FINSIA
FINANCIAL SERVICES INSTITUTE of Australasia

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Head of Secretariat
Financial System Inquiry
GPO Box 89
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To whom it may concern:

RE: Financial System Inquiry – submission

The Financial Services Institute of Australasia (Finsia) appreciates the opportunity to provide comments to the Financial System Inquiry on two important aspects of the terms of reference.

Finsia has undertaken consultation and research in the areas of international integration of Australia's financial system, particularly our place in the Asia-Pacific region, and the retirement risk zone, the challenges that arise during the critical phase between saving for retirement and realising retirement income.

Finsia's approach to the Financial System Inquiry has been one of individual member engagement and consultation, supported by a strong research focus on important areas for the industry. As a professional association that represents the individual voice from across the spectrum of financial services, Finsia is well placed to provide the Inquiry with an independent, industry practitioner reflection about these important issues.

Finsia's research and policy activities consist of two streams - practitioner and academic led research, and senior member roundtables. The consultation with practitioners during the Financial System Inquiry will be conducted through a series of eight roundtables, involving industry leaders discussing opportunities and challenges directly related to the Inquiry's terms of reference. These roundtables have been influenced by recently released Finsia research including:

- Regulating foreign direct investment in Australia (Appendix 1)
- Sequencing Risk: a key challenge for creating sustainable retirement income (Appendix 2)
- How safe are safe withdrawal rates: An Australian perspective (Appendix 3)

The roundtable forums have allowed senior members from across the industry to examine particular issues in relation to the Inquiry and identify policy responses to shape the future direction of the industry. This submission details many of the discussion points from the first two roundtables:

- Roundtable 1: Integrating Australian financial services in the international marketplace
- Roundtable 2: Australia's superannuation system

The remaining six roundtables and a greater emphasis on professional skills will be a focus for Finsia's next submission to the Inquiry later in the year.

Roundtable 1: Integrating Australian financial services in the international marketplace

Finsia believes that Australia must align itself globally with economies demonstrating long term high growth rates rather than many of its traditional trading partners whose indebted economies mean they will struggle to grow at trend pace. This means that Australia must align its people, products and services to the faster-growing economies of the Asian continent. The flow of capital in and out of Australia has been part of Finsia's research and policy agenda over the last 12 months. Recently launching a discussion paper titled *Regulating Foreign Direct Investment in Australia* (Appendix 1), initiated by Finsia's Corporate Finance Advisory Group, the paper examined the regulatory environment for capital inflows, stakeholder influences and the role of the foreign investment review board in handling cross-border transactions in Australia. The paper identified that both investors and vendors of assets are best supported by a regulatory process that is transparent, consistent and predictable.

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Foreign direct investment is vital to the Australian economy and accounts for over half the domestic capital stock. It commonly involves widespread economic investment in employment and infrastructure whilst also providing knowledge transfers and productivity spillovers that enhance the productive potential of the Australian economy over and above the direct contribution made by capital accumulation. It further enhances competitiveness of the market for ownership and control of equity capital, inevitably leading to a more efficient allocation of capital across the Australian economy. Drawing on OECD and ABS data, the paper finds that Australia underperforms its potential in attracting foreign direct investment and makes a number of recommendations to attract greater foreign capital. By value and by number, more cross-border mergers and acquisitions were withdrawn for regulatory reasons or political opposition in Australia than any other country between 2008 and 2012. The value of these deals was worth $87.8 billion.

The publishing of this discussion paper was the catalyst for the first of this year's Financial System Inquiry roundtables, which covered both the technical and professional skills topics that will need to be addressed to ensure Australia's financial services and funds management sector is "Asia ready".

A panel of experts from major employer groups with diverse and wide-ranging industry experience outlined the roles they saw for business and government in managing Australia's integration into international financial markets.

The discussion threw into sharp contrast a strongly diverging opinion among industry players as to how to best achieve regional integration in a one to two decade time span.

In simple terms, the areas to be addressed by the forthcoming inquiry in financial services can be split into two distinct arms:

- Harmonisation of bank regulations, investment and financial products, and services - technical, legal and distribution networks;
- Professional skills such as leadership, increased cultural awareness and deeper promotion and development of relevant language skills.

Given the recent and potential development in the integration of foreign capital markets, including the rise of the RMB towards a global currency, Australia needs to respond in a more assertive manner to the internationalisation of finance. Specifically, rapidly-growing Asian markets for financial services represent one of the best opportunities for Australian expertise to be deployed, but the industry is at a crossroads when it comes to:

- achieving greater recognition as a destination for investment among Asian investors and global money looking for access to regional opportunities;
- removing legal and regulatory impediments to free flow of funds and trade between jurisdictions.

