including intra-fund advice (now provided by over 90 per cent of superannuation providers – ASFA research 2014)
- MySuper product dashboards and ultimately, choice product dashboards, will allow greater comparability
- implementation of SuperStream means that it is much easier to choose and to consolidate accounts through the ATO, not through superannuation funds.

The accumulation of public policy over the past two decades has resulted in an Australian superannuation system in which the individual wears the investment risk of their superannuation account balance, and also has the choice in the manner in which it is invested.

The extent to which Australians have embraced choice within superannuation can be shown in two ways: firstly, through the take up of SMSFs and secondly through the exercise of choice within the institutional environment. For example, choosing to stay in their current fund, even when they change jobs, is the current mode of choice for many employees. The number of members and the percentage allocated to default portfolios has also decreased.

In asset terms, SMSFs have grown significantly in recent decades. In June 1997, as the Wallis Committee was reviewing the regulation of the financial system, numbers of 'small funds' – the common term at that time for an SMSF – sat at around 145,000. These funds accounted for assets of $27 billion, or around 10 per cent of the total system assets, and represented about 1.4 per cent of total superannuation members. In December 2013, assets of SMSFs had risen to around $545 billion, around 30 per cent of total superannuation assets, and around 7 per cent of all members.

This equates to about twice the growth in a broader superannuation market. Some, but not all, of this can be attributed to SMSFs receiving the lion share of the up to $1 million non-concessional contributions when available. However, the most significant rate of growth in the number of SMSFs occurred in 2007, which coincided with the introduction of the government's superannuation simplification measures.

While still strong, contributions to SMSFs have been reducing since this surge in 2007. Overall, SMSF contributions, as a proportion of contributions to all funds, fell from over 40 per cent in 2007, to 22 per cent in 2013.

Although there has been an increase in the number of Australians opening an SMSF, choice of superannuation option before retirement has not been embraced with the same alacrity by members of not-for profits funds. Rice Warner estimates that only 15 per cent of industry fund, corporate and public sector members choose an option other than the default, or MySuper option offered by their fund. But we know many now exercise choice to stay in a fund when they change employers.

On the other hand, members of commercial (retail) funds are far less likely to opt for the default, with two-thirds of these members making a choice about their investments. Retail fund members are more likely to be advised by a financial adviser, and because the default employer options are at a product rather than a fund level, when the employee leaves that employer, they must also leave that product.

Rice Warner believes that the trend towards more active involvement in investment choice within superannuation is likely to continue within the institutional framework over the next decade. They estimate that in 2023, the proportion of not-for-profit members using the default MySuper option will fall to around 65 per cent (from 85 per cent). They also believe that there will be a decline of about 8 per cent of retail fund members using the default option. If true, this is will leave only 24 per cent of the total superannuation market assets invested in the default options, down from around 36 per cent today.

A.2. Choice in retirement: drawdown phase

Based on 2011 data, Rice Warner's estimates of exits, one year after retirement, by assets and by number of accounts are provided in table 7 and table 8. The key points to note are:

- members with lower account balances are more likely to take a lump sum than to roll their balance over to a pension within their current superannuation product, a commercial product or an industry product. For example, around 60 per cent of industry fund accounts opted for a lump sum, but these accounts only represented around 30 per cent of the value of the assets of all retirees
- while a true 'default' option akin to MySuper does not exist within the post-retirement world, members may roll over into their own product's pension arrangements. The data suggests there is a fairly strong trend for this to occur. Across corporate, industry and public sector funds in particular, there appears to be a preference for individuals with larger accounts to remain in a pension option with their existing service provider
- larger balances, especially in employer master trusts or personal superannuation accounts appeared to be more likely to rollover to a commercial product
- between five and ten per cent of all retirees chose an industry product for their retirement savings
- very few – around two per cent – of retirees chose to establish an SMSF at the point of retirement.

The availability of choice before and after retirement, and the increasing preference of individuals to exercise that choice, will have a profound impact on the way in which financial services evolve over the coming decades.

Table 7: Retirement benefit types – assets first year (as at June 2013)

Market segment	Lump sum	Pension within fund	Rollover to commercial product	Rollover to industry product	Start SMSF
	%				
Corporate funds	21.5	36.6	19.1	19.1	3.7
Industry funds	30.3	34.6	31.4	0	3.7
Public sector funds	11.1	71.0	7.1	7.1	3.7
Self-managed super funds	2.0	96.0	1.0	1.0	-
Employer master trust	21.5	-	63.2	11.6	3.7
Personal superannuation	21.5	-	63.2	11.6	3.7
Retirement savings account	63.2	-	18.4	18.4	-
Eligible rollover funds	100.0	-	0	0	-

Source: Rice Warner.

Table 8: Retirement benefit types – accounts first year (as at June 2013)

Market segment	Lump sum	Pension within fund	Rollover to commercial product	Rollover to industry product	Start SMSF
	%				
Corporate funds	51.4	23.0	11.8	11.8	2.0
Industry funds	59.4	20.6	18.0	-	2.0
Public sector funds	35.4	52.0	5.3	5.3	2.0
Self-managed super funds	3.0	95.0	1.0	1.0	-
Employer master trust	51.4	-	39.0	7.6	2.0
Personal superannuation	51.4	-	39.0	7.6	2.0
Retirement savings account	86.0	-	7.0	7.0	-
Eligible rollover funds	100.0	-	-	-	-

Source: Rice Warner.

CHAPTER 3

Investment and funding

Investment and funding

While the primary purpose of superannuation is to promote better retirement outcomes for members, there is a complementarity in the benefits that the superannuation industry brings to the broader economy and financial system. These benefits include:

- adding depth and liquidity to financial markets, and acting as a buffer against external shocks
- contributing to growth in the economy through savings growth
- reducing the fiscal burden on government of providing an age pension
- promoting capital formation and funding investments which support economic growth.

The positive role which the superannuation system plays within the broader economy has been the subject of interest and research at ASFA for a number of years. This chapter of the submission draws extensively on research we have undertaken recently, and in particular on the analysis undertaken for us by Deloitte Access Economics, in the *Maximising Superannuation Capital report, 2013*.

Our submission is based on an overarching principle with respect to superannuation investments. This principle is that the primary purpose of superannuation is to provide income in retirement. While incentives may help to maximise the economic impact of superannuation capital, directing investments into particular assets or investments classes has the potential to derail the superannuation industry from that purpose. Market forces will determine that capital will flow where it is most valued. This obviates the need for any specific interventions mandating asset allocation of superannuation fund investment strategies, as this is an invitation for poor performance and lower returns.

That said, we note that there are several areas where we could remove impediments and better match funding needs with the risk and return objectives of superannuation investors. These are:

- to reassess the ways in which we require superannuation funds to manage liquidity risk, potentially exploring innovative solutions to this issue. For example:
  - » considering some regulatory relaxation of the liquidity requirements in products that are mainly invested in by younger members with longer investment horizons
  - » looking at whether product disclosure statements could explicitly lengthen redemption terms to allow funds greater exposure to less liquid assets
  - » exploring the potential for liquidity limits to be based on some historical assessment of the behaviour of members' redemptions over time
- to ask state governments, and other infrastructure developers to be more flexible in the structuring of funding and financing of infrastructure projects to better match the risk and reward preferences of superannuation investors. For example:
  - » to follow the NSW Government approach of seeking superannuation funding after the initial development risks have been mitigated.

This chapter describes the contribution that superannuation makes to the economy, describes the current investment approach and some of the issues around investments in specific asset classes.

3.1. Helping stabilise financial markets

The growth of the share of financial assets under the control of superannuation funds, including offshore, potentially has implications for the stability and functioning of the financial system.

Since the GFC, regulators have become more concerned about financial system stability thus the size of superannuation alone is a prima facie reason for examining its impact on system stability. While the GFC has largely prompted a reassessment of the regulation of banks, the linkages to other financial institutions including superannuation mean interactions throughout the system should be scrutinised.

There are some important differences between banking and superannuation fund business models. These differences, illustrated by the following two quotes and summarised in Table 8, suggest that the growth of superannuation, in

isolation, should strengthen financial stability.

> *Superannuation's large pool of stable and unleveraged superannuation assets contributes to financial stability by adding depth and liquidity to financial markets; providing an alternative source of finance for other sectors; and acting as an important buffer against external shocks (Parkinson 2012).*
>
> *The presence of market participants with different horizons and risk preferences is an important contributor to financial stability and it also helps promote efficient resource allocation by reducing overreliance on the banking sector or on foreign sources of finance for the mobilisation of savings and financial intermediation (Financial Stability Board, 2013).*

Importantly, unlike banking liabilities, the majority of superannuation liabilities are fully-funded, eliminating default risk and thereby ameliorating financial instability.

Table 9: Differences between superannuation and banking business models

Area	Superannuation	Banking
Business scope	Funds management services	Payment services, intermediation with maturity transformation
Funding	Liability driven	Liability and market funding driven
	Short and long-term funding	Mostly short-term funding
		Assets and liabilities not strictly linked
	No inter-company borrowing/lending	Inter-bank borrowing/lending significant
Balance sheet	Assets and liabilities influenced by financial markets	Assets exposed to business cycle
Risks	Interest rate risk	Credit and liquidity risk
	Low liquidity risk	Risk due to maturity transformation and wholesale funding
	Low interconnectedness	Substantial trading among banks
	Low assumed risk	Low owner risk retained, especially securitisation
	No leverage	Significant leverage
ALM and investment	Relatively stable funding and liability-driven investment	Low liquidity and asset-driven investment

Source: ABS (2013).

The Financial Stability Board does not appear especially concerned about the impact of DC funds on system stability. However, superannuation is exposed to banks through direct share holdings, the economic cycle, deposits at banks and banks as counterparties for hedging. A particular focus of regulators is around liquidity.

3.1.1. Banking-style liquidity problems

Inflows and outflows wax and wane. In any given year, liquid outflows may exceed contributions. Thus, for some funds, it may be necessary to draw down assets in order to satisfy timely roll-over requirements. This is challenging for funds with volatile inflows, outflows and contributions.

Unlike banks, superannuation funds face liquidity risks derived mainly from:

Currency hedging:
Superannuation funds make active decisions about hedging currency risks for international investments. This can be done at an investment level, or portfolio level, with most funds establishing currency hedging arrangements at a portfolio level. A movement in the Australian dollar can have both a positive or negative impact on investment returns. General experience is that superannuation funds hedge half of their international investments. In circumstances where the Australian dollar drops, superannuation funds must utilise cash holdings to meet funding of derivative commitments.

Illiquid assets:
Superannuation funds invest in illiquid assets including direct property and infrastructure. Such assets cannot be sold quickly. Superannuation funds earn an 'illiquidity premium' that compensates investors for the lack of liquidity. The combination of the illiquidity premium and the nature of investments that have strong track record of positive returns and lower volatility are reasons why superannuation funds have an appetite to invest in illiquid assets.

Pension commitments:
Superannuation funds may make payments to retirees in a number of forms. For members with small account balances this may be in the form of withdrawal requests. Superannuation funds also offer pension products for members. Payments can be in the form of regular payments that are used by members to fund day-to-day living expenses. Superannuation funds need to ensure they have sufficient liquidity to meet these payments as and when they become due (refer Box B).

The advent of choice for superannuation members, combined with ready access to online functionality by members, raises the likelihood of a fund receiving significant requests for redemptions or switches over a short time period.

This is a different liquidity risk to that faced by banks – and it would not be expected to affect financial system stability because funds remain in the system and liabilities and assets both move in line with market prices. The mobility of assets within superannuation is further limited by regulations that require assets to remain within the system up to retirement age. Funds are also able to freeze withdrawals for a period (although this is not good for confidence).

In the GFC period, we observed some funds experience a period where up to 50 per cent of membership looked to switch from their current option to a lower risk option. For a fund with significant illiquid assets this presents two problems: firstly having the ready access to cash to pay out redeeming members; and secondly ensuring that remaining members are not disadvantaged by a 'fire sale' of less liquid assets.

Within funds, there were also some cash flow problems. However, industry experts suggest the main reason for these was superannuation funds hedging their foreign currency exposures; that is when market volatility forces funds to cover adverse movements in their hedge books. The issue is whether they have enough liquid assets to cover these losses without moving their asset allocation outside the ranges signed off by the fund's board of trustees. If superannuation funds increase their foreign currency assets to service their Australian dollar liabilities – as seems likely – then the 'liquidity' risks that APRA is concerned about are unlikely to diminish.

However, a recent research paper published in the *Australian Journal of Management* suggested that most members did not choose to exercise their rights to switch funds, even during the GFC. The paper, entitled 'Retirement savings investment choices in response to the global financial crisis: Australian evidence', found that less than seven per cent of fund members changed their investment in reaction to the GFC between 2006 and 2009. These findings suggest that the impact of switching on liquidity would be small.

