asfa the voice of super

Financial System Inquiry

Summary of submission

March 2014
Association of Superannuation Funds of Australia (ASFA)

Financial System Inquiry summary

The Financial System Inquiry has offered the superannuation industry the opportunity to provide input into policy thinking around the financial system in which it operates. In its submission, ASFA has highlighted the quality of the Australian superannuation system, while acknowledging some of its inherent complexities. As a significant participant, the superannuation system will be positively impacted by any improvements in the efficiency and competitiveness of the Australian financial system, which can be developed through this Inquiry process.

Setting the scene

Conversations with David Murray and the Inquiry secretariat suggested that the level of understanding of the superannuation system, and its development since 1997, was not as well understood as we perhaps would imagine. Chapter one of the submission was about setting the scene for the subsequent policy recommendations. In providing this background, ASFA:

- was able to point to the growth in superannuation assets since the previous Financial System Inquiry ('the Wallis Inquiry') in 1997, from around $321 billion, to today's asset pool of more than $1.8 trillion. We noted that the growth in assets will continue for some time
- noted the history of the development of the superannuation system and the influence some of the key policy initiatives have had on the shape of the industry. Here, we were keen to point out the effect of the early adoption of the compulsory Superannuation Guarantee (SG), and also the embedding of consumer choice in the superannuation system process
- highlighted some of the structural changes that have taken place, such as the demise of defined-benefit (DB) schemes, the consolidation of larger players and the growth in self-managed super funds (SMSFs). We also highlighted the impact choice has had on the number of products, options and services that are available to superannuation consumers. While numbers of traditional superannuation 'funds' have declined, there are still many, many products, and a plethora of service providers competing for a share in the superannuation market.
- discussed the performance of the superannuation system, both in terms of the design of the system in meeting retirement needs, and the average performance that members have experienced
- discussed the impact of changes in technology and the legal and governance framework, within which superannuation operates.

With more than $1.8 trillion in assets, the superannuation industry has more, and significant, linkages with the other participants in the financial system: Assets in superannuation represent more than a third of the Australia Securities Exchange (ASX) capitalisation; around half of in-force annual insurance premiums are linked to superannuation; around $400 billion of the funding of banks comes from the superannuation pool; 78 per cent of managed funds assets are within superannuation and, as a system, superannuation is linked to the payments system, to administrators, custodians and other third-party providers.

Overall, a picture was painted of a highly sophisticated, fairly well-designed system, which achieves its main objective: to promote better retirement outcomes for Australians.

> *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.)*

That said, we also highlighted some of the challenges that the system faces. These challenges are the result of change, and particularly of the limitations of our regulatory framework to deal with this change as it has occurred.

Regulatory framework

The submission compares the current regulatory framework for superannuation with what we believe is needed.

The current framework is based on the fact that superannuation is compulsory, that it is taxpayer funded and that it reduces the burden of the Age Pension on current and future governments. The associated philosophy is that firstly, retirement outcomes are maximised to increase the rate of self-funded retirees, and secondly, that taxpayers receive value for money. Put another way, the tax incentives provided within the superannuation pool deliver a better result for the economy than they would applied to other vehicles or consolidated revenue.

While 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.

We argue that this assumption is no longer valid. The changes in the structures, the players in the industry and the way people invest all tell us that this is not the case in 2014.

The submission maintains that the new regulatory philosophy and framework must have the flexibility to respond to the significant changes that have occurred and will continue to occur. The submission contests that the key driver of the changes in the industry we have seen to date is the increase in the availability of choices for individuals in relation to their superannuation, and the continued growth in individual decision making, both pre and post retirement. This trend is seen as continuing, rather than abating, in the years to come.

Tax incentives promote savings in the system. Over the long term, this policy initiative will prevent the problem of liabilities for the government, which would otherwise occur under a universal Age Pension system. We have seen these problems happen 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 that is consistent with supporting their long-term retirement needs for income. This is a form of consumer protection, but it also protects the government investment in the superannuation system through tax incentives.

