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The Review so far...

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Introduction

1. There is only a little over three weeks to go before the final report of the Super System Review must be handed to the Government.
2. Given the audience, I won't tell any lame jokes about how many stockbrokers it takes to change a light bulb; it would be just too tempting to play around with the concept of 'shorting' and we wouldn't want that.
3. Instead, I thought I would walk you through aspects of the Review that would be of interest to the stockbroking community. There are quite a few areas of super where stockbrokers play a very important role. The interaction between Australian equities and superannuation is still very significant and has every sign that it will remain that way for some time.
4. There is no doubt that the ASX would not look anything like it does now were it not for the superannuation system. It is now a matter of public record that super recapitalised the banks and then the major corporates as the dramas of the GFC unfolded. It was the super funds that had the liquidity and the appetite for equities.

A bit about the mechanics of the Review

5. The Panel has received around 450 formal submissions, and many more informal submissions, amounting to over 7,200 pages of opinions, ideas and data. Importantly, 225 of those submissions were made by individual super fund members.
6. We have released a total of nine of our own documents: issues papers, preliminary reports and the like; ten including the Deloitte report on what MySuper would be likely to cost.

Title	Date of release	Content
<i>Scope of the Review: A Three-Phased Consultation</i>	25 August 2009	Sets out the Panel's approach to the Review
<i>Phase One Issues Paper – Governance</i>	25 August 2009	Raises issues relevant to this phase to guide interested parties in making submissions
<i>Phase Two Issues Paper – Operation & Efficiency</i>	16 October 2009	Raises issues relevant to this phase to guide interested parties in making submissions
<i>A Statistical Summary of Self-Managed Super Funds</i>	10 December 2009	A broad factual overview of the SMSF sector

Title	Date of release	Content
<i>Phase Three Issues Paper – Structure</i>	14 December 2009	Raises issues relevant to this phase to guide interested parties in making submissions
<i>Clearer Super Choices: Matching Governance Solutions</i>	14 December 2009	The phase one preliminary report that outlines a 'choice architecture' for the industry
<i>SuperStream</i>	22 March 2010	A phase two preliminary report addressing 'back office' issues with the superannuation industry
<i>MySuper</i>	19 April 2010	Further detail on an aspect of the choice architecture outlined in the phase one preliminary report
<i>Self-Managed Super Solutions</i>	29 April 2010	A phase three preliminary report discussing SMSFs

2035 projection

7. Set out below is a table showing Treasury's projection of where the super system might be in 25 years' time in 2035 in nominal dollars and then in today's dollars.

	1996	June 2009	2035 (nominal \$)	2035 (current \$)
Overall industry scale	\$245B	\$1.1 trillion	\$6.1 trillion	\$3.2 trillion
Ratio of accumulation to post-retirement assets	-	4 : 1	3 : 1	3 : 1
Biggest fund	-	\$41.5B	\$350B	\$187B
Number of funds (excluding ERFs)	4734	447	74	74
Average fund size	\$40M	\$1.5B	\$53B	\$28B
Average accumulation member account balance	\$15,000	\$70,000	\$335,000	\$180,000
Total super assets - proportion of GDP	47%	90%	130%	130%

8. A couple of key take-outs are the number of funds: 74 and the biggest fund approaching \$200bn in today's dollars. This is based on historical trend data and does not assume any consolidation or impact of MySuper. Also interesting is super at 130 per cent of GDP.

Themes

9. What are we seeing as we approach the finish line?
 - (a) Scale, MySuper, the back office
 - (b) Transparency and outcomes
 - (c) Governance

10 Principles

10. The Panel recognises the wider government policy concerns that affect the superannuation system; overall fiscal sustainability, broader retirement policy and taxation policy among them. However, it has been guided by the following principles, relating purely to superannuation itself, in making its recommendations:
 - (a) Superannuation must always be for the benefit of members. The superannuation system does not exist to support intermediaries. Trustees must be relentless in seeking returns for members at the expense of other participants.
 - (b) The superannuation system needs to be well-regulated to address prudential and other risks so that members can have the confidence to invest their retirement savings for their long-term financial benefit.
 - (c) Transparency and disclosure are essential for the effective operation of the system, but are not substitutes for well-designed products that work in members' interests. Disclosure is a necessary, but not a sufficient, condition for ensuring that member interests prevail.
 - (d) Individual choices for members should be available and respected, but members must recognise and accept the increased responsibility that comes with making those choices.
 - (e) The superannuation system must be supported by high quality research and data and intermediaries with professional standards.
 - (f) Financial literacy is an important long term goal, but a compulsory superannuation system cannot depend on all its participants having the skills necessary to comprehend complex financial information.
 - (g) Fees and costs matter; they detract from members' retirement savings and need to be managed at least as diligently as the generation of investment returns.