That said, a recent focus of regulation has been on liquidity risks. Prudential reviews have focused on the magnitude of less liquid securities and the effectiveness of the fund's liquidity management plan (LMP) as set out in the new

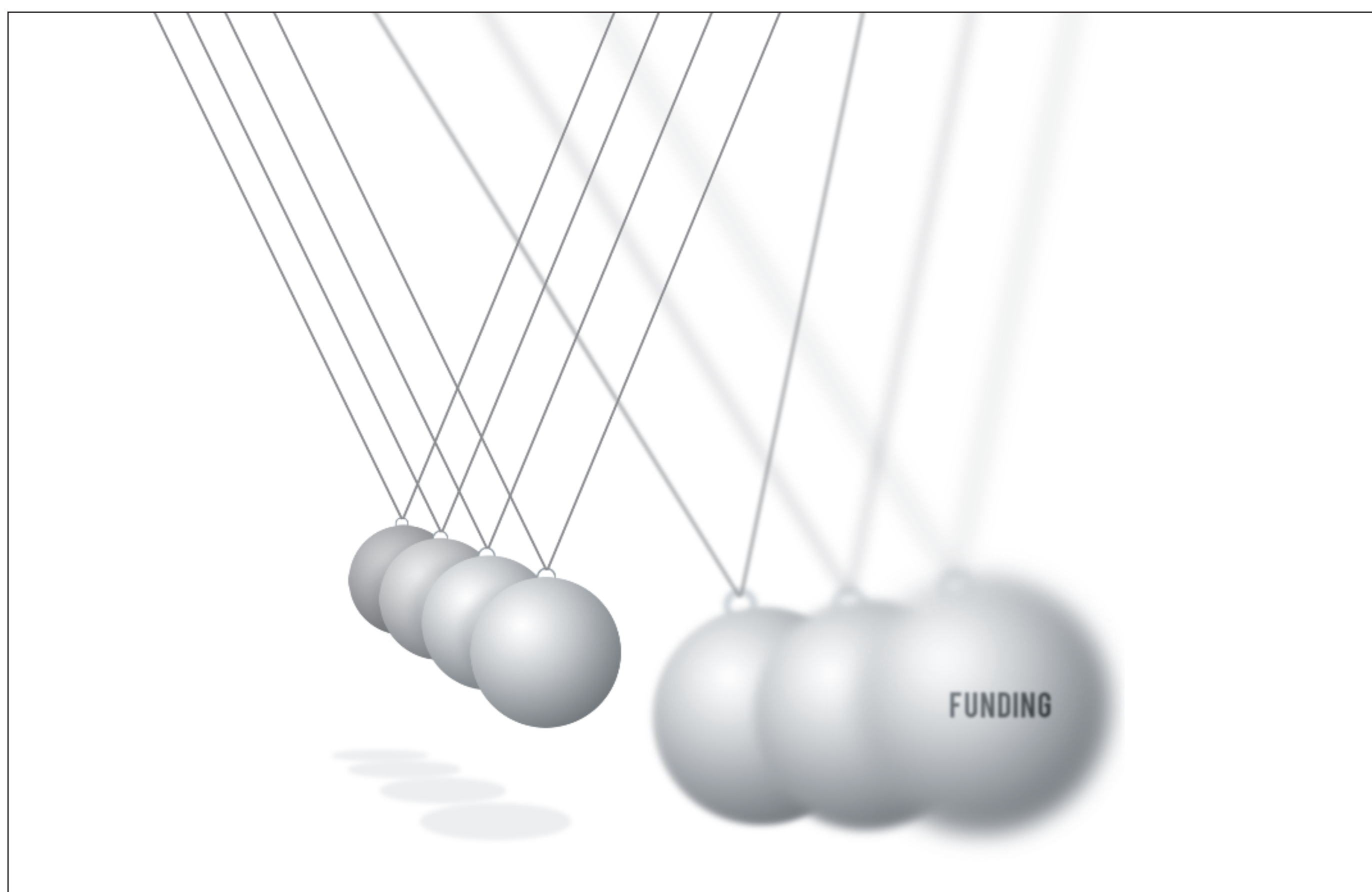
investment governance requirements in SPS530. This requires super funds to formulate and implement a liquidity management plan and undertake comprehensive stress testing of investment portfolios in a range of stress scenarios.

Superannuation funds have by and large, responded to this by limiting their exposure to less liquid assets. The average superannuation fund has around 15 to 30 per cent of illiquid assets: defined as being able to be liquidated in 30 days or less. However, this approach may be overly conservative and may result in missed opportunities for investment. Further, while for a large part of the past two decades, liquid shares, particularly Australian shares, have provided good investment opportunities for superannuation funds, this may not be the case in coming decades. We can envisage circumstances where shares offer little value to investors, and less liquid investments offer relatively better risk and return characteristics as included in a diversified portfolio.

An approach which may be considered to mitigate these issues is the use of repurchase arrangements or overdraft facilities. A number of superannuation funds have put such arrangements in place as part of their liquidity management plan. These arrangements are typically between the superannuation fund and a major bank. The contract is a commitment by the bank to provide cash either: by way of an overdraft type facility, or by way of a repurchase agreement where collateral is provided by the superannuation fund.

These arrangements are effective when a single superannuation fund has liquidity concerns. However, they are likely to be less effective, and indeed may fail altogether, when the financial system as a whole is under pressure.

An area where it may pay to be more open to innovative solutions is this liquidity issue. An example is considering some regulatory relaxation of the liquidity requirements for funds which are mainly invested in by younger members with longer investment horizons. There may also be a case for product disclosure statements to explicitly lengthen redemption terms to allow funds greater exposure to less liquid assets. There is also the potential that the liquidity limits be based on some historical assessment of the behaviour of members' redemptions over time.



Box B: Liquidity risk around benefit payments

Within the financial system, liquidity risk differs across sectors, and in particular, differs for banks vis-à-vis superannuation funds. Banks' asset and liability profile inevitably involves a maturity mismatch – contractual maturities of deposits may be much shorter than the loan assets on balance sheet for example. For superannuation funds, which are by and large unleveraged, liquidity risk arises mainly where withdrawal requests cannot be met in the usual timeframe without damaging the interests of the remaining members.

This raises two main issues: firstly, how significant is the risk of a liquidity event at a superannuation fund to the Australian financial system and should we be concerned over the size of funds' investments in illiquid assets which, arguably, offer an illiquidity premium to long-term investors; and secondly, should we be considering some form of special protection for regular pension payments in the event of a liquidity crisis at a fund?

A liquidity event may affect all superannuation funds at the same time, or be idiosyncratic to an individual fund. An example of a systemic liquidity event could be a major market dislocation when buyers and sellers withdraw from markets and illiquid assets (usually private market assets) are difficult to value and/or transact in at roughly fundamental values.

In all events, we want to make sure we do not create instability in the system by members looking to withdraw or move benefits in a short space of time.

It is important that trustees manage this through appropriate liquidity risk policies, which are set in the context of their fund membership demographics. Some potential issues include:

- reducing the pension money exposure to liquidity risk. Options include: differentiating the asset allocations of pension options from accumulation options; or limiting the access to options with more illiquid assets for pensioners
- managing the increase in risk which will arise from greater use of investment choice
- APRA currently allowing funds to apply for some relief from benefit payments in these circumstances, although during the GFC this relief was not widely sought
- allowing funds to borrow temporarily to fund benefit payments. However, this does expose remaining members to risk if assets are devalued.

While there are a number of disadvantages to a higher proportion of illiquid investments in a portfolio, their inclusion offers a number of benefits including diversification of risk. ASFA's member funds are seen to be materially increasing exposure to illiquid assets (real assets in private markets and alternative assets with limited liquidity). This is based on a widely recognised belief that long- term investors can accrue an illiquidity premium.

As the system moves towards maturity and benefits more than offset contributions, we may need to consider a special status for pension payments as the superannuation system will be used to generate pension payments that will be used by members for day-to-day living. The reputational risk of not meeting these payments is significant and while the size of the payments are not large, relative to the size of the overall account balance, failing to make these payments may create great uncertainty over the financial system as a whole. Ideally, these payments would be prioritised in a liquidity event.

3.2. Participation in the equity markets

Australia is generally regarded as having weathered the GFC better than many other countries; and in the period since the GFC, Australia's unemployment rate has been substantially lower than the OECD average, while its GDP growth is substantially higher. Along with a better economic outcome, the Australian market experience of the GFC was less disrupted than in other markets.

Prior to the GFC, most corporate bonds of large Australian firms were raised in international markets, where they were able to access lower yields. With the GFC, the yield of these bonds increased dramatically, seemingly overnight. For banks, this negatively impacted the marginal cost of long-term wholesale funding.

A consequence of this sudden tightening (removal of liquidity) in the corporate bond market was that Australian firms seeking to raise capital had to do so through share raisings, rather than through debt markets. Banks were able to deal with this problem by increasing their shares on offer in the domestic market, thereby improving their leverage position.

> *It is a testament to the strength of Australia's companies and their leadership, and to the strength of the capital markets, that Australian businesses have been able to raise $119.9 billion by equity issues between July 2008 and September 2009 and $77.1 billion since January this year. This record equity capital raising has allowed companies to repay debt and has undoubtedly helped to forestall foreclosures and promote credit growth through the Australian banking sector. (Source: Belinda Gibson, ASIC, 2009.)*

The 2009 financial year saw a new record in share issuance. In this year, placements accounted for 43.4 per cent of all capital raised ($38.2 billion), share purchase plans raised another 4.3 per cent (or $3.8 billion), and the rest was via rights issue. Share purchase plans are offered to all shareholders, unlike placements, which usually only go to large institutional shareholders.

The size of the private placements reflects the support of the superannuation system for banks and other large Australian companies at this time. It contrasts sharply with the poor take up of capital offers by the retail sector, reflecting the shaken confidence in equity markets of this sector at the time.

3.3. Contributing to national saving

Traditionally, Australia has had to borrow from offshore to supplement domestic saving in order to fund domestic investment. Superannuation is a form of saving that competes with other forms of saving. Superannuation funds invest large amounts at home but also offshore. Consequently, the growth of superannuation has implications for national saving and the external accounts.

The question as to whether compulsory superannuation has increased the level of national saving is difficult to answer with certainty as there is no true counterfactual. Indeed, studies and attempts at answering this question necessarily make assumptions about the counterfactual, and the outcome is often quite dependent on these assumptions.

For example, modelling performed by the Retirement Income Modelling Group in the Australian Treasury showed that the Superannuation Guarantee contributed positively to national saving, but this was based on the strong assumptions that the counterfactual was one in which compulsory contributions were instead paid as wage rises, and 50 per cent of the increased take-home pay was then saved in savings accounts (Kirchner, 2012). The results do not consider the possibility that tax concessions for superannuation lead to increases in other taxes, or that the increased costs to employers reduce their capacity to invest.

Nonetheless, an assessment of the available theory and evidence suggests that compulsory superannuation raises household and, in turn, national saving (see for example, Gruen and Sodig, 2011). This theory and evidence is explored below.

3.3.1. Measuring the impact of compulsory superannuation on national saving

National saving comprises household, corporate and government saving. It is useful to consider the theoretical implications of compulsory superannuation on each of these types of savers, then to look at the available evidence.

It is generally accepted in the literature that compulsory superannuation leads to an increase in household saving, largely due to the credit constraints of low-income earners. To illustrate, consider the following three types of household savers:

- households that in the absence of compulsory superannuation would not have saved as much as compulsory superannuation forces them to.
  - » these households spend most of their income (generally low-income earners) and therefore have little scope to offset forced contributions by decreasing other savings or increasing liabilities
  - » **compulsory superannuation increases the savings of these households**
- those who would have voluntarily saved at least the amount that compulsory superannuation forces them to, but they offset all of these savings with reductions in other forms of saving and/or increasing liabilities.
  - » **compulsory superannuation has no impact or decreases the savings of these households**
  - » the tax advantaged status of superannuation compared to other forms of saving may result in these households saving at a lower rate overall (compared to the counterfactual of no compulsory superannuation) because they no longer need to save as much through other vehicles to achieve their desired level of net wealth (Kirchner 2012)
- those that would have voluntarily saved at least the amount that compulsory superannuation forces them to, but they do not offset (all of) these savings with reductions in other forms of saving.
  - » **compulsory superannuation increases the savings of these households.**
  - » all else being equal, the presence of superannuation might increase the overall saving rate of these households because they simply don't consider their superannuation contribution in their budget constraint; because superannuation increases their awareness of the need to save for retirement; or because the tax advantaged status of superannuation compared to other forms of saving induces them to save more than they otherwise would (or a combination of all three).

