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SUPERANNUATION ALERT
MURRAY INQUIRY: PAVING THE WAY FOR "OLDER SUPER" AND PROVIDING POTENTIAL OPPORTUNITIES FOR PUBLIC OFFER SUPERANNUATION FUNDS

21 JULY 2014

The Financial System Inquiry (Murray Inquiry) Committee handed down its Interim Report on 15 July (**Report**). The Inquiry is the first financial system inquiry since the 1997 Wallis Report, and clearly much has changed in the financial services landscape over that time.

What is abundantly clear is that much of the Report's 460 pages are directly relevant to APRA-regulated superannuation funds (**Funds**). Added to this, we take the view that the Murray Inquiry actually provides the opportunity for Funds to take charge of their destiny, especially in respect of retirement product development and the growth of self-managed superannuation funds (**SMSF**), both of which the Inquiry had a focus on.

OVERVIEW

The Inquiry noted that Australia has the fourth largest pool of superannuation assets in the world with assets forecast to exceed those of the banking sector by the early 2030s, reinforcing the importance and effect of the superannuation sector in funding economic activity. One challenge ahead might be that funds will allocate a higher proportion of their assets to overseas investments because of the reduced capacity for the Australian market to absorb those funds, and therefore impacting on Australia's balance of payments.

Currently, around 30% of assets are held in the retirement phase, but this is expected to increase to more than 40% over the next 30 years having the following effects:

- it is likely that a greater proportion of total assets will be invested defensively, such as in Government and corporate bonds, with older superannuants likely to prefer yield over capital appreciation;
- defensive overlays will increasingly be used to protect members against significant falls in asset values. This will require greater depth in derivative markets and include balance sheet guarantees of banks and insurers, which will require them to expand their capital bases; and
- there will be increasing interest in products that protect against longevity risk increasing the demand for fixed income assets that could also stimulate demand for securitised assets, which is an important funding source for smaller lenders.

Further, Funds could engage in direct lending to households and businesses in direct competition with the banking sector, which has already occurred in other economies, such as the United Kingdom. This would require superannuation funds to develop credit assessment capabilities and would have implications for how funds might be regulated.

Additionally, consolidation in the superannuation market will be accompanied by a shift to more illiquid assets as the cash flows for large funds become larger and more predictable.

From a taxation perspective, the Inquiry noted that:

- the large number of individuals with very large superannuation balances suggests the superannuation system is being increasingly used for tax-benefit purposes; and
- a growing proportion of Fund-held Australian equities (and the effect of refundable imputation credits and tax-free retirement benefits),

may erode the Government's revenue collection abilities at the same time as expenditure pressures are increasing.

FEES AND COSTS

The Inquiry found that the operating costs of Australia's superannuation funds are among the highest in the OECD, with estimates that fees have consumed more than a quarter of returns since 2004. These issues are not unique to Australia, and the Inquiry stipulated that fees should not be considered in isolation and that, ultimately, superannuation funds should be judged on their after-fee return for a given risk profile.

In general, competition has led to feature-rich, but more costly, superannuation products, in part reflecting that many consumers are not fee sensitive.

Further the benefits of increased scale over the past decade have been largely offset by higher fund expenses from:

- a shift towards investing in higher-cost asset classes;
- substantial growth in member engagement services;
- investment in modern administration platforms;
- active investment management (leading to transaction costs and management fees) by funds; and
- high demand for liquidity from superannuation funds, driven by:
  - the mandatory three day inter-fund portability requirement;
  - the need to make benefit payments;
  - the need to maintain target asset allocations within a fund;
  - the need to cover margins on currency hedging positions; and
  - member investment switching.

The Inquiry considered the following issues in respect of Funds' high fees:

- whether Funds are excessively focused on delivering short-term returns, and to what extent more tailoring of asset allocation to members (lifecycle investments) would produce net benefits for members;

- introducing more competition in relation to default employer contributions through changing awards. The Government is currently considering policy options on this issue;
- the Chilean model in which superannuation contributions of ***all new members*** are placed in the same default fund. Default fund management is auctioned on the basis of fees, creating stronger competition between funds for default fund status. However, the Inquiry noted that this model raises a number of other policy issues that would need to be considered before being contemplated for Australia, such as the number of default funds, concentration risk, asset allocation and regulatory requirements;
- whether Funds should have access to a liquidity facility at the Reserve Bank of Australia (**RBA**) that would provide reliable access to liquidity during times of stress and increase Fund's capacities to invest for the long term. The Inquiry noted that to access the RBA liquidity facility, Funds would need to hold repo-eligible assets, which tend to be highly liquid. It is therefore unclear how access to such a facility would reduce Funds' holdings of liquid assets. The Inquiry also noted that Funds can compete indirectly for liquidity at the RBA through an entity that already participates in the open market operations of the RBA, as long as the fund has eligible assets to exchange with the entity. Alternatively, Funds can participate directly in open market operations by becoming a member of the RBA's Information and Transfer System (**RITS**) and holding their liquid assets in Austraclear. The Inquiry was not convinced that access to a liquidity facility at the RBA would overcome the concerns raised; and
- whether a principles-based approach to portability transfers may be more effective than the current prescriptive approach.