Technological improvements and innovation generally should be encouraged when they benefit members.

- (h) Superannuation is a large and complex system with an increasingly important social and macroeconomic dimension. It must be regulated and administered coherently and rule changes, including to taxation rules, should be made sparingly and in a way that engenders member confidence.
- (i) The system must have sufficient flexibility to accommodate its inherent growth path and should strive for continual improvement, rather than abrupt changes. Where possible, government and trustee decisions about superannuation should be taken with a long-term perspective. Stability and a longer-term horizon should predominate over short-term opportunism.
- (j) Governments should not seek to direct super funds to invest in particular assets or asset classes, regardless of how much it might seem in the national interest to do so.

SMSFs

- 11. I though this audience would be particularly interested in our work in the SMSF area.
- 12. One of our reports was a statistical summary of SMSFs issued on 10 December 2009.
- 13. This was a fairly detailed piece of work that looked at what is a very substantial customer base for this industry.
- 14. Overall, we found the SMSF sector to be in fairly good health. In this sector, members are older, wealthier and more likely to be in pension phase than average members in other sectors. They are people who are generally fairly comfortable making decisions about capital and seem to be doing a sound job.
- 15. Our main messages have been that SMSFs need to stay focused on investing for retirement savings, rather than related party transactions, collectables and leverage. Do that, and self-managed super funds start to look much more like the legitimate vehicles for retirement savings that they actually are.
- 16. If there is one area of interest for stockbrokers it is in the asset allocation of SMSFs:
 - (a) 59 per cent of SMSF assets comprise listed Australian shares and cash/term deposits; and

- (b) Over 63 per cent of SMSFs hold Australian shares, with a median value of \$200,000 (and an average of \$436,000) in that population.
- 17. One of the key distinguishing features of SMSFs is their preference for 'direct' investing, rather than through managed fund products. Given the preference that SMSFs have for direct investing, it seems likely that traditional broking and advice services, even if some of it is delivered online, will be with us for some time to come.
- 18. There are a number of competing products here, namely the super wrap and the separately-managed account (SMA) to name two. However, according to our statistical summary, SMSFs like getting advice with about one-third getting advice on investment strategy or regarding fund investments. In fact, only about 11 per cent of the SMSF population say that they administer everything themselves. So, the image of the sector as being totally 'DIY' is inaccurate and it is fair to say that there is a lot of interest in what products and services this market needs and is going to need in the future.

Advising SMSFs

- 19. One such service is clearly advice. The competency and knowledge levels of licensed advisers are particularly important given their role as one of the 'gatekeepers' in a substantially 'DIY' sector. It is widely thought that adviser competency standards and qualifications are too low and that all advisers to SMSFs require specialist knowledge, in particular knowledge of the SIS Act, SIS Regulations and the Tax Act, and their application to SMSFs.
- 20. The ASIC Regulatory Guide 146 expresses ASIC's policy about the level of training necessary for advisers. This imposes minimum requirements, requiring advisers to demonstrate that they have met both generic and specialist knowledge requirements relevant to their activities.¹ Among the 'specialist' knowledge requirements is 'superannuation'. Any person advising on SMSFs must complete, as a minimum, the training requirements for superannuation. Regulatory Guide 146 also recommends that advisers should undertake additional specific product training in relation to SMSFs before advising on these products; this, however, is not mandatory.
- 21. There is a proposal in the Future of Financial Advice reform package announced by The Hon Chris Bowen MP, the Minister for Financial Services, Superannuation and Corporate Law, on 26 April 2010² to establish an expert advisory panel, which will review professional standards in the financial advice industry, including conduct and competency standards.

22. The Panel considers that competency standards for SMSF advisers need to be raised. The Panel believes ASIC should amend RG 146 to include a specialist 'SMSF' knowledge requirement that must be obtained before advisers can provide advice in relation to SMSFs. This could be developed by ASIC, in consultation with industry and the 'expert advisory panel' announced as part of the *Future of Financial Advice* reform package.