Supporting the notion that superannuation results in an increased awareness of the need to save and therefore an

increase in total saving, Gruen and Soding (2011) note that there is significant evidence that commitment devices and default options have a significant impact on aggregate levels of retirement saving.

As noted, it is generally accepted in the literature that the combination of these three impacts results in a voluntary savings offset to compulsory superannuation of greater than zero but less than one (Connolly and Kohler, 2004; Gruen and Soding, 2011). Empirical estimates of this offset range from 17 cents to 75 cents in the dollar and microeconomic evidence suggests that the offset is smaller for financially constrained households (Kirchner 2012).

This apparent increase in household saving only contributes to national saving if it is not offset by dissaving in other sectors. The tax-preferred status of superannuation means that the public sector forgoes tax revenue that would have been collected had compulsory superannuation contributions been paid as wages to employees (Gruen and Soding, 2011).

If this forgone tax revenue decreases government saving, then the increase in household saving brought about by an increase in superannuation contributions does not equate to an increase in national saving. However, as Gruen and Soding (2011) argue, the government's fiscal strategy commits it to achieving budget surpluses on average over the medium term, which means that any budget shortfall arising from the tax-preferred status of compulsory superannuation must be offset elsewhere in the budget, on average over the medium term, and therefore that the boost to private saving translates (on average over time) to the same boost to national saving.

Available evidence supports the notion that compulsory superannuation has contributed to national saving. As a share of GDP, Australia's national saving has tended to be higher than that in other advanced economies and has increased since the late 80s, whereas saving in other advanced economies has declined. This higher and increasing trend in national saving is in line with the introduction of award-based superannuation in 1986 and the compulsory superannuation guarantee system in 1992.

It is difficult to isolate the effect of compulsory superannuation from other external factors that influence saving. For example, the widening gap in saving between Australia and other advanced economies over the past five years largely reflects the effect of the economic downturn. However, the divergence was clearly present prior to the GFC, suggesting that other factors, such as Australia's long history of prudent fiscal policy and the maturation of Australia's compulsory superannuation system, are at play (Bishop and Cassidy, 2012).

Based on an RBA analysis of data from the Household Income and Labour Dynamics in Australia (HILDA) survey that estimated a private saving offset of 30 per cent or less (Connolly, 2007), Gruen and Soding (2011) estimate that the current boost to national saving from the compulsory superannuation contribution is 1.5 per cent of GDP. They estimate that this contribution will rise significantly over the next decade, as the superannuation guarantee rises gradually to 12 per cent.

3.3.2. The importance of national saving

The obvious question to follow from this analysis is *why do we care*? That is, if we accept that superannuation increases national saving, what are the implications of this?

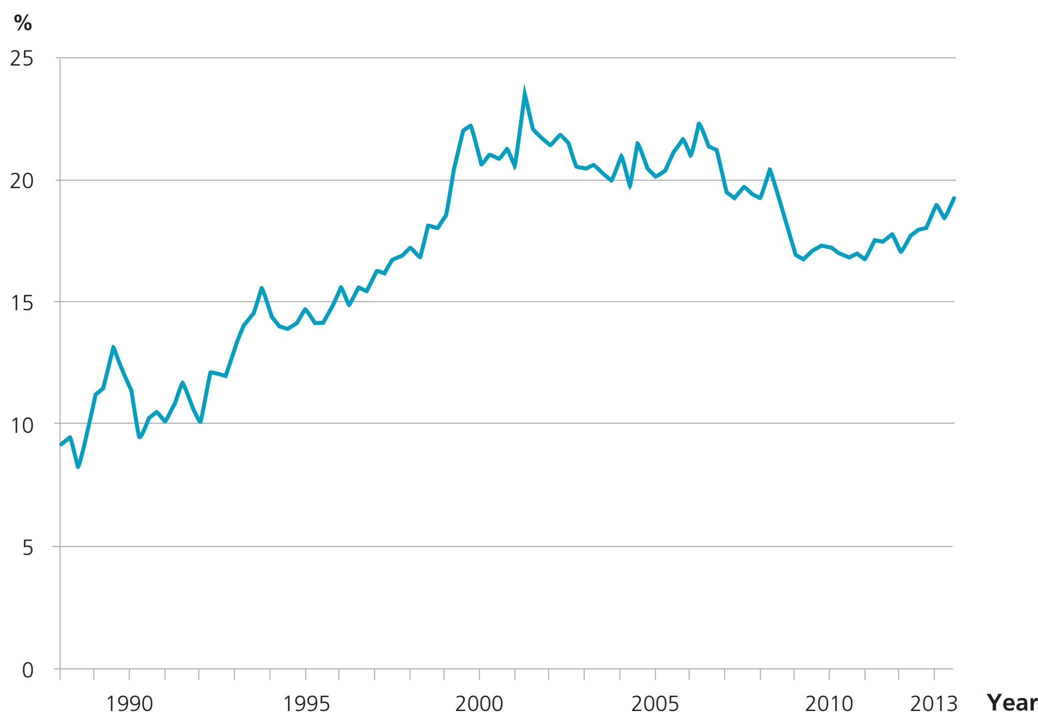
There are numerous economic arguments in the literature both in support of and against the assertion that, in the absence of compulsory superannuation, Australia would not save enough. However, what is *enough* is subjective and is open to debate. What is important is that, if we take it to be true that superannuation increases national saving, what does an increase in national saving mean for the economy?

Essentially, increased national saving through superannuation provides an avenue for financing investment in Australia and to reduce our reliance on foreign savings to finance such investments (Kirchner, 2012). Generally speaking, lower (and negative) current account balances increase a country's risk premium, so from a risk management perspective, financing investment internally is preferred especially given Australia's long-standing position as a net borrower.

Some commentators argue that increased national saving in the form of superannuation does not lead to investment

in infrastructure and it in fact gets sent offshore anyway as Australian superannuation funds invest relatively heavily in overseas markets. However, although superannuation funds' share of assets invested overseas increased quite rapidly to peak at around 24 per cent in the early 2000s, this share has since declined and currently, only around 18 per cent of Australia's superannuation assets are invested offshore.

Figure 6: Proportion of offshore assets held within superannuation funds



Source: RBA.

Even if superannuation savings were all invested onshore, this would not necessarily reduce the current account deficit. That would depend on national investment. So what matters is the gap between national investment and national savings, not where superannuation savings are invested. In fact, investing superannuation offshore helps diversification and risk mitigation.

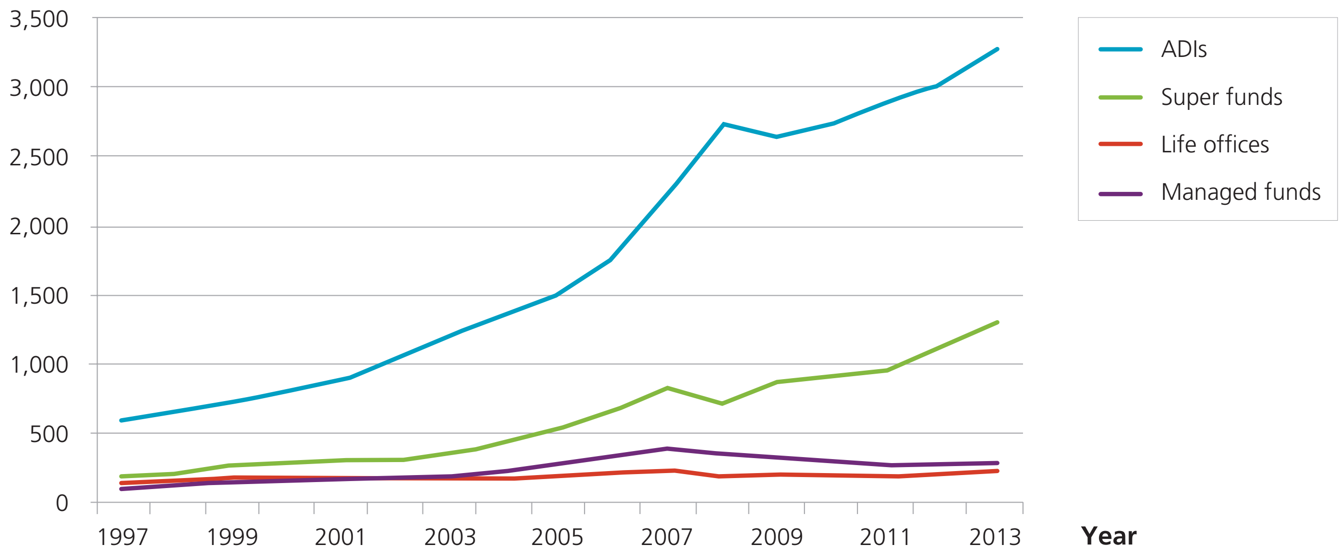
Moreover, while funding investment through national saving lowers the risk profile of a country and thereby contributes to financial stability, this offshore investment provides a hedge to the country's domestic investments, also lowering risk.

Indeed, super funds provided a key source of capital to Australian companies during the GFC when retail demand and global corporate bond markets dried up, enabling Australian corporates to weather the GFC better than their overseas counterparts. In terms of financial stability, this was particularly important for Australian banks (refer to 3.2.).

While recognising substitution effects in national savings, we do not believe that superannuation has affected the ability of banks to raise funds via retail deposits to date. While savings have flowed into superannuation, there is no sign that this has been at the expense of investment into the Australian banking system. As the Reserve Bank of Australia notes in the September 2013 Financial Stability Review (FSR):

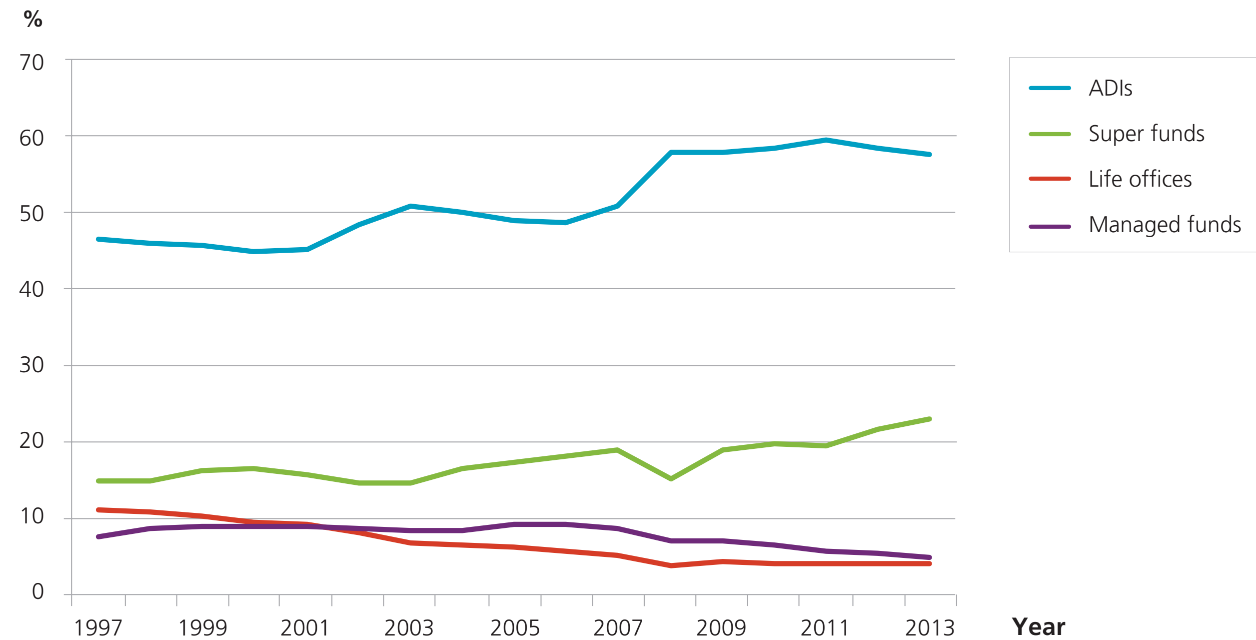
> *"There have been concerns over the years that superannuation would impair the ability of banks to raise funding in the domestic market through retail deposits. Data shows however, that not only has this not occurred, but that banks have been able to increase growth of retail deposits, thereby reducing their dependency on the wholesale debt market."*

Figure 7: Assets of financial institutions ($ billion)



Source: RBA.

