

26/08/2014

By email: fsi@fsi.gov.au

Mr David Murray AO
Chair
Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Dear Mr Murray,

Re: AUSTRALIANSUPER SUBMISSION TO THE FSI - INTERIM REPORT

AustralianSuper welcomes the opportunity to respond to the interim report of the Financial Systems Inquiry.

About AustralianSuper

AustralianSuper is one of Australia's largest super funds and is run only to benefit members. We don't pay commissions to anyone to recommend us, nor do we pay dividends to shareholders. We have over 2 million members and manage over \$78 billion of members' assets. Our sole focus is to provide the best possible retirement outcomes for members.

AustralianSuper supports the content of the Industry Super Australia submission. We also seek to specifically comment on the matters outlined below.

1) The need for stability of superannuation policy settings

As the pool of superannuation savings continues to grow, it is important that measures are placed around the retirement incomes system to ensure that it meets its objectives over the long term.

Such measures will help Australians have more confidence that superannuation policy is consistent with the long term goal of providing them with a secure and comfortable retirement income.

Superannuation is a long term compulsory investment and is also a financial product with a social policy component. As an overall policy objective superannuation should be able to provide sufficient retirement savings to augment, and increasingly for some, replace the Aged Pension and provide a retirement with dignity. To the extent that this public policy objective is not met, the taxpayer ultimately bears the burden to fund the Aged Pension for those who have insufficient retirement savings.

Superannuation is a public/private sector partnership in Australia – the tax concessions provided to superannuation by the Government should reasonably be subject to some review of their effectiveness in assisting the overall retirement incomes policy objective of replacing all or part of the Aged Pension and providing for a comfortable retirement for Australians.

To this end we contend that any retirement income products should be fit for meeting the legitimate objectives of the retirement incomes system. The concept of 'fit for purpose' should be included in the principles for stable settings in retirement incomes policy.

Recommendation: Use of key principles in development of superannuation and retirement incomes legislation

AustralianSuper suggests key principles be observed in the development of superannuation/retirement incomes legislation. We provide no comment on the body or forum that should uphold and apply these principles except to say that an independent body is best placed to do this.

As a minimum, draft legislation should be subject to a review process prior to being released for public consultation which would encompass consideration of the principles outlined below:

Fit for purpose

Superannuation and retirement incomes products and approved strategies need to be 'fit for purpose', designed for providing better retirement outcomes. This must be measured consistently across all industry sectors, including retail, industry, corporate and self-managed superannuation funds.

Adequacy

The retirement income system should enable people to achieve a comfortable standard of living in retirement relative to an objective standard for all retirees.

Sustainability

Funding of retirement through both the Age Pension and superannuation tax concessions must be affordable over the long term. As a component of this, superannuation will continue to need some concessional tax treatment as a tradeoff for preserving savings until retirement.

Fairness

A fair superannuation system is one that treats people in similar circumstances equally and is perceived to be fair by the community. It accounts for differing work patterns

and rates of savings over a working life. It is taxed concessionally for all users, up to the point where it is necessary for provision of retirement outcomes and no further.

A fair superannuation system is one where taxation concessions provided by all taxpayers are not used to advance estate planning or tax minimization strategies that are inconsistent with the purpose of the superannuation system.

2) **Scope for greater efficiencies in the superannuation system**

AustralianSuper considers that investment returns, net of administration fees, and net of investment fees and costs (“net net returns”) is the most accessible and comprehensible way that consumers can determine whether to invest in a particular superannuation investment. Fees are a subset of this primary consideration and lower fees should result in a better net net return for superannuation investors.

AustralianSuper agrees with the general conclusion of the Inquiry in its interim report that fees are too high in superannuation in Australia and that there needs to be greater efficiency in the management and provision of benefits to superannuation fund members.