The Inquiry is seeking submissions in respect of fees including whether:

- MySuper provides (or is likely to provide) sufficient competitive pressures to ensure lower fees and higher after-fee returns, or whether it should be changed, including whether auctioning default fund status should be considered;
- the three-day portability rule should be amended;
- the recent trend of greater vertical integration in the wealth management and superannuation sectors is reducing competition and contributing to higher fees;
- there are net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements;
- Funds have an undue focus on short-term returns and how might it be addressed;
- there is a trend away from active asset management within asset classes;
- Funds price switching properly; and
- superannuation's trust structure is a cost-effective vehicle.

Thomson Geer comment

It is clear that the high costs of extra regulatory compliance resulting from implementing MySuper and Stronger Super has made it difficult for Trustees to pass on cost savings to members.

ROLE OF BOARDS

The Inquiry noted concerns that APRA's requirements have become too prescriptive and do not delineate appropriately between the role of Boards and management. Many industry participants believe the requirements imply an excessive level of managerial ownership by the Board and, in some cases, overstate the Board's influence. Submissions argued that this diminishes Boards' abilities to focus on governance and strategic direction, hampering their capacity to perform their core functions.

According to APRA, its standards do not require Boards to micro-manage the organisation. Instead, they aim to ensure Boards implement appropriate policies and frameworks, particularly relating to risk, and are satisfied that these policies are effective. Correspondence is often addressed to Boards, but with the intention of ensuring that they are aware of APRA's concerns and ensure that management addresses them.

The Inquiry is seeking submissions in respect of issues including whether:

- there should be a review of prudential requirements on Boards to ensure they do not draw Boards into operational matters; and
- Regulators should continue to clarify their expectations on the role of Boards.

Thomson Geer comment

We are aware of APRA Prudential Reviews and interviews with Boards that appear to expect the Board to be intimately aware of all operational issues affecting their Funds. This appears to contradict APRA's statements, above.

We therefore recommend that further clarity of APRA's expectations of Fund Boards occurs.

RETIREMENT PRODUCTS

The Inquiry clearly focussed on the fact that the retirement phase of superannuation will become a greater issue over time. Of special note was that the superannuation drawdown phase provides limited choice for managing risk in retirement.

The ageing population is expected to contribute to a deterioration of the Government's fiscal position, resulting in a net cost to Government of 3% of GDP by 2050. Additionally, the structure of retirement income products may also affect the allocation of funding in the economy and productivity growth. As the stock of superannuation assets in the retirement phase increases, demand for defensive assets such as fixed income products can be expected to increase.

Lump Sums

The Inquiry noted that Australia may have a "lump sum culture" predominantly for the reason of extinguishing debt, and the Inquiry noted that the number of households entering retirement with debt, particularly a mortgage, is increasing.

Further on average, around one-third of superannuation assets are withdrawn by the time an individual reaches the Age Pension eligibility age. Around one-quarter of people with a superannuation balance at age 55 have depleted their balance by age 70.

Annuities and pensions

The Inquiry noted a range of behavioural biases have been found to discourage people from purchasing products with longevity protection:

- annuities are perceived to be risky gambles rather than insurance;
- individuals underestimate their life expectancy;
- retirees want the flexibility to meet unforeseen cash requirements and leave their residual assets as a bequest;
- individuals undervalue future consumption relative to current consumption;
- annuities are not perceived to deliver value for money; and
- annuities restrict a person's eligibility to receive the Age Pension.

Potential retirement products

The Inquiry noted a range of potential options available to the Government, including:

- requiring that part of an individual's accumulated superannuation benefits be directed into a default non-commutable income stream that provides protection against inflation and longevity risk, unless the individual opts-out; and
- mandating that all or part of superannuation benefits be moved into a non-commutable income stream that provides protection against inflation and longevity risk.

Such options would need to accommodate for members with adverse financial or health-related circumstances. In the UK, for example "enhanced" or "impaired" annuities, which pay higher incomes for the same purchase price, are available to people with certain medical conditions that lower their life expectancies.