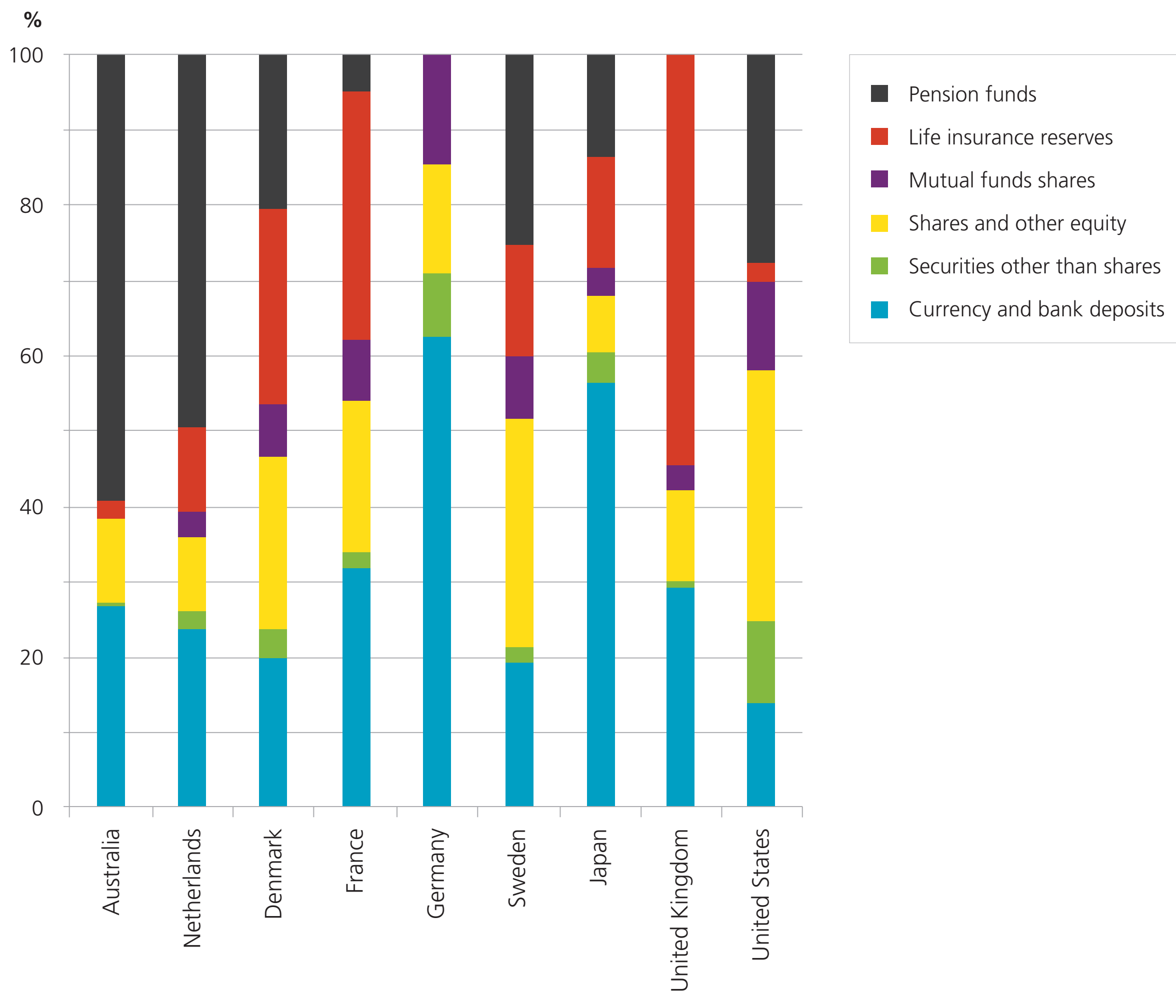
Figure 8: Assets of financial institutions (percentage share of total)



Source: RBA.

Further, OECD data on the financial assets of households demonstrates that Australia is not an outlier when it comes to the balance between bank savings and long-term savings. While different nations have different systems and therefore different interpretation of what is long-term savings which makes direct comparison of retirement savings difficult, Denmark, Netherlands, France, the United Kingdom and the United States are all nations where the portion of household savings held in bank savings is between 18 per cent and 29 per cent. The OECD 2010 dataset, collected after the Global Financial Crisis, would raise the question as to whether in an open market economy there is a limit beyond which households seek to diversify outside of bank savings.

Figure 9: Financial assets of households by type (per cent of total financial assets)



Source: OECD Factbook 2012.

3.4. Supporting long-term fiscal sustainability

Properly implemented, a defined contribution scheme should result in a lower liability to the government via the Age Pension. In 1991, Keating estimated that a 12 per cent reduction in the take up of the Age Pension, would reduce the total estimated spending on aged pension social security assistance by one fifth.

Today, calculating the net effect of the cost of tax incentives for superannuation and the cost of the maintaining the Age Pension, adjusted for the time value of money, is a complex task. Inevitably, it is subject to the accuracy of the assumptions used in the modelling process. The Treasury undertake some calculations to estimate the value of the tax incentives applied to super that are received by taxpayers.

The Treasury has two methods for this calculation. Both look at tax revenue implications but neither method looks at long-term pension savings, which are addressed by Treasury's RIMGROUP model. This process has its own methodology that seeks to assist policy makers trading off tax incentives and actual expenditures to decide the best use of government money.

The **revenue forgone** method is similar to forward estimates, and assumes the continuation of the concessional taxation treatment of superannuation. The revenue gain method is like a costing – it assumes that contribution and earnings incentives cease on a particular date and examines the cumulative consequences of relatively lower contributions and assets. Regardless of the method used, the cost of the tax incentives for superannuation is rising, both in absolute terms and relative to other tax costs. The *Super Charter* report identifies the reasons for these rises as: firstly, that the superannuation system is subject to a robust growth rate, averaging a net compound annual growth rate of approximately 11 per cent – it doubles in size roughly every six or seven years; and secondly, the calculations reflect the increase in Superannuation Guarantee contributions to 12 per cent by the fiscal year 2020.

The report goes on to criticise these methodologies. In particular, it questions the validity of the output given the lack of consideration of the response of individuals. Would individuals be more inclined to invest in an investment property with negative gearing benefits? Would there be a move to investments where capital gains tax could be deferred? The costings do not take account the fact that assets inside the superannuation system would reduce year on year without incentives to continue to invest. The report also questions why the long-term savings in Age Pension outlays are not factored in to the calculation. To offset these criticisms, there are some estimates of revenue gain within the Treasury's processes. The revenue gain estimates also have low or negligible taxation for amounts newly invested outside superannuation, but they still use a full marginal tax rate for earnings remaining in the system.

The detail and rationale behind the costings and their methodology are too detailed to be covered here, but the process of these calculations and the knock-on effect they may have to the superannuation market and broader economy are significant. It highlights the need to consider the cause and effect of decisions that are made to ensure that we are viewing these issues holistically, rather than through the one lens.

Other modelling suggests that there is a long-term benefit in play here, rather than just a short-term fiscal trade off. Treasury's RIMGROUP model projects the increasing income and wealth of successive cohorts of retirees. This model incorporates the maturing of the Superannuation Guarantee arrangements and other government policies, as well as other recent changes such as the legislated change to the Age Pension age and the 2012 Budget measure that reduces superannuation incentives for very high income earners. Growth in private incomes and wealth interacts with means tests to constrain future spending on age-related pensions. The impact of higher wealth is shown in the projected decline of full-rate pensioners and projected rise in part-rate pensioners.

The RIMGROUP model estimates the projected change in the proportion of the population of eligible age receiving full, part or no age or service pension. Their data projects that by 2047, the proportion of those of eligible age not receiving an age or service pension will remain around 20 per cent, while the proportion receiving a part pension will rise to around 50 per cent and the proportion receiving a full pension will fall to around 30 per cent.

This data suggests that the superannuation pillars are expected to achieve the objective of providing people with a better

standard of living in retirement by supplementing the Age Pension, while not necessarily reducing the budget cost of retirement income policy overall. While costs from tax incentives for superannuation contributions would continue to grow, they would be offset by a reduction in the use of the Age Pension.

ASFA has also conducted its own research into the cost of tax incentives for superannuation, including offsetting savings in expenditure on the Age Pension (Part 4 of the ASFA White Paper: *Super System Evolution*).

The budget savings are substantial:

- around $3 billion savings annually from around 160,000 people with super balances sufficient to take them completely outside the Age Pension system
- around $3 billion savings from around 500,000 people receiving around $5,000 less a year from the Age Pension due to the income test on superannuation income streams
- over $1 billion savings from around 150,000 people no longer receiving a part Age Pension because of either the asset test or income test.

This $7 billion amounts to around 20 per cent of the current Age Pension bill. And, going forward, the amount saved from the Age Pension bill will increase because:

- there will be more Age Pensioners as a result of the ageing of the population structure
- private pension balances are increasing
- the Age Pension maximum payment is increasing in real terms.

Of course, without private pensions, at least some individuals would save for retirement, but the amount would be much less, especially after the deduction of tax at personal marginal tax rates.

Once this current $A7 billion annual saving in Age Pension expenditures, as a result of private superannuation is taken into account, the cost of tax concessions for private superannuation drops substantially. In calculating the ongoing cost to tax revenue, it is also necessary to deduct the leakage of savings into other tax-advantaged areas such as negative gearing, which would occur with any decrease in tax concessions. Removing tax incentives would also shrink the superannuation pool directly through the higher amount of taxation extracted. Taking these various factors into account, a more meaningful estimate of the aggregate tax concession for superannuation on an ongoing basis would be around $A16 billion. This is roughly half the headline figure in the Tax Expenditure Statement and only just above one per cent of GDP.

The treatment of pension benefits as tax free when they are received after age 60 has also drawn public commentary on sustainability. At present, the tax revenue forgone by allowing retirees to withdraw a pension from their super tax-free is around $A500 to $800 million per annum. It would not be possible to tax super benefits at full marginal tax rates because contributions and fund earnings had already been subject to considerable taxation, albeit at concessional rates.

While the average balance in retirement is growing, it is only at a modest rate and there are still very few individuals with very large accounts. Accordingly, it is unlikely that the cost of tax free benefits after 60 will grow significantly, even over coming decades.

While the absolute amount of the tax concessions will grow with the growth in assets relative to GDP and the prospective growth in compulsory contributions, this will not be that large in relative terms. Taking into account system assets increasing by 50 per cent and contributions by less than a third (both relative to GDP) and a shift to more assets in pension phase, the ongoing cost of the tax concessions is likely to be around 1.5 per cent of GDP.

Improving private retirement income also helps take pressure off government to fund other age-related expenses. For example, without private pension income very few retirees would be able to afford private health insurance or fund various in-home care expenses. Other areas of budget expenditure such as health, aged care and pensions are projected to grow substantially over the next few decades compared to Age Pension expenditures and tax concessions for super.

In total, the amount of government assistance to retirement incomes in the form of Age Pensions and tax concessions for private pensions is unlikely to exceed six per cent of GDP by the year 2050 and could be closer to 5.5 per cent. By international standards, this is a relatively low figure. It is below the starting point for most other developed countries and well below the projected level for nearly all other developed countries and even many developing countries.

3.5. Providing finance to the economy

Sustainable economic growth is driven by productivity, participation and population: the '3Ps'. In the future, population growth and rising participation will contribute less to Australia's economic growth, leaving future prosperity increasingly dependent on productivity growth.

There are two main causes of this. The demographic shift currently underway in Australia – Australia's population is ageing – means that the working-age population as a share of Australia's total population will begin to fall. Secondly, Australia's population grows by around 1.7 per cent each year. This is well above the average of most other developed countries. It is unlikely that Australia will be able to sustain this level of growth over the long term.

The catalyst for rising productivity is competition and innovation. These are characteristics often associated with new enterprises. Access to capital is an important element for these businesses to promote innovative activity and compete with existing businesses. However, for many small and medium enterprises (SMEs), accessing capital is more difficult than for larger business for which provision of requisite information to lenders is often easier, and this acts as a barrier to growth. Providing additional funding here may help entrepreneurs bring new ideas to market and assist small and medium-size firms to become large.

Superannuation funds have a large pool of funds at their disposal, have long-term liabilities that would appear to be well matched by making long-term investments, and will have net inflows for at least a few more decades.

Super funds are heavily invested in a range of asset classes that help to fund Australia's long-term growth, but gaps in financial markets and funds' investments offshore leave them vulnerable to criticism that they should invest more.

3.5.1. How do superannuation funds invest?

Our current legislative framework supports a flexible approach to the investment of superannuation assets. This has not always been the case. In 1961, the then government introduced a requirement that life insurance and superannuation funds hold 30 per cent of their assets in the form of government securities, at least two thirds of which had to be commonwealth government securities. This so-called '30/20 rule' was driven by, amongst other things, a perceived need to ensure a market for government debt. This rule was abolished in 1984, and replaced with the ability for superannuation funds to invest in 'any manner.'

In the absence of significant restrictions on investment, superannuation funds are able to invest where the best risk-adjusted returns are to be found. Both the Australian and global investment environments will have a major influence on the ability of Australia's superannuation system to deliver.