Importance of investing in retirement

23. Investment returns continue to matter in the post-retirement phase. According to Treasury, around 40 per cent of total benefit (in nominal terms) can be expected to be derived from post-retirement earnings. In contrast, Russell³ and Mercer⁴ found that between 60 and 66 per cent of total benefits (in nominal terms) can be expected to be derived from post-retirement earnings. Treasury estimates that for a person who retires aged 65, their total superannuation benefit will be around 8 per cent higher if they can achieve a 1 per cent per annum higher net return post-retirement.
24. What this challenges is the view that retirees need, universally, to move substantially out of growth or market-linked assets in retirement. The interaction between exposure to growth assets and longevity risk is something that the Panel will deal with in its final report.
25. Member needs in retirement vary greatly so there is no 'one size fits all' retirement product solution. The Panel's current thinking is that Government should not mandate what retirement income products are available in the market. Trustees should, however, be required to consider longevity issues more explicitly. It is also important the regulatory system supports product innovation.

Financial literacy

26. Many submissions advocated that the Government sponsor a program of financial literacy. This is already Government policy and this function is performed by the Financial Literacy Board, supported by ASIC.⁵ A key focus of current financial literacy policy is to embed financial literacy in the secondary school curriculum.⁶ To augment financial literacy efforts that are already under way, the Panel favours well-designed default options that work well for people who are not, and never will be, investment experts. In this way, the Panel proposes that the same outcome as intended by those advocating financial literacy can be achieved by improving the design of superannuation so that it does not call for so many complex decisions to be made by ordinary people.⁷

27. The Panel's proposal for the MySuper product is largely founded on this philosophy and the Panel rejects the notion that all that needs to be done is for information and training to be given to members by the Government.

Past investment performance

28. United States research house DALBAR has conducted a number of studies showing how individual investors in mutual funds earn much lower net investment returns than the headline returns of the funds they invest in. This is because investors often chase past performance by switching funds or investment options irrationally, while overlooking tax and transaction costs.
29. DALBAR's most recent annual 'Quantitative Analysis of Investor Behavior' (QAIB) survey released on 31 March 2010 looked at 20-year returns for investors in shares and mutual funds to the end of 2009. The survey found that for the 20-year period, equity fund investors averaged 3.17 per cent per annum compared to 8.20 per cent for buy-and-hold stock investors (S&P 500).⁸
30. *"While investors seem to be learning hard lessons from the past 15 years, the original QAIB findings still hold true: Mutual fund investors do not achieve the returns cited by fund firms due to their irrational behavior,"* said Lou Harvey, president of DALBAR.⁹
31. The Panel is considering whether super fund members should be made aware of the likelihood of variance from those past returns in the future. In other words, should it be mandatory for trustees to disclose a standardised measure of the uncertainty or volatility associated with the return when quoting past performance? This would enable members to examine the theoretical likelihood of achieving a similar level of performance in subsequent periods.

MySuper

32. Our biggest aim with MySuper is lowering overall costs while maintaining a competitive market based, private sector infrastructure for super. We want to make super better value for money and we have designed the MySuper concept with this in mind.

What would MySuper mean to the way super funds invested?

33. It has been said that MySuper seeks to 'dumb down' superannuation and that it will drive trustees to the lowest cost investment strategies, thereby harming long term investor returns. For that very reason, the Panel does not seek to intervene in how funds invest or to set a maximum

price on what they spend on investment managers. The Panel is acutely aware of the dangers of the Government picking winners or dictating how investments are to be made.

34. In particular, the Panel does not seek to buy into, for example, the 'active' versus 'passive' debate other than to say, as with any investment strategy, the trustees need to be very clear about the objective of the strategy.
35. The trustee would have to formulate an investment strategy at an overall cost aimed at optimising fund members' financial best interests, as reflected in the net investment return over the longer term. This does not mean that a trustee would have to provide the lowest possible cost investment strategy. While there is an emphasis on low costs, this would not be at the expense of investment returns. The Panel recognises the importance of asset allocation and that some investment strategies would be more costly to provide than others.
36. Although there would not be an overall fee cap or other regulation of the cost of a MySuper product, a MySuper trustee would be required to operate with a clear and transparent justification for the investment strategy it formulates and the overall cost and net return to members.
37. The Panel also envisages a mandatory system for explaining investment aims, volatility and costs.