We are concerned however, about the reliance on OECD comparative data as the basis for this finding when key countries have not provided data, and the variety of different pension provision systems have not been properly compared. Whilst concerns have been raised about the ability to make accurate, like-for-like comparisons with overseas pension systems, the concern about high fees expressed by the Inquiry can be readily confirmed by looking solely at the superannuation industry in Australia and seeing how the industry has grown, yet the scale benefits of the rapidly growing system are being disproportionately enjoyed by agents rather than consumers.

The FSI Interim Report highlighted the problem by reference in Chart 4.2¹ to the problem of fees not declining in the system despite increasing economies of scale. Whilst causes of high fees in the superannuation industry have been discussed in the interim report, we suggest that there are two additional areas of relevant concern that the Inquiry may wish to consider further:

- 1) Investment Management Fees
- 2) The level of accrued default amounts existing in the superannuation industry.²
Commissions can still be charged on these superannuation accounts until 2017.

¹ FSI Interim Report 2-102

² ‘Accrued default amounts’ are defined in s20B of the *Superannuation Industry (Supervision) Act 1993* and are accounts held in default investment options in superannuation that are not MySuper products.

AustralianSuper contends that the most needed change to affect fees and efficiency in superannuation is a real consideration of the fees charged in investment management. Investors in superannuation need a more robust and transparent system of fee and cost disclosure that applies to all relevant participants in the market, not just superannuation trustees.

Investors in superannuation suffer information asymmetry – they do not know, nor do they have access to information about the real fees and costs of the investments they make, because this information is not always available to the market.

The Australian Securities and Investments Commission (ASIC) have recently considered what is needed to improve disclosure of underlying fees and costs. We refer to ASIC's recent Report 398 *Fee and Cost Disclosure: Superannuation and Managed Investment Products*³ where it highlights concerns about 'fee gaming' in the superannuation industry as follows:

*"Fee gaming refers to issuers taking deliberate actions (eg. structuring investments, operations or other arrangements with third parties, or adopting a particular interpretation of the requirements that may or may not be correct) with the objective of intentionally disclosing lower fees and costs that would otherwise be required."*⁴

Recommendation

Legislative reform that places higher responsibilities on trustees to inquire, understand and then disclose all fees and costs applying to investment management, investment in collective investment schemes and costs applying to underlying investments of those schemes.

This suggested reform is not only relevant for MySuper products but for choice products, which should be subject to the same level of scrutiny over their performance as they too gain taxation concessions for operating to provide retirement benefits.

To be effective, this reform should apply to managed investment schemes as well as superannuation funds.

3) The cost of passive and active management

AustralianSuper contends that superannuation funds should be free to observe their fiduciary duty to invest in the best interests of members, and be able to choose between active and passive investment management as they think appropriate.

³ Report 398 *Fee and Cost Disclosure: Superannuation and Managed Investment Products* at www.asic.gov.au.

⁴ *Ibid* paragraph 10.

The decision to use either active or passive investment management really depends on the skill of the investment teams making those decisions. AustralianSuper holds some actively managed investments on behalf of our members, and is conscious of the need for those investments to outperform the index.

If there is a concern that active management is too expensive, then clearly fund managers should be required to report and provide information on investment performance on a net return basis. Trustees acting in the best interests of fund members should be selecting active managers on their ability to deliver alpha on a *net* return basis and simply not select those that are too expensive. It is also worth noting that low cost and high performance in superannuation do not necessarily have a causative relationship. Good performing funds are those that are able to achieve consistent performance and keep fees down.

AustralianSuper uses active asset management within asset classes and returns higher long term returns for its members, with a ten year average annual return of 7.49% as at 30 June 2014.⁵ For a large fund such as AustralianSuper, capacity constraints may lead to using passive investment in equity portfolios in the short term. This is further reason for large funds to bring some investment management in-house as AustralianSuper has done. AustralianSuper also invests in direct property, direct infrastructure and private equity, where the concept of active vs passive management is less relevant.

Recommendation:

Consider legislative reform of fees and costs disclosure as discussed in Item 2) as this is of key relevance in determining the effectiveness of active management.