Superannuation fund investment is further influenced by a range of factors including:

- **diversification:** superannuation funds seek to invest in a diversified pool of assets to manage risk and return
- **investment choice of individual members:** superannuation fund members can have different appetites for risk. However, a large number of superannuation fund members do not make an active investment choice and are invested in default investment strategies
- **demographics of fund:** superannuation funds with members closer to retirement may consider investments that have reduced risk or investment return volatility profiles
- **scale of super funds:** larger superannuation funds are able to make bigger investments
- **taxation:** taxation incentives do influence the investment environment

- **liquidity constraints:** superannuation investors require the ability to exit investments in a reasonable time frame. While different investors have different liquidity needs, all superannuation investors need to be able to exit investments efficiently and cost effectively
- **due diligence costs:** where the due diligence costs of investment are prohibitive this can act as a deterrent to investment. Due diligence costs are particularly important in small scale investments
- **volatility of investment:** volatility of investment can act as a deterrent to superannuation fund investors. This is particularly prevalent in areas including venture capital and emerging markets
- **lack of market depth:** where a deep market is not present that allows investors to enter and exit at a reasonable price, investors may be deterred from investing or seek out markets which do offer depth
- **absence of skills:** there are a number of areas where superannuation funds do not have a depth of skills. This includes the ability to analyse science-based investments where scientific knowledge is required, but also exists in areas where expertise in particular areas of finance is required that can include credit skills.

The flexibility provided to superannuation investments has meant Australian superannuation vehicles invest in a wide range of assets. For diversification reasons, a substantial proportion of superannuation assets are invested in overseas assets, and we expect this to continue over coming decades. However, Australian superannuation decision makers have exhibited significant home bias in their investments to date. Superannuation assets are heavily invested in all domestic asset classes, particularly: Australian fixed income securities; Australian equities; Australian property and Australian infrastructure.

In the more liquid equity securities market, shareholdings of pension funds and insurance companies together comprise over one-quarter of the ownership of ASX-listed companies. This illustrates their key role in funding corporate investment and growth (ACG, 2011). Superannuation funds hold around 11 per cent of Australian corporate debt (Black et al, 2012). As a whole, superannuation controls around one-third of system assets, and holds a similar portion of domestic corporate equity and debt issues.

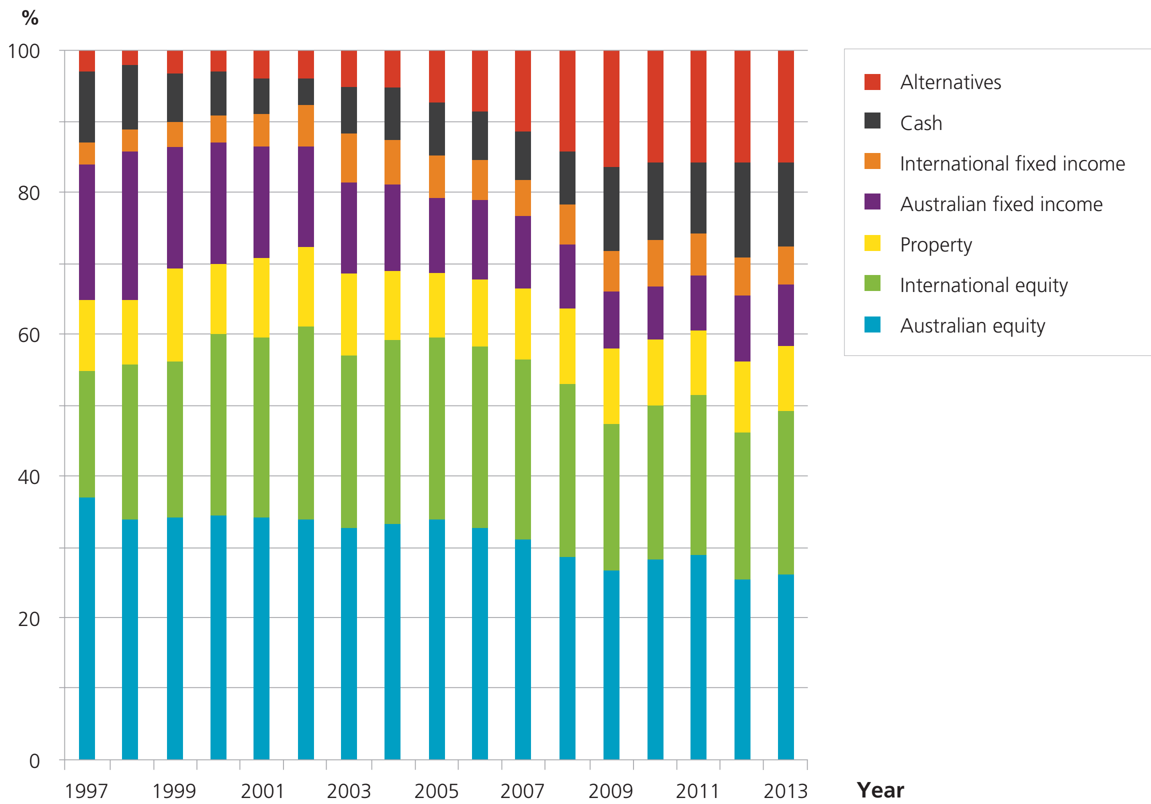
The table below shows the average allocation to various asset classes over the period between 1995 and 2013. Of total assets held, assuming that the bulk of property is domestic, superannuation funds have put to work at least 56 per cent of their assets, domestically. This is a likely underestimate of the domestic versus international breakdown for two reasons: firstly, the calculation does not include any alternatives as we did not have access detailed data for this asset class; and secondly, this data does not include SMSFs that are significant investors in Australian equity and cash.

Table 10: Average asset allocation of not-for-profit funds and retail balanced funds (1995 to 2013)

	Australian equity	International equity	Property	Australian fixed income	International fixed income	Cash	Alternatives
Not-for-profit average	32%	23%	10%	13%	5%	8%	9%
Retail average	37%	22%	8%	17%	5%	8%	3%

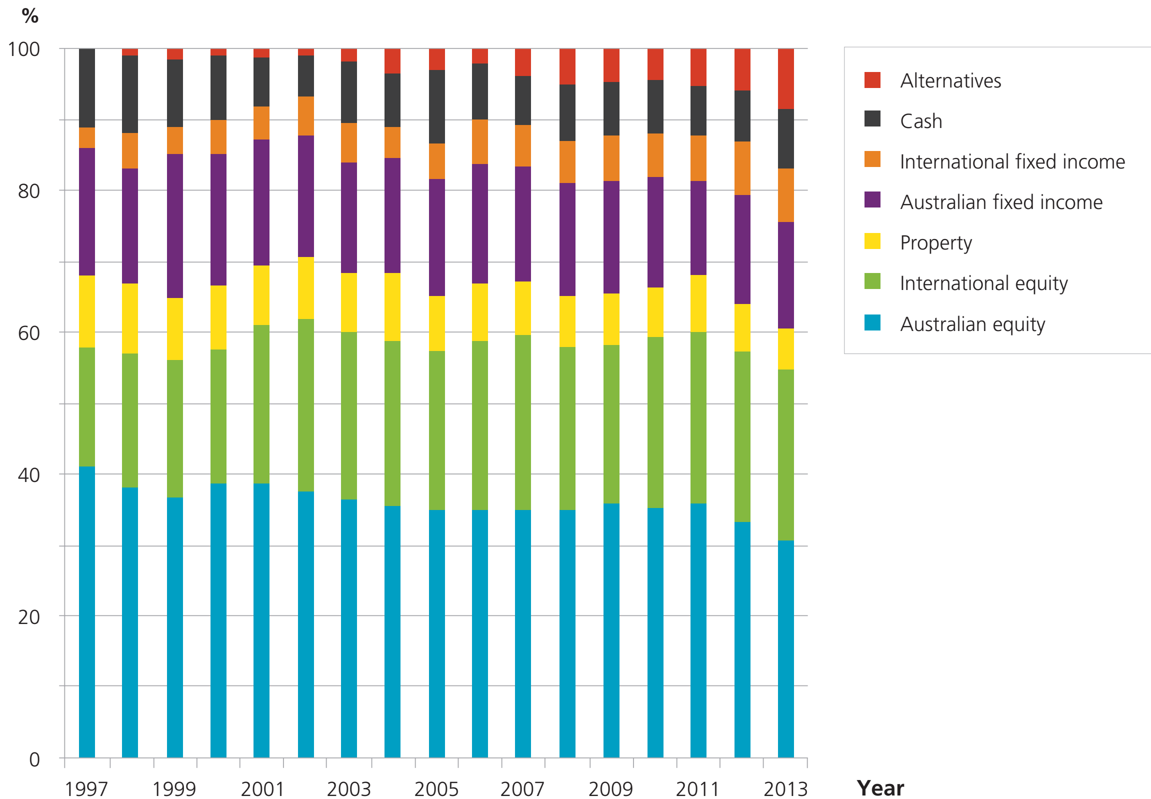
Source: Rainmaker.

Figure 10: Asset allocation of not-for-profit superannuation funds



Source: Rainmaker.

Figure 11: Asset allocation of retail superannuation funds (balanced)



Source: Rainmaker.

3.5.2. Emerging trends in investments

Pre-retirement accumulation trends

Alternatives

In pre-retirement, we are observing a gradual increase in the investment into asset classes that are less traditional in nature. These are often collectively referred to as 'alternatives' and will include private equity, infrastructure, high yield credit, hedge funds and so on. There is no strict definition of alternatives in the market; what is classified as an alternative in one fund, may not be defined the same way in another. Nevertheless, we can observe from the Rainmaker data, that the total allocation to these alternative investments has risen markedly over the past two decades. The graphs above show that the allocation to alternatives by not-for-profits is currently 15.8 per cent, compared to 8.5 per cent for retail funds.

This growth in allocation to alternatives has helped drive investment in venture capital and later-stage private equity. Venture capital and later-stage private equity is high-risk capital directed towards businesses with prospects of rapid growth and/or high rates of return. Australian superannuation funds contributed 60 per cent of the total of funds committed toward venture capital and later stage private equity, or $10.4 billion of the total $17.26 billion committed as at 30 June 2010 (ABS). Of all funding committed to venture capital and later stage private equity in Australia, 93 per cent comes from Australia. Of all funds from Australia, Australian superannuation funds contribute 65 per cent of all venture capital and later stage private equity (ABS 2010).

Superannuation funds that are invested in venture capital and later-stage private equity vehicles are then invested in a wide range of industries, helping to drive growth in Australian businesses with prospects of rapid growth or high rates of return. When analysed by activity, the retail, services and real estate group of activities attracted the largest share of investment, with $3,138 million or 38 per cent of total investment as at 30 June 2013. The manufacturing and transport group of activities, with $2,428 million, also maintained a large share of the total investments at 30 per cent (ABS 2014).

Direct investment

SMSFs traditionally have made substantial use of direct investments into bank deposits, listed shares, and commercial and residential real estate.

As well, APRA-regulated funds have made increasing use of direct investments, rather than investing through investment managers or life insurance company statutory funds. As superannuation funds have increased in size and also as they have developed in-house investment teams, a greater proportion of assets have been directly invested.

This is clearly indicated by APRA data. In 1996, around 25 per cent of the assets of APRA-regulated funds were directly invested. This rose to 32 per cent by 2001 and reached 42 per cent by June 2013.

Superannuation funds have increasingly become players in their own right in investment markets, rather than being customers of wholesale or retail investment managers.

Post-retirement investment trends

As the superannuation industry matures, the average asset allocation of the total industry will shift. We are expecting to see a greater uptake of lower risk, higher income generating assets, as benefits paid begin to overtake contributions to the system.

Demographic influences

With no changes to the current financial market system and regulatory framework, the asset allocation of superannuation funds will evolve to reflect the ageing population. While asset allocation in accumulation and in retirement may exhibit similar patterns, it is unlikely that an ageing population will have an increasing risk appetite.

As an increasing share of superannuation members approach retirement and begin to draw down on their superannuation savings, individuals are expected to switch assets towards less volatile investments with stable income

streams, and the asset allocation for the industry as a whole is expected to evolve towards less risky investments with steady income streams.

This will have implications for specific asset classes as well as the financial sector more broadly. Specifically, growing demand for less risky investments that deliver long-run income streams will increase the demand for bonds relative to shares. It will also increase demand for infrastructure investments that can offer stable income streams.

More broadly, as the superannuation industry continues to expand as a share of the financial sector, a shift towards specific asset groups will have broader implications for the financial system. It may drive product innovation, as well as adjustments in relative prices and returns across asset classes.