Regulatory and other barriers

Products such as Deferred lifetime annuities (**DLA**) (where income payments are delayed for a set amount of time) or group self-annuitisation (participants contribute funds to a pool that is invested in financial assets and regular payments from the pool are made to surviving members) do not meet the standards set out in the SIS Regulations. In practice, if a product cannot qualify for a tax exemption, the market for that product is unlikely to develop.

The Age Pension assets test and income test (through deeming an income on assets) apply to DLAs, even during the deferral period, and therefore an exemption during the deferral period would be required.

Providers of new retirement income products must deal with multiple Government bodies for approvals, including the ATO, APRA, ASIC and the Department of Social Services.

Providers of guaranteed retirement income products, especially long-dated or whole-of-life products, are exposed to interest rate, investment and longevity risk. Mitigating these risks requires using more capital, obtaining reinsurance, or managing them in financial markets, for example, by taking offsetting positions in bond or derivative markets.

The Inquiry is seeking submission in respect of policy options or other alternatives including:

- improving the provision of financial advice and removing impediments to product development;
- providing policy incentives to encourage retirees to purchase retirement income products;
- introducing a default option for how individuals take their retirement benefits or mandating the use of particular retirement income products;
- reconsider the Age Pension means-tests in respect of certain retirement products; and
- issuing longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.

The Inquiry is seeking submissions in respect of issues including whether:

- products including deferred lifetime annuities, group self-annuitisation are relevant for Australian retirees;
- the private sector would be able to manage longevity risk if there is a large increase in the use of longevity-protected products;
- Government should increase its provision of longevity insurance and how would institutional arrangements be established to ensure they were stable and not subject to political interference; and
- regulations impede the development of products to help retirees reverse mortgage their homes.

Thomson Geer comment

We have had "Simpler Super" and "Stronger Super". It will only be a matter of time before we have "Older Super". Retirement product development is the next looming challenge for Funds, and some may argue that SMSFs are perceived as providing retirees with better retirement options. Funds should consider the issues raised by the Inquiry and make relevant submissions because retirement is likely to expose superannuation funds to (growing) member leakage for two reasons:

- *retirees taking out lump sums; and/or*
- *retirees seeking independent financial advice (triggered by their impending retirement) and moving their superannuation into an alternative superannuation fund (most likely a SMSF) that offers more flexibility.*

SELF-MANAGED SUPERANNUATION FUNDS

Size

The Inquiry noted that the number of APRA-regulated funds (excluding small APRA funds) fell from more than 4,700 to 299 since 1997, and the number of SMSFs has grown rapidly to the point where SMSFs currently account for around one-third of total superannuation assets, or $559 billion. SMSFs now make up the largest segment of the superannuation system in terms of the number of entities and the size of funds under management.

Reasons for establishing an SMSF

The majority of SMSF establishments derive from accounting and financial advice, in circumstances where the quality of that advice varies., to the extent the SMSF Professionals' Association of Australia (SPAA) noted improvements to the current financial advice environment is warranted.

One major reason for SMSF establishment has been to establish tax effective vehicles, though the Inquiry appeared to take the view that tax treatment of all superannuation funds is the same, although in practice SMSFs may achieve better tax outcomes (during retirement phase).

The Inquiry noted that the Tax White Paper could examine the tax outcomes of SMSFs and other Funds and measures to ensure that SMSF establishment is not motivated purely by tax outcomes.

Borrowings

The estimated number of SMSFs using geared products grew by more than 11% to 38,000 over the year to April 2014. Total borrowings in 2012 were over $6.2 billion.

The Inquiry noted that the general lack of leverage in the superannuation system is a major protection for the financial system and the ability to borrow directly may, over time, erode this strength and create new risks and vulnerabilities for the superannuation and financial systems.

The Inquiry also took the view that some evidence suggested that borrowing is often associated with poor financial advice and often poor advice resulted in members establishing SMSFs as a specific part of a geared investment strategy. This Inquiry shares the Super System Review Panel's view that leverage should not be a core focus of any superannuation fund (including SMSFs) and is inconsistent with Australia's retirement income policy.

The Inquiry is seeking submissions in respect of .

- restoring the general prohibition on direct leverage of superannuation funds on a prospective basis;
- whether the Inquiry be concerned about the high operating expenses of many SMSFs; and
- whether there should be any limitations on the establishment of SMSFs.

Thomson Geer comment

*The Report failed to mention or identify that many SMSF members receive an **immediate** tax benefit if they hold business real property that they operate a business out of. In these circumstances, the immediate tax-benefit to the member is that the rent paid to the SMSF is deducted from the business' assessable income, resulting in a lower taxation liability to the business.*

*In our experience, the ability of SMSFs to hold a member's business real property so the member's business can obtain an immediate tax-benefit, is often a **very powerful reason** for members to establish SMSFs.*

Members of Funds cannot access this benefit, because Funds do not hold their members' business real properties.