4) Retirement Incomes Framework

Now that baby boomers have started entering the retirement phase and are drawing on their superannuation and the Age Pension, it is important to improve the design of the retirement incomes system to ensure that it is easy to use.

AustralianSuper is interested in reforms to the retirement incomes framework that better help Australians, especially those on low to average incomes, to transition to an orderly successful retirement. It is also important to ensure that any reforms engage pre-retirees and educate them about the benefits of retaining superannuation savings to draw down an income stream where appropriate, instead of making a lump sum withdrawal where it may not be in their interests to do so.

Users of the retirement income system in Australia would benefit from the use of income stream products instead of lump sum withdrawals by allowing the following:

⁵ <http://www.australiansuper.com/mysuperdashboard>

a) Ability to pay lump sums into income stream (pension) accounts.

There are circumstances where a member would have a valid reason to place an additional lump sum into their income stream account, including inheritance, downsizing the family home, a transition to retirement transfer from an accumulation account, or a redundancy payment.

Currently if a member wants to add money to their existing income stream (pension) account they have two options:

- (a) Open a new pension account. This requires the pensioner to roll their old pension account and any additional money into the new pension account.
- (b) Open a second pension account.

Both of these options result in an unnecessary administration burden and extra costs (which erode retirement savings) being imposed on retirees.

Recommendation: Amend pension requirements to allow for the topping up of pension accounts.

b) Tax treatment of deferred annuities

The existing law requires that income streams must make payments at least annually. As a deferred annuity does not meet this requirement, it does not qualify as an income stream, and therefore is not entitled to the associated concessional tax treatment that applies to earnings on superannuation assets supporting income streams.

As a consequence a deferred annuity is not an attractive option in retirement yet it meets a longevity risk need.

Further, in conjunction with point 1(a) above retirees may need the flexibility of being able to purchase a deferred annuity over a period rather than with a lump sum. This period may be before retirement, after retirement or a combination of both.

Recommendation: Amend taxation of deferred annuities to assist in providing a product that enables retirees to better manage longevity risk in retirement. Allow deferred annuities to be purchased over a defined period rather than at one point in time.

c) Mandated retirement products

AustralianSuper does not support mandating the use of annuity products by retirees and is concerned about the savings disincentive this measure would be likely to generate.

The UK has recently scrapped mandatory annuities derived from defined contribution pension savings due to concerns with the low interest rates effectively forcing retirees to

buy bonds at the very top of the market, when much better yields were available elsewhere. Other concerns with mandatory annuities included the high margins achieved by insurers where retirees rolled over to the default provider, the complexity of products offered, and the lack of competition or flexibility in the mandatory provision of these products.

There is definitely a place for annuities in the marketplace but the benefit of an annuity varies widely for different people. There are few consumers for whom an annuity should comprise their entire superannuation balance. The reality that there are some expenses in retirement that require capital expenditures, for example, aged care bonds, out of pocket medical expenses for serious illness, and home renovations to factor in living at home with a disability.

Recommendation

Do not mandate the use of annuity products by retirees.

d) Default pension

AustralianSuper contends that creating a default income stream derived from members' accumulation account balances is a constructive step in engaging members and potentially reducing the prospect of lump sum withdrawals in the system. It takes away the reflex action of withdrawing a lump sum from superannuation when it is not necessary, and not in the member's best interest. A default income stream supports the philosophy that this is a retirement incomes system rather than a wealth accumulation system.

There are some issues to be considered further. Amendment to the current pension requirements would also need to be made to accommodate the following:

- Deferral of minimum drawdown for a specified period to give time for contacting members and taking payment instructions.
- Enable the member to top up the default income stream (as described above).
- Transfer to pension at a specified age, in specified circumstances, without member instruction.
- A 'no detriment' test covering fees, investment strategy and insurance is required.

Recommendation: Establish a Treasury and regulator-supported working group applying the Retirement Incomes policy-making principles outlined above to consider this issue further.

5) The Dividend