Developments in fixed-income markets

Fixed-income investments are a useful diversification strategy for most portfolios, and depending on the level of credit risk, are likely to be included as part of the defensive component of the asset allocation. Typically, funds with lower risk profiles will have a higher allocation to fixed interest as these assets exhibit lower volatility than other, growth-oriented assets, such as equities. Traditionally, fixed interest is also used as an income de-generating asset class, as the coupon payments form a steady predicable cash flow for individuals who are relying on their assets to fund day-to-day living.

That said, many investors underestimate the risks associated with investing in fixed income. The potential for capital depreciation in the holdings of fixed income securities is seldom considered. Yet, with interest rates at historically low levels, this risk is very prescient to today's investors. Further, the potential to lose capital in the event of a default, or portfolio value in the event of a ratings downgrade is not well understood.

ASFA expects that over the coming decade the demand for fixed-interest investments by superannuation funds will continue to grow. Increased demand for fixed-interest investments will be supported by two fundamentals. Firstly, continuing contributions into superannuation will result in continued allocation to fixed-interest investments as part of the existing asset allocation of superannuation fund members. Secondly, the ageing of the Australian population will result in increased demand for fixed-interest investments. In particular, many post-retirement products will have higher allocations to fixed-interest investments compared to investments in the accumulation stage.

There are already signs of change in Australia's debt market. The average tenor of unsecured issuance has risen to five years, compared with around four years at the beginning of the financial crisis (Debelle, 2013). Similarly, issuance in Australia's securitisation market has recently increased, and spreads have tightened considerably. This took place, with little or no support from the Australian Office of Financial Management (AOFM), and was largely the result of increasing demand by investors; capital will flow to worthwhile opportunities without intervention.

One of the challenges for developing domestic fixed-interest markets is that the ability of SMSFs to invest in capital guaranteed bank deposits reduces the incentive to seek alternative fixed interest investments. The SMSF market consists of investors whose age profile would suggest the greatest interest in defensive investments. Over 80 per cent of all SMSF members are over the age of 45.

Low take up of post-retirement products

Award superannuation was introduced in 1986 as deferred pay (in lieu of an alleged productivity wage rise). It was promoted to members as an addition to the Age Pension. The Superannuation Guarantee has increased the value of contributions but the message has not changed – members consider that superannuation is their own money and they expect flexibility of payments.

The government allows all members above age 60 to retire and draw a tax-free lump sum or pension. There is only a limited fiscal incentive to leave money in the system during retirement since most Australian retirees will pay a relatively low rate of tax on their income outside superannuation. As there are no longer maximum withdrawal factors on account-based pensions, no one is forced to draw their benefits over time.

Members can buy lifetime annuities from the private sector (albeit from a small number of suppliers), but most choose not to purchase them. Research conducted by Rice Warner shows that most people are unreasonable about the pricing of an indexed lifetime annuity and expect much more than fair value.

Many members retire with small benefits and they appear comfortable with leaving the money in an interest-bearing bank account rather than in superannuation. This may be influenced by their perception of safety in the bank or by a short-time horizon where they do not value higher (but uncertain) returns. They may also value instant access to their funds. Many people today retire with debt (including mortgages) and it is a rational decision to take a superannuation lump sum to clear all debts before retiring. Additionally, they may have a need to make some large payments. Typically this includes financing a trip overseas, updating kitchens or bathrooms or buying a new car. Again, this is rational and a good use of their 'deferred pay'.

However, there are no limits imposed on the amount of superannuation consumed this way, nor is there compulsion to take an income stream. This has made the provision of income streams, which can also protect members from their longevity risk, difficult.

3.5.3. Specific asset class trends

Concentration risks in Australian equities

Superannuation funds invest more in the ASX than overseas equities or indeed any other asset class. The continued growth of superannuation assets over the coming decade means that it can be anticipated that superannuation funds will continue to make new allocations to Australian equities that will provide the capital for Australian businesses to grow. While the growth of superannuation assets has been strongly correlated with the growth of the ASX, over coming decades it is questionable whether Australian superannuation funds will invest as much proportionately in Australian equities as they have done in the last two decades. The importance of Australian equities as an asset class means that the industry has a material interest in the structure, efficiency and development of Australia's capital markets.

The core challenges that the superannuation industry faces in terms of future investment in Australian equities is concentration risk and the future pipeline of investable companies. More detail on this matter is provided in Appendix B.

International Investment

Over the last 25 years there has been an increase of around 10 per cent in the proportion of superannuation fund assets that are invested offshore. Despite this, as noted above, Australia's superannuation system has a strong home bias. The growth of SMSFs has undoubtedly contributed to the continuation of this home bias with SMSFs having less than $5 billion invested in assets that are identified as being offshore.

It can be expected that over the next decades the superannuation system will invest more offshore. This will be driven by a number of factors:

- ASX has sought support from ASIC to allow trading in unsponsored depositary receipts (UDRs) of foreign companies. This would allow SMSFs to directly trade in shares of major companies such as Apple and Google
- APRA-regulated funds are likely to increase their investments offshore to diversify portfolios. ASX concentration risk is one factor that is driving funds to seek diversification outside Australia.

International investment should be regarded as a positive for both superannuation fund members and the Australian economy. According to Deloitte Access Economics' *Maximising Superannuation Capital* report "even if superannuation savings were all invested onshore, this would not necessarily reduce the current account deficit. That would depend on national investment. So what matters is the gap between national investment and national savings, not where superannuation savings are invested. In fact, investing superannuation offshore helps diversification and risk mitigation. Moreover, while funding investment through national saving lowers the risk profile of a country and thereby contributes to financial stability, this offshore investment provides a hedge to the country's domestic investments, also lowering risk."

Direct property

Superannuation funds have been heavy investors in retail, commercial and industrial property for many years. More recently, there has been innovation in the types of property investment to include health care and aged care facilities. This investment is either though unlisted property trusts, direct holding and in some circumstances, superannuation vehicles also undertake direct property development.

There is a continued focus on the role that large superannuation funds can play in the housing market. Housing represents a challenging investment class for a number of reasons. In Australian cities landholdings are tightly held that impacts on the affordability of final housing. Housing is also subject to significant taxation concessions including home owner concessions for capital gains tax and pension eligibility as well as negative gearing incentives. These concessions are either not available, or not as valuable for superannuation fund investors, which impacts on the attractiveness of investment. Another significant impediment to investment is the lack of scalable investment opportunities. Where super funds have invested in housing, it has principally been in developing apartments that can be built at scale.

Superannuation funds have made forays into investment in farmland but have found the asset class to be difficult to extract sustainable returns. Food security has been identified globally as a macro trend that will drive global investment in food. The demand for protein, particularly from developing countries such as China, will support food commodity prices over the long term. The challenge for superannuation funds to invest in farmland however, is scale and liquidity. Superannuation funds are not managers and when investing in an asset will seek to either invest where a management structure is in place, or put a management team in place.

Infrastructure

As long-term investors, superannuation funds are natural holders of infrastructure assets.

Australian superannuation funds were amongst the first pension funds in the world to invest in infrastructure, investing in the Victorian Government's privatisation program, including the creation of projects such as Melbourne's CityLink. Australian superannuation funds are invested in infrastructure assets across the country, owning assets including airports, ports, toll roads, energy pipelines, wind farms, bus interchanges and desalinisation plants.

According to Rainmaker estimates, superannuation funds invest over $140 billion in infrastructure through fund managers. The total superannuation industry investment in infrastructure would be boosted by the direct infrastructure investments managed by superannuation funds themselves, for example Sunsuper and AustralianSuper.

Superannuation funds are seeking long-term stable investment returns and are not seeking to flip out of projects in order to take short-term profits. Super funds are also representative of the community, which means that where governments are privatising an asset, there may be more community support for a sale if the asset is ultimately held by a super fund. Some of the issues that face superannuation investors in infrastructure are discussed in Appendix C.

3.5.4. Small and medium enterprises, corporate bonds and infrastructure

Funding for newer, smaller corporates – both listed and unlisted – and the latent development of the corporate bond market and infrastructure are the main areas where commentators point to under-investment by the superannuation system.

Superannuation and SMEs

Banks and superannuation funds have tended to play complementary roles in Australia's financial system. Banks have generally played an important role in debt funding, while superannuation funds have tended to invest more heavily in equities.

Currently, for a dollar invested in superannuation, 10-15 cents goes to fixed income (split between government, international and domestic corporate issuers). This compares to a dollar on deposit at a bank of which about 30 cents is loaned to businesses.

However, as savings continue to flow to superannuation, and banks have been pushed away from SMEs by increased capital requirements, the financing for SMEs has become difficult to obtain. This is the space where banks have traditionally been the primary source of funding due to their size and the nature of their business.

The structure of the Australian economy consists of a large number of small businesses and a small number of large businesses. As at June 2012, there were 2,141,280 actively trading businesses in Australia, of which 835,187 employed at least one person. There were 514,859 businesses that employed '1-4' employees, followed by 231,591 businesses that employed '5-19' employees, 82,326 businesses that employed '20-199' employees and 6,411 businesses that employed '200+' employees.

The structure of Australian business raises the question as to what role superannuation funds play in funding small businesses. There are number of ways that the superannuation sector funds small business:

- a number of SMSFs invest in direct property that is related to a business. For instance, a business premises may be owned by an SMSF
- superannuation funds invest in companies seeking to expand in a variety of ways including venture capital. This was discussed earlier
- superannuation funds invest in businesses that provide finance to the small business sector. In particular, superannuation funds are significant investors in the banking sector.

A significant question is whether superannuation funds should seek to expand the role they currently play financing small business. There are a number of challenges that superannuation funds face, but principally the issue is that superannuation funds do not possess credit skills that would enable funds to assess credit risk. A number of investment managers have recently emerged that are offering products that invest in small business credit. It is likely that such products will find a place in superannuation fund portfolios over time on the basis that they offer diversification of fixed interest investments.

Superannuation and domestic corporate debt

Mainly reflecting the focus of Australian superannuation funds on equity investments, superannuation funds have invested a relatively low six to seven per cent of their asset portfolios in domestic corporate bonds over the past decade. Indeed, the share of total assets invested in domestic corporate bonds has been declining for several decades. Managed funds – including superannuation funds, life insurance offices, public unit trusts and cash management trusts – purchased 36 per cent of Australian corporate bonds in the 1970s. But by the 2000s, the share had fallen to just 11 per cent (RBA, 2012).

The relatively low investment in Australian corporate bonds is likely to reflect several factors. Australia has a small corporate bond market relative to other developed economies, influenced in part by government policies that favour equity investment. In addition, the corporate bond issuance is predominantly driven by financial institutions, which account for over two-thirds of all non-government debt outstanding. Non-financial corporates account for a minority of the corporate bond market, tending instead to issue in overseas markets. At the end of 2011, almost 90 per cent of the outstanding stock of non-financial corporate debt was issued overseas.

Thus, a low level of Australian superannuation fund investment in domestic corporate bonds may reflect:

- concentration risk (funds have significant exposures to bank equity)
- availability (non-financial issuers issue in offshore markets)
- foreign appetite for Australian bonds.

More detail on corporate bonds is provided in Box C.

Box C: case study: corporate bonds

For decades, there have been discussions around why there is not a deep and liquid corporate bond market. It has been argued that Australia's financial system has an imbalance in that Australia's banks are reliant on funding from offshore markets while superannuation funds seek investments offshore. A suggestion to address Australia's financial system imbalance is to encourage the development of a deep and liquid corporate bond market that would provide alternative avenues for the corporate debt to finance their debt needs.

Wallis argued that the domestic corporate bond market will grow only if it offers corporations the ability to borrow at more competitive interest rates than alternative sources. The Wallis Inquiry noted that the future of Australia's corporate debt market would depend on three factors:

- the number of companies able to achieve a sufficiently high credit rating to attract demand for their paper from investors
- the willingness of investors to hold a portion of lower-rated paper in their debt portfolios
- the intensity of competition from alternative sources of funds from both the banking sector and offshore debt markets.

So why hasn't it happened? One reason seems to be that, by and large, corporates are satisfied with access to international wholesale markets. And the yields at which they are able to obtain funds on the international market is not any greater than they would pay here in Australia. Perhaps then the issue is less one of demand from the superannuation market, but the willingness to supply on the corporate side? Certainly, there is no impediment to corporates issuing more into the domestic market. Superannuation funds can be expected to respond to increased issuance in the domestic market as attractive yields are offered.

That said, there are some constraints for superannuation funds, including SMSFs, investing significantly in corporate bonds, while the market remains small.

The first reason is one of **diversification**. The Australian economy consists of a large number of small companies, and a small number of large companies. This results in a relatively small number of corporates offering corporate bonds to the market. The dominance of materials and financial companies provides an overall lack of diversification. The yield offered on Australian corporate bonds needs to compensate investors for this lack of diversification, or to pay them for the extra risk they are taking.