Scale of assets and members

38. One of the key concepts in MySuper is scale. There has already been significant industry consolidation. There were almost 5,000 super funds regulated by the Insurance and Superannuation Commission in June 1996. We are now down to less than 500; 463 in June 2009, to be precise. However, the Review Panel believes this is still not enough consolidation.
39. Realising that we would need empirical data to back up our proposition that scale really matters in super, we commissioned Deloitte to do a report on the cost savings that could be achieved were our MySuper recommendation to be implemented.¹⁰
40. Specifically, the Deloitte report showed that a member with an account balance of only \$25,000 in super would be paying around \$200 a year,¹¹ and in some cases less than half that, in total costs under the MySuper proposals.

Table 1: Potential total costs per MySuper member

MySuper fund size/investment strategy	\$2bn	\$5bn	\$10bn	\$20bn
Passive balanced	0.60%	0.46%	0.38%	0.32%
Passive conservative	0.58%	0.45%	0.37%	0.32%
Active balanced	0.94%	0.83%	0.70%	0.60%
Active conservative	0.80%	0.70%	0.59%	0.49%
Active balanced (with alternatives)	1.04%	0.89%	0.77%	0.66%
Active conservative (with alternatives)	0.89%	0.76%	0.64%	0.54%

41. The Deloitte Report shows once again the power of economies of scale in reducing per member investment and operating costs. But, there are impediments to achieving that scale. For example, it has been suggested that some mergers have not occurred because the board cannot agree on the name of the fund or the number of trustee directors. More seriously though, there are systems issues, taxation issues and legal technicalities that can hinder efficient mergers and the Review is looking at solutions to some of these.
42. I should also stress that these numbers do not take account of any savings from our SuperStream proposal to modernise the 'back office' of the super industry. We also asked Deloitte to keep the account balance used in the examples low (reflecting the arithmetic average account balance in a system distorted by multiple accounts). An account balance of \$250,000 would see operating costs, including for intra-fund advice, of between 0.05% for a \$2bn fund and 0.03% for a \$20bn fund, to which percentage-based investment management fees would have to be added.

Governance is generally the solution

43. Most of the solutions that the Review will recommend are governance-oriented. In other words, nearly every problem we have encountered is a governance problem one way or another. What do I mean? What are some examples of this? Ones that come to mind are things like:
 - (a) Not managing for after-tax returns.
 - (b) Reporting fees and costs only at the top level of a layered fund-of-funds structure.
 - (c) Poor disclosure of insurance offerings.

- (d) Poorly designed performance fees.
- (e) Products that are not true to label.
- (f) Unsatisfactory valuation practices, particularly of unlisted assets.
- (g) A general lack of transparency, comparability and accountability.

Dollar values on major recommendations

44. As part of concluding its work, the Panel is very focused on what it all means for members. After all, we were specifically tasked with carrying out the Review with interests of members front and centre. When we present our final report, we will be including an estimate of what we think our two major recommendations: MySuper and SuperStream (the clean up of the back office) will actually save members. I can't tell you the numbers yet, but they are significant.

Endnotes

¹ ASIC, Regulatory Guide 146, Licensing: Training of financial product advisers, December 2009.

² http://ministers.treasury.gov.au/Ministers/ceba/Content/pressreleases/2010/attachments/036/Future_of_Financial_Advice_Information_Pack.pdf

³ Russell Investments, 'The Russell 10/30/60 Retirement Rule', http://www.russell.com/CA_FP/PDF/Invest4Retir_Investr_Final.pdf.

⁴ Mercer, 'Securing Retirement Incomes', http://www.mercer.com.au/attachment.dyn?idContent=1357160&filePath=/attachments/English/mercer_SRI_full_report.pdf.

⁵ <http://www.flb.gov.au/default.asp>.

⁶ ASIC advisory AD08-54: New financial literacy resource for secondary schools; <http://www.fido.gov.au/yourmoneystarter>.

⁷ Thaler et al, *Nudge: Improving Decisions about Health, Wealth and Happiness*.

⁸ <http://www.dalbar.com/>

⁹ <http://www.dalbar.com/Portals/dalbar/cache/News/PressReleases/pressrelease20100331.pdf>.

¹⁰ http://www.supersystemreview.gov.au/content/downloads/mysuper_paper/Deloitte_report.pdf.

¹¹ 80 basis points.