In order to get the balance between providing choice and managing consumer protection (and the government's investment), the submission suggests 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.

Further, the four main gaps within the current regulatory framework are described as:

- 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.

The submission does not propose the replacement of the current 'twin peaks' model. Rather, it suggests that 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/retirement regulator is appropriate, but we are not yet at that decision point. The growing complexity of retirement income policy may also drive a decision to implement a centralised government policy agency as the connection with other health and aged care public policy areas grows.

Key regulatory recommendations

There are 10 key recommendations relating to the regulatory framework. These are summarised below.

1. The rise in individual decision-making

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: 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 Australians, which can be achieved by 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 a challenge, as the products in which people invest, and the investment risks they take, are very diverse. The challenge is that the system is taxpayer funded and there is a government imperative to reduce the cost of the ageing population on the public purse.

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. Emerging regulatory gaps

The submission suggests that the regulatory approach needs to be adjusted to:

- ensure consumer protection gaps are identified and addressed as appropriate
- create regulatory efficiency of implementation, while ensuring consistency and limited regulatory arbitrage.

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 submission highlights some of the current regulatory differences, and notes that where the member has exercised no choice, the fiduciary oversight is very high. However, 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.

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 be broad.

3. Systemic risk

The submission notes that the current system has no high-level view of superannuation available to a regulator or public policy maker. In particular:

- 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.

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. Going forward, it will be critical to monitor the system more holistically, so as to understand and pre-empt emerging risks in the system.

4. Connectivity to social security and the tax system

The nature of retirement income policy and the system is that there will be increasing interaction 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 of approach, with respect to such matters as the use of terminology, the format of data storage and transmission and security protocols.

5. Post-retirement products

It will be very important that an appropriate legislative and regulatory framework is established before the post-retirement product market is further developed.

Superannuation funds are able to provide allocated pensions and account-based pensions, life offices are able to provide annuities, and DB funds can provide a lifetime pension. However, there is still scope to improve both 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.

6. Globalisation

Increasingly, there are rules and regulations affecting private pensions and superannuation that involve extra-territorial or international application. While a less pressing problem for our financial system, we believe that any changes in current policy should be made with an eye to international developments and the likelihood of the increasing global mobility of retirees.

7. Cost sharing

The submission argues that implementing public policy and providing regulatory oversight requires funding and should be borne equitably by all participants. Any 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.

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 programme of review which would scope the areas to be assessed and considered over a three year period, for example.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.

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.

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.

9. Competition

The submission argues that there is significant competition in the superannuation market as a result of consumer choice. 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.

The submission outlines minimum characteristics that should be applied to these arrangements.

10. Regulatory response to an ageing population

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 identify, and recommend, some 'tweaks' to the system which may marginally improve this. However, we argue that we need to do more if we are to create a pension scheme where individuals retire with an investment which will generate income for their whole retirement and provide some buffer against health care costs.

The submission notes that this may mean an adjustment of the tax arrangement 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
- that product innovation and competition needs to be enabled
- the creation of a post-retirement approved product category that is consistently regulated and taxed across all product manufacturers
- the relative tax treatment of arrangements on investments which are not 'retirement friendly'
- holistically managing all public policy, including tax relating to superannuation and retirement incomes, health, and other aged care costs
- rethinking 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.

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 expansion of the economy through savings growth
- reducing the fiscal burden on the government in terms of providing an Age Pension
- promoting capital formation and funding investments which support economic growth.

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

Our submission is based on the overarching principle 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 to 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 which 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's approach of seeking superannuation funding after the initial development risks have been mitigated.

asfa
the voice of super

The Association of Superannuation Funds of Australia Limited
Level 6, 66 Clarence Street, Sydney NSW 2000
PO Box 1485, Sydney NSW 2001
T +61 2 9264 9300 or 1800 812 798 (outside Sydney)
F 1300 926 484
W www.superannuation.asn.au
ABN 29 002 786 290 ACN 002 786 290