The second reason is that superannuation funds prefer the bonds to have a rating and the cost/benefit analysis of this does not stack up for the company. To achieve a credit rating, an Australian corporate must go through a lengthy and costly process. But absent these ratings, the appetite of investors is lower.

Higher yields may attract SMSF investors to corporate bonds provided the retail structure is in place, however, any demand will be dampened by the **government guarantee** available to SMSF investors on bank deposits.

While changes are underway to improve the ability of corporates to offer bonds directly to the retail sector, they will require mechanisms to communicate directly with retail investors. The time and resources required to communicate directly to retail investors may act as a disincentive for some corporates to utilise the reforms. It is also likely that retail investors will be attracted to invest in corporate bonds issued by corporates that have an established brand in the market place. In most instances, this will mean that it will be household brands and large corporates that will have the capability to issue to retail investors.

It is considered that the additional issuance in the Australian market to retail investors will be marginal compared to the overall size of wholesale markets. In practical terms, it is therefore not expected that these reforms will significantly increase the depth and liquidity of the domestic corporate bond market.

Meeting domestic infrastructure needs

Infrastructure is generally a suitable asset class for superannuation fund investment, given the longer-term nature of the investment. The sector has undergone rapid growth over the last decade, underpinned by Australia's mining boom, economic stimulus spending, and projects to rebuild infrastructure following several natural disasters. Nonetheless, it is estimated by that there is currently a $700 billion shortfall in essential infrastructure in Australia (Infrastructure Partnerships Australia 2009).

Greater investment in infrastructure projects, particularly brownfield projects with predictable cash flows, will potentially assist superannuation funds to diversify and reduce risks associated with being equity-heavy or being forced into investing in offshore markets.

Historically, Australian superannuation funds have been involved in funding large-scale long-term infrastructure projects throughout their lifecycles. Examples range from greenfield assets to privatised operating assets such as airports. Both funds and Infrastructure Australia have expressed an interest in increasing the superannuation industry's investment in domestic infrastructure. As well as offering diversification opportunities, infrastructure and other long-term investments that offer steady income streams are well suited to the long-term nature of superannuation liabilities.

However, investment in infrastructure is a small proportion of total superannuation investment. Only one third of superannuation funds invest in infrastructure. In total, just five per cent of total assets under management are invested in infrastructure (ASFA, 2011).

This can be attributed to several factors:

- **Illiquidity:** long-term investments are inherently illiquid. This may impede the ability of funds to invest in them, given legislative requirements for timely roll-overs and making funds available for draw-down
- **Valuation issues:** for funds that have daily unit pricing, long-term investments with low (or no) short-term return or market valuation may be difficult to value on a day-to-day basis
- **Size:** infrastructure projects, as well as many long-term investments, often require substantial initial capital. Smaller funds may be unable to invest in these projects without heavily biasing their portfolios, thus threatening their asset diversification strategies.

There are ways however, to shift the structure of the investment to better meet the needs and demands of the superannuation investors. What superannuation funds want to invest in will vary according to the stage of life of the members, the cash flow profile of the fund and the risk tolerance of investors. A 'greenfield' infrastructure opportunity might not match the risk profile of most superannuation funds out there, but a 'brownfield' infrastructure opportunity may well fit most portfolios well. Same asset class, but a different risk and return payoff – less risk and less return.

The NSW Government appears to have harnessed this idea, and are managing to construct infrastructure opportunities which have been relatively well subscribed by the superannuation industry while meeting the government's funding needs. Restart NSW is a pool of money, set aside to fund high priority infrastructure projects. The $5 billion in Restart NSW has been funded by the sale of brownfield – already established – infrastructure assets to willing superannuation clients. For example, the NSW Ports consortium recently paid over $5 billion for the 99 year leases over Port Botany and Port Kembla. Australian superannuation funds represent more than 80 per cent of the membership of this consortium.

Mike Baird – NSW Treasurer – also points to the new financing strategy the government is taking to fund the WestConnex motorway. This strategy explicitly deals with the poor appetite of superannuation investors for higher risk infrastructure investments, such as new tollways where there is significant patronage risk. Baird is proposing that the NSW Government funds and builds the first stage of the project – taking on the development risk – until the tolls are proven and revenue is being generated. The government would then offer the asset for sale, with characteristics closer to what superannuation funds are looking for on behalf of members. Such an approach is likely to be welcomed by the superannuation industry.

APPENDIX B

Superannuation, concentration and the ASX

Superannuation, concentration and the ASX

The ASX is concentrated in two ways: there are a small number of large-cap stocks and two industry sectors that dominate the market. This has an impact on superannuation and other investors in the form of concentration risk.

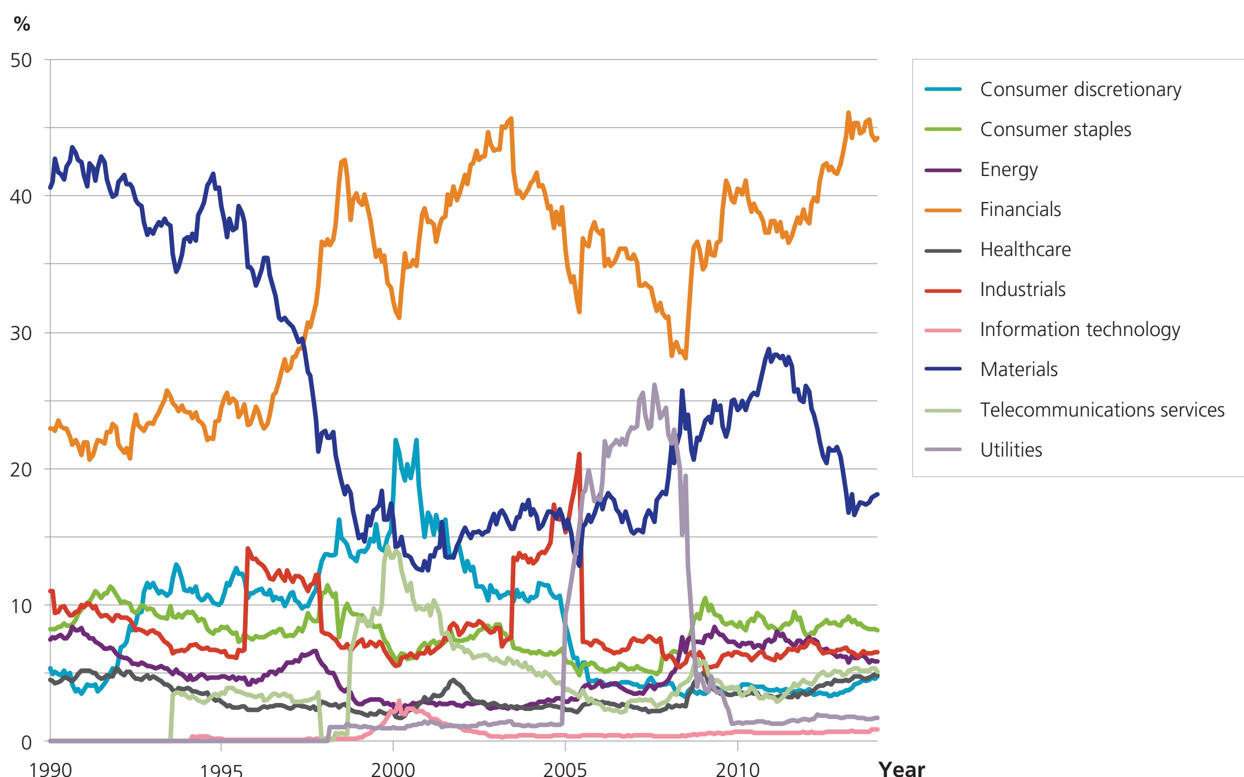
The ASX is dominated by large-cap companies. While there are a reasonably large number of companies on the ASX, the market has a small proportion of companies with a large capitalisation and large proportion of small companies. The 15 largest companies on the ASX have a market capitalisation of $842 billion; over half of the entire capitalisation of the Australian market.

Across the industry sectors, the market is dominated by financials and materials. Figure 13 shows the allocations to the financial and materials sectors in the index over the past 20 years. In the early 1990s, the materials sector peaked at 45 per cent of market capitalisation of the ASX 200. Over the next decade, this declined until it was below 15 per cent by the turn of the decade. Over the last 10 years, the materials sector has steadily climbed, nearly hitting 30 per cent, although it has fallen back more recently. Among the small and medium-cap companies market concentration risk to the mining, resources and energy sectors is even higher, accounting for over 50 per cent of the market. Holdings in financials, while historically always in the top two sectors, have increased over time, and represented around one third of the index since the time of the Wallis Inquiry.

The high concentration of same names in the index, and the exposure to these names through other sectors of the Australian financial markets, may also result in very large exposures to these companies on a 'look-through' basis. In particular, superannuation funds invest in corporate bonds of Australian companies and hold deposits issues by Australian banks. Their exposure to the credit risk of each company will be assessed against the total portfolio exposure. Further, where the name is also a market participant in the over-the-counter derivative market, or the clearing broker on the Futures Exchange, the superannuation entity may have counterparty exposure on market transactions undertaken with the same company.

This can create an impediment to superannuation investors, as they will be managing the total credit and counterparty exposure to a single name across the different markets and products. Excessive concentration may result in a superannuation fund deciding to change brokers, or electing not to use a particular bank as a term deposit provider.

Figure 13: Industry sector composition of ASX 200



Source: UBS.

B.1. Diversification of the ASX

Superannuation funds predominantly invest in ASX 200 companies. According to Rainmaker, 95 per cent of superannuation fund investment in Australian equities is in ASX 200 companies. The five per cent of Australian equities funds invested outside of the ASX 200 equates to around $21 billion or around 15 per cent of the total small cap market.

As the size of superannuation capital continues to grow, superannuation funds will seek new investment opportunities outside the ASX 200. Australia's regulatory environment, with its emphasis on choice and fund liquidity, is one reason why superannuation funds will look to invest in listed companies to gain exposure to growth opportunities. At this stage, we believe it is unlikely that Australian superannuation funds will be able to diversify into Australian venture capital. Our venture capital market is still embryonic; estimates suggest that, over the last 10 years, venture capital firms in Australia have only invested $1.5 billion.

According to research by Contango MicroCap Asset Management, the bottom of the ASX has 1,583 companies that have an overall market capitalisation of around $95 billion, with the smallest 1,300 companies having a market capitalisation of $47 billion (based on data as 31/12/2010). This compares to the total market capitalisation of venture capital industry in Australia at $2.3 billion.

The pipeline for superannuation funds outside of the ASX 200 is dominated by mining and resources companies. Despite the fact that 50 per cent of the market cap outside the ASX 200 comes from the mining and resources sector, new listings continue to come from this sector. ASFA notes there are a significant number of ASX-listed resource companies that are active globally, with 186 companies actively exploring or producing in Africa alone.

There has been a great deal of debate about why the ASX has been so strongly influenced by the resources sector. It wasn't always that way. In the 1970s, the mining industry was hit with a series of scandals known collectively as the 'Poseidon Bubble'. Poseidon NL was an Australian nickel mining company whose shares exploded as speculators sought to benefit from the lack of global supply at a time when the Vietnam War meant demand was strong. The popping of the Poseidon Bubble led to a parliamentary inquiry, but its most lasting legacy was that the mining industry came together and realised that, if they were to attract investors in the future, they needed to improve their disclosure. The mining industry established the Joint Ore Reserves Committee (JORC), which has subsequently become the benchmark for resource company disclosure. JORC has helped facilitate over 200 ASX companies that solely work in Africa. There is the potential that the lessons from JORC can be applied to other industries. One example is the *Code of Best Practice For Reporting by Life Science Companies* which has recently been re-launched. There is evidence that US biotech companies have been attracted to list on the ASX because of this code. ASFA is supporting the Australian School of Business at University of New South Wales, which is conducting research as part of a Centre for Finance and Regulation grant into the role that codes play in capital formation.

B.2. Australian equities ESG risks

In investing in small-cap companies, investors face the challenges of lack of liquidity, volatility of share prices and lack of research data. Compared to large-cap companies there are also concerns around the management capacity of small cap companies, in particular around a range of environmental, social and corporate governance (ESG) risks.

The fact that Australian companies are active on a global basis provides investors with an ability to gain exposure to the global economy. However it also introduces risks that must be managed. The superannuation sector understands the important role that ESG factors can play in delivering long-term investment returns. A great deal of work is being done by many super industry participants to build their capacity to understand and manage ESG risks across their portfolios.

Small and medium cap companies in the resources sector are particularly exposed to human rights risks when operating in developing and under-developed countries. Australia should aim to have world best practice standards in regards to these companies.