From a commercial perspective, if SMSF leverage encourages members to establish SMSFs, Funds should consider leverage as an exposure to member leakage.

We recommend that Funds consider these issues and make submission to the Inquiry, noting that even though ASFA may make submissions, it represents both Funds and SMSFs.

INVESTMENTS

The Inquiry noted (briefly) that Investments in infrastructure are viewed by some as being illiquid and that infrastructure investment could be facilitated by developing liquid, tradeable claims on infrastructure projects which could provide greater scope for investors, including superannuation funds, to invest in infrastructure.

The Inquiry seeks further information on what are the impediments to the development of liquid, tradeable claims on infrastructure projects.

ADVISERS

The Inquiry noted that the competence of advisers varies widely in an environment in which consumers find it difficult to gauge the differences.

Stakeholders raised concerns about the adequacy of SMSF advice, in particular that some consumers are advised to establish SMSFs where it is not cost-effective or appropriate for their needs.

Some submissions argued that some of the conduct currently regulated as general advice could more accurately be described as "sales information", "advertising" or "guidance". The aim of this relabelling would be to give consumers a clearer indication of what is involved.

The Inquiry is seeking submissions in respect of the policy options or other alternatives including:

- improving the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators;
- removing disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery;
- subjecting product issuers to a range of product design requirements to promote provision of suitable products to consumers;
- providing ASIC with additional powers such as:
    - product intervention powers to prescribe marketing terminology for complex or more risky products; and
    - powers to temporarily ban products where there is significant likelihood of detriment to consumers;
- raising minimum education and competency standards for personal (including SMSF) advice and introduce a national examination for financial advisers;
- introducing an enhanced public register of financial advisers (and their employees) which includes a record of each adviser's credentials and current status in the industry;
- enhancing ASIC's power to include banning individuals from managing a financial services business (as distinct from providing a financial service); and

- renaming general advice as "sales" or "product information" and mandate that the term 'advice' can only be used in relation to personal advice.

PRIVACY

The Inquiry briefly touched upon Privacy Law and is seeking submissions in respect of the following policy options or other alternatives:

- reviewing and assessing the new privacy requirements two years after implementation to consider whether their impacts appropriately balance financial system efficiency and privacy protections; and
- reviewing record-keeping and privacy requirements that impact on cross-border information flows and explore options for improving cross-border mutual regulatory recognition in these areas.

PENALTIES AND FURTHER REGULATION

Penalties

The Inquiry noted that on a comparison, Australia's penalty regime enforceable by ASIC under the Corporations Act provided for considerably lower civil penalties (including in respect of disclosure and inappropriate advice) than Canada, Hong Kong and the United Kingdom (which included uncapped civil penalties).

Accordingly, the Inquiry is seeking submissions as to whether it should review the Corporations Act's penalty regime.

Thomson Geer comment

Funds may wish to consider this issue.

Providers of scale

Additionally, the Inquiry considered whether certain service providers outside the regulatory perimeter are of such scale and potential influence that service disruption or failure would affect regulated institutions such that there may be a case for considering direct regulation. Two potential direct regulation cases include administrators and technology service providers of scale, that the Inquiry considered extending AFSL requirements to (in our view administrators usually are licenced, or at least authorised under an AFSL).

Prudential regulation of Funds

The Inquiry noted the differences between the regulation of APRA-regulated superannuation funds and ASIC-regulated managed investment schemes (**MIS**) with differences lying predominantly in the intensity of the requirements applying to governance and risk management and the intensity of supervision applied in respect of these standards. Differences also exist in the requirements for financial resources, reserving and liquidity.

The Report states that Funds are subject to heavier prudential regulation than MIS, and states that applying prudential regulation to Funds is likely to impose additional costs, whilst acknowledging the benefits of this regulation especially when superannuation is integral to retirement income policy.

The Inquiry is seeking submissions on whether there is a strong case for change including whether to align regulation of APRA-regulated superannuation trustees and funds with responsible entities and registered management investment schemes.

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The Inquiry is inviting submissions, which are due on Tuesday 26 August 2014.

We highly recommend that Fund trustees, and their service providers, carefully consider the Report's contents and whether submissions should be made. Submissions made will aid Funds in:

- *seeking to clarity or improvements to the current regulatory environment;*
- *seeking to enhance the retirement product offerings that will help to retain retired members; and*
- *seeking a more level-playing field when competing with SMSF advisers.*

If you would like us to assist, please do not hesitate to contact us.

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