The Financial System Inquiry represents the best chance to set out how to make best use of the natural advantages Australia enjoys, while considering what needs to be done to boost local capability in areas of competitive disadvantage. The floating of the Australian dollar just over 30 years ago and the subsequent freeing up of the economy has shown how important it is to defend the proposition of free flows of investments into and out of Australia. The view of roundtable participants is that anything which will slow the free flow of capital should be seen as a negative step. A more efficient economy is a mobile economy and attracting investment flows is critical.

Freedom of investment across borders is fundamental to the finance sector, and the health of the economy generally. This has become all the more urgent, given recent research showing that the Asian financial system is on track to be bigger than the US and Europe combined by 2030. This includes a growing Chinese equity market, bond market and ever-increasing capital outflows as China's domestic portfolios become more diversified.

The counter-arguments often run in this context are that:

- our superannuation funds should be directing more money into Australian infrastructure, taking financing pressure off the banks and governments, and creating attractive investment opportunities
- our banks are made more susceptible because they need to raise so much of their funding offshore
- our financial regulators have, from time to time, indicated that they would prefer to manage a more domestically focused system, where our banks are less exposed to offshore markets.

It is the view of roundtable participants that these types of arguments will begin to fade, as the internationalisation of the RMB continues apace, and rival financial centres – notably Singapore and Hong Kong, line up for a share of the inevitable trade opportunities that will flow.

The interaction of Asian capital with the rest of the global financial system will result in Asia's private sector playing a far greater role in allocating Asian savings and large increases in investment flows within Asia.

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The consensus view of participants was that most of the free-market factors that boost investment across borders are good for business. In this regard, the role of regulation should not be overlooked. Australia is becoming more of a services-based economy and it's vitally important that we play a role to influence the harmonisation of regulations in the financial sector. The Asian Region Funds Passport agreement is viewed as a "path breaker" and will create significant investment opportunities for Australian institutions to invest further in Asia. The exploration of these types of agreements and bilateral trade agreements should be actively sought by the Australian Government.

Finsia is also aware that there remains considerable market uncertainty regarding the tax treatment in Australia of offshore investors investing through Australian domiciled investment vehicles. Although we believe this will be addressed by other professional bodies and financial institutions as part of the submission process, the consensus view of roundtable participants was that an effective Investment Manager Regime and the implementation of the Johnson Review recommendations should be a top priority.

Another vital move to improve Australia's competitiveness as a regional financial hub and exporter of financial services is to have an Asia ready workforce. An important step towards achieving this is to ensure there is wider, first-hand recognition among industry leaders that each country in the region has its own particular way of doing business. Anecdotal commentary was provided to support a view that first-hand workplace experience in all Asian jurisdictions is generally lacking across Australian business, and financial services is no exception. Likewise, boosting the flow of talent in both directions - into and out of Australia – needs to be encouraged just as positively as the flow of investment funds. Pivotal to our financial sector leadership is for our people to travel and work in the region, and therefore gain direct experience of the similarities and differences which need to be factored into any strategy. Building cross-cultural capability and developing relationships with high-achieving students from China and elsewhere in the region is an important factor as they are going to be the wealth creators of the future. For many roundtable participants, there was no question that Australia has a skills gap when it comes to professional skills needed to develop an Asia ready workforce. The English language, which was our natural advantage for 100 years, is being diminished, as all over the world people are becoming proficient – and it's a second or third language for other nations. Asian companies can access low-level technical skills anywhere, but they need the professional skills - leadership, management and cultural understanding – that is still an advantage in developed economies.

For this, Australian business leaders and the financial services institutions need to have a clear understanding of their own products and a sound cultural knowledge if they are to withstand the challenge on a cross-cultural basis from US and European competitors. Finsia believes Australia's proximity to Asia and favorable time-zone ensures we should be encouraging a flow of professionals working throughout the region and it's vital that we are willing to understand Chinese culture and the different nuances in the region. A recommendation to enhance this is the removal of tax barriers that are standing in the way of building management experience and technical competency among local staff that already have Asian language skills and cultural knowledge.

Roundtable 2: Australia's Superannuation System

Finsia hosted the second of its roundtable series focused on Australia's superannuation system with 20 industry leaders from across the major employer groups. Since the Wallis review was handed down in 1997, the growth of the superannuation industry has been remarkable. The underlying demographics that affect superannuation policy have also significantly changed since it was instituted. This includes increasing life expectancy and the aging of the population which creates challenges to balancing longevity risk and sequencing risk.

Roundtable participants struggled to answer the opening question: Is Australia's superannuation system achieving its mandate? The sentiments expressed by attendees was one of questioning, "what is the superannuation industry's mandate?" If the retirement system is working well, then what benchmark should it be measured against? It became evident throughout the discussion that the Financial System Inquiry needs to provide guidance about the overall aims and objectives for the superannuation system. This can then inform the financial services industry to accurately benchmark its overall performance.

Currently, it is apparent that Australian superannuation funds typically benchmark on two grounds: mean time-weighted returns over some horizon (say 10 years); and, peer-relative terms. According to the first issue, a minus 25 per cent return is equivalent no matter whether it occurs at aged 30 or age 60. When considering performance on the latter, a minus 25 per cent return is a 'good' outcome if the performance of one's peers is worse over the same timeframe. When considered from the perspective of the end investor however, neither of these approaches can be considered satisfactory. A minus 25 per cent return is vastly worse in wealth terms if it occurs at age 60 because it impacts a lifetime of returns, but also contributions and compounding. This is an example of what is now widely known as sequencing risk and was extensively modeled in Finsia's 2012 research, *Sequencing Risk: a key challenge for creating sustainable retirement income* (Appendix 2). Similarly, a minus 25 per cent return is a very poor outcome even if 'peers' achieve minus 30 per cent.

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Ultimately the fund member cares more about their individual wealth outcome, than any other conception of performance. The superannuation industry's performance measures should be aimed directly at the retirement adequacy of its members.

Finsia began a research program into the Retirement Risk Zone in 2012 to identify the scope of the retirement adequacy challenge facing Australia and investigate policy responses to improve the sustainability of retirement savings for all Australians. The 'Retirement Risk Zone' represents the critical years that incorporates the final two decades of one's retirement saving journey during the accumulation phase and the first fifteen years of one's retirement years during the withdrawal or decumulation phase. The significance of this zone arises as a result of this period being when many of the key risks that determine the sustainability (or otherwise) of retirement income are at their most threatening.

During the research and roundtable consultation, it became clear that there was a lack of community understanding and engagement in superannuation. Similarly, financial products and investment options were not being designed to account for one's retirement needs. This includes freeing up regulation to encourage a greater diversity of investment products, such as income-orientated products that incorporates greater pooling of risk and debt products (annuities, corporate bonds and long-dated government bonds should be considered).

The roundtable consensus was that in discussing the objectives of the system, the industry has a responsibility to change the mindset of investors from "lump sum" to "income replacement". This can be achieved by utilising better technologies to connect with individual members and implementing tools such as a "glide-path" to begin educating the population about superannuation as a 'life financial goal'. Finsia supports the efforts of some financial institutions who have implemented IT systems that focus on member income-replacement in retirement.

The second phase of the research program, *How safe are safe withdrawal rates: An Australian perspective* (Appendix 3) examines more closely the post-retirement challenges facing many Australians and in particular the sustainability of the mandated 4% withdrawal rate in superannuation. The research questions whether this rule of thumb is a good approach to ensuring a sustainable retirement income and suggests that the use of the 4% withdrawal rule, popular around the world, is not the silver bullet some have recommended.

Finsia believes that the financial services industry has an obligation to confront retirement sustainability and needs to develop financial products that assists in mitigating longevity risk. This can be enhanced by a regulatory and taxation level-playing field across financial products. It also includes industry practitioners and superannuation funds carefully educating their clients on retirement adequacy and advising sustainable, income-replacement withdrawal rates rather than simply reporting a lump-sum value to members. Whilst the 4% rule is a baseline for withdrawal (and a mandated minimum in retirement), the superannuation industry needs to move from a silver bullet approach to one that takes greater care in calculating asset allocation, planning horizon, scenario testing and risk management to alleviate the asset-liability mismatch in retirement.

There was general agreement from roundtable participants that five aspects of the superannuation system should not be changed:

- The choice and freedom to invest;
- Preservation rules work well;
- Measures to prohibit the use of superannuation savings as borrowing collateral;
- The balance between adequacy and affordability is right;
- The existing regulatory oversight generally works well but it could be simplified.

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Finsia will continue its Financial System Inquiry roundtable series throughout the year and engage industry leaders to discuss a range of challenges and opportunities that can provide value to the finance sector. We are able to privately provide names and institutions of roundtable participants upon request. The roundtables are co-hosted with major industry employers and the remaining six topics include:

16 April	Efficient and effective funding of the Australian economy
1 May	Tech and finance: funding game-changing innovation
5 June	Developing deep and liquid debt markets in Australia
16 July	The future of infrastructure funding and financing
August	The competitive landscape of Australia's financial services
September	Balancing stability, efficiency and innovation through regulation

Finsia is grateful for this opportunity to respond to the Financial System Inquiry and looks forward to contributing further throughout the inquiry. If you have any further questions please contact Samuel Bell SA Fin, Manager, Policy on (02) 9275 7953 or email s.bell@finsia.com.

Yours sincerely,

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