In the US, the Securities and Exchange Commission (SEC) has been required to issue new rules around disclosure practices for resources companies that operate in conflict zones. There is an international body of work focused on the Extractive Industries Transparency Initiative that requires countries to disclose revenues from resources, in order to stop bribery and corruption in developing countries. The SEC move, which came from a Congress directive, will, in the end, set a new standard for disclosure of resources companies. Given the dominance of resources companies in the ASX, the SEC model should be considered in the Australian context.

B.3. Australian equities international exposure

ASFA notes that, over the last decade, there have been many new listings of companies whose primary business activity is undertaken outside Australia. The globalisation of markets will mean that superannuation funds will need to have a greater appreciation that the listing environment does not necessarily correlate with economic exposure.

The listing of companies involving new industries, services, products and markets would provide superannuation fund investors with new investment opportunities, which would balance the impact of the projected medium to long term decline of commodity prices, as forecast by the Australian Government's Mid-Year Economic and Fiscal Outlook (MYEFO). The Government's medium-term projections assume that Australia's terms of trade will decline by 20 per cent over the next 15 years. It is not likely that a decline in Australia's terms of trade will correlate directly with the capitalisation of the ASX 200, however, we can expect that, all things being equal, a decline in commodity prices will impact on the valuations of companies in the materials sector.

As Australian superannuation funds seek greater international exposure there is an opportunity for the ASX to provide that exposure by capturing international listings. This would provide alignment with superannuation funds, which have a number of incentives to invest domestically, including transparency of governance, currency hedging and taxation incentives.

B.4. Importance of the ASX to superannuation

The structure, efficiency and development of the ASX are of material interest to superannuation funds. ASFA acknowledges that the market for exchange trading and clearing and settlement is subject to competition. The current focus on exchange competition has, however, failed to appreciate the importance of the ASX as a source of future capital for future companies, and for superannuation fund flows. Consideration needs to be given to policy mechanisms that would support diversified listings.

ASFA actively participates in ASX forums that are focused on the efficiency and governance of the market, and is a member of the ASX Corporate Governance Council and the ASX Clearing and Settlement Forum. The ASX Corporate Governance Council has played a particularly important role in establishing and reviewing Corporate Governance Principles. The Council is a collaborative stakeholder body that has been responsible for the evolution of corporate governance practices in Australia. Under Listing Rule 4.10.3, ASX listed entities are required to benchmark their corporate governance practices against the Council's recommendations and, where they do not conform, to disclose that fact and the reasons why. The Council has recently completed a revision of the principles which will be formalised shortly. The regular review of the principles provides stakeholders with a mechanism to address corporate governance issues in a structured, non-confrontational way.

ASFA is supportive of changes that the ASX have been making to assist small-cap companies and support diversification. In particular reforms that have made it easier for small-cap companies to raise capital have the potential to support institutional investors investing. The *Code of Best Practice for Reporting by Life Science Companies* has already supported the listing of bioscience companies. The Code has the potential to support new listings of companies with the prospect that Australia could, in the long term, be one of the major capital markets for listing of bioscience companies.

The ASX is also trialling a broker research scheme that aims to progressively increase the broker research coverage of companies outside the ASX 300, on the basis that there is a demonstrated link between broker research and share value.

These developments have the capacity to support the growth of small and medium-sized companies. However, more can be done to support the listing of diversified companies that will provide a long-term pipeline of diversified opportunities for the superannuation industry.

ASFA is concerned that there has been insufficient attention paid at both a market, regulatory and policy level on the implications of encouraging a diversified capital market, thereby reducing concentration risk. Left unmanaged, the long-term impact of concentration risk will be that in order to achieve portfolio diversification, superannuation funds will need allocate new funds outside of the ASX, either offshore or to other asset classes. To the extent that concentration risk increases, this has the potential to have a long-term impact on the allocation by the superannuation sector to Australia's capital market.

It is in the interest of the superannuation industry to encourage the diversification of the ASX. A diversified ASX provides superannuation funds with a broad range of investment opportunities that superannuation funds can invest in according to their different risk and return objectives.

APPENDIX C

Infrastructure

Infrastructure

There is a natural symmetry to, on the one hand, a growing population and changing infrastructure needs, and, on the other, a large pool of money in superannuation accounts. This has led to discussions on ways to open up new infrastructure projects to superannuation funds investment. Superannuation funds have a long track record of investing in infrastructure, and have continued to invest, an example of this is the recent sale of Sydney ports. The challenge that superannuation funds face is not the availability of capital, but rather addressing the risk, return and liquidity needs of investors.

The demand for Australian infrastructure investment is led by Australian investors, but supplemented by international investors that are increasingly seeking global exposure to infrastructure. Infrastructure is becoming a growing international asset class for pension funds and insurers who are seeking to match long term liabilities with long-term, low-volatile, cash-flow positive assets. According to Prequin, the level of institutional investor capital secured by private infrastructure funds that closed in 2013 was US 38 billion, an increase of 31 per cent on funds that closed in 2012, and 58 per cent on funds that closed in 2011.

Despite the continued strong appetite to invest in infrastructure, superannuation funds face a range of challenges that have the potential to limit the growth of their investment and impact on the sustainability of investment returns.

C.1. Infrastructure liquidity

One of the major challenges that superannuation funds face when investing in infrastructure is liquidity. Superannuation funds are constrained in the portion of a fund's assets that can be invested in illiquid assets such as unlisted infrastructure. A combination of choice of fund, hedging of currency and demographics, mean that funds must strictly manage their liquidity position. This issue has been discussed in our submission in Section 3.1.

Liquidity is a particular issue for infrastructure investments because of the sheer size of infrastructure assets. While secondary markets do exist for infrastructure assets, these will not operate effectively in times of market stress. Investors require an illiquidity premium over the expected returns from other, more liquid growth-oriented investment opportunities, before there can be a justification to include infrastructure investments in the portfolio. However, even if the illiquidity premium is available, liquidity constraints mean that superannuation funds cannot invest more than a small portion of total assets into infrastructure assets.

That said, superannuation funds have not yet reached their capacity limits in terms of infrastructure asset exposure. The continued growth of superannuation fund assets over the next decades means that there is a strong pipeline of available capital that has the capacity to invest in infrastructure.

C.2. Pipeline of projects

Over the last few years ASFA has consistently called for a long-term pipeline of infrastructure projects. A pipeline of projects is important for a number of reasons:

- It will provide superannuation funds with a clear pathway of projects that will be coming on line. Infrastructure investments are lumpy and, in order to 'digest' them into a portfolio, a superannuation fund needs to be able to plan future investments.
- It will enable superannuation funds, and other institutional investors, to build bidding teams. Where projects are sporadic, institutional investors cannot justify keeping bidding teams together. A pipeline of projects therefore results in competitive tension, which would otherwise not necessarily be there.
- A pipeline of projects addresses the tendency for governments to seek infrastructure projects that have short-term political appeal. This may relate to delivering benefits to a segment of the electorate, or may focus on projects that offer short-term economic stimulus.

C.3. Recycling of capital

ASFA supports the 'recycling of capital' model whereby governments use proceeds from asset sales to develop infrastructure assets where infrastructure investors are unwilling to take on patronage risk. There has been much discussion around governments recycling capital. The NSW Ports deal demonstrated that super funds are very interested in stable, mature assets. For sales to be electorally sustainable, there needs to be a demonstration that recycled capital is invested into new projects.

C.4. Greenfield assets

Superannuation funds have varying appetites to invest in greenfield assets. The experience that superannuation funds had investing in toll roads, where traffic forecasts proved to be in excess of actual traffic, resulted in significant losses to funds. One of the results of the failure of these investments was that superannuation funds appreciated that they had different incentives to other bidding partners. Over the last few years, superannuation funds have built internal expertise in-house which is providing funds with enhanced ability to negotiate terms that reflect their interests as a long term holder of capital. Superannuation funds that invest in infrastructure have different appetites for greenfield construction risk, depending on their risk/return profile, the demographics of fund and the risk profile of existing projects. It is important to note that some superannuation funds have an active interest in taking development risk.

C.5. Broadening funding base

There is considerable focus on the funding mechanism for new infrastructure. Further community discussion is needed on spreading user pricing over a wider base. Uplift charges on land that becomes more valuable as a result of the new infrastructure asset are one option that needs further consideration.

C.6. Small-scale infrastructure

Australia has overwhelmingly focused on the development of large-scale infrastructure. Small-scale infrastructure has the capacity to deliver significant economic and social outcomes. A different approach to developing small-scale infrastructure is required that addresses the challenges that investors have conducting due diligence on small projects.

C.7. Infrastructure debt markets

One of the outcomes of the GFC was the collapse of the monoline insurance market. The role of monoline insurers in the infrastructure market was to insure bonds, guaranteeing that, if a bond defaulted, the insurer would cover the principal and interest. The impact of the monoline insurance market was to create AAA debt that was attractive to institutional investors out of project bonds that carried more risk.

Infrastructure Australia examined the impact of the closure of the monolines on infrastructure in an Infrastructure Debt Financing Paper issued in January 2013. According to Infrastructure Australia, "since the closure of the project bond market, Public Private Partnerships [PPPs] have in the main been financed with short term bank loans at significantly higher margins – increasing refinancing risk and potentially reducing public sector value for money."

There is the potential that the non-bank sector, including superannuation, can invest in infrastructure debt. There is evidence in international markets that the 'shadow-banking' sector is emerging as a substitute to the banking sector for funding infrastructure debt. The advantage of the shadow-banking sector is that institutions are able to finance debt with long tenors that match the equity interests. This reduces re-financing risk.

There is already evidence that superannuation funds are investing in infrastructure debt. However superannuation funds will not invest in infrastructure debt where they are already holding equity. The reason for this is that, in the event of a dispute in relation to the asset, superannuation funds would be in a conflicted position, having to represent the interests of both debt and equity.

Federal government support for the development of a project finance market would be a great initiative that would support investment from superannuation funds. While the media has referred to the opportunity to create Australian infrastructure bonds, the reality is that the market will not be structured for 'mum and dad' investors. The nature of infrastructure, with large lumpy investments, means that it is ideally suited to institutional investors. Fund raising for large infrastructure projects is never likely to be achieved by going direct to the SMSF market, although this market may be a source of repackaged loans.

For an infrastructure bond market to function efficiently it is important that Australia is open to global investment. There is a growing appetite among pension funds and insurers to invest in long duration infrastructure debt. The conflict between debt and equity at an asset level means that Australia needs alternatives to a small number of superannuation funds to finance the nation's infrastructure interests.

C.8. Taxation

Superannuation funds are not looking for taxation incentives to invest in infrastructure. The issue for superannuation funds is not just the rate of return on an investment, but whether to invest or not. Infrastructure assets are often subject to regulatory risks. The changing of regulation can have a significant impact on investment returns. A recent example of this was the Spanish Government's decision to unilaterally change renewable energy tariffs, resulting in capital losses to investors. In a world where governments are likely to be fiscally constrained, government support can be used in a variety of way including addressing investor needs for risk guarantees and reform of PPP processes.

C.9. Infrastructure and economic growth

There is no doubt that infrastructure can play an important role in driving long-term economic growth. However there is danger where infrastructure comes to be seen as a tool to stimulate short-term economic growth. SMART Infrastructure Facility at the University of Wollongong have recently released a green paper *Infrastructure Imperatives for Australia* that states, "an institutional mind shift is required where infrastructure should not be just a counter cyclical economic policy past time. The infrastructure industry does not function well as a 'short-order' cook. It would be beneficial to the nation to expand the supply capacity of the infrastructure industry and for governments to engage it in a more consistent manner with a 10 to 15 year project pipeline." The process of selecting projects is critical to long term success of investment. Poor projects will, in the end, lead to poor economic outcomes as well as poor investment returns.

Superannuation funds are long-term holders of infrastructure assets, and will be owners of assets long after short-term economic stimulus has passed through the economy. In order for there to be long-term community support for private investment in infrastructure assets, it is important that the customers that are served by the infrastructure asset are happy. The experience of the superannuation sector is that the terms of the original investment will significantly impact the success of the investment in the long term. Examples of toll roads in Australia, where investors paid upfront fees to governments, have not ended happily for investors. Inefficiency in the bidding process, that has led to a bias for projects that projected traffic that proved to be well in excess of reality, undermined the confidence of superannuation fund investors.

On the other hand the superannuation industry understands that, if assets are sold too cheaply, this can lead to community resentment. This, in turn, creates electorate support for regulatory changes that would have the impact of winding back windfall gains. For superannuation funds, which are long-term investors, it is important that the sale, or development, of infrastructure assets strikes a balance between value for the community and value to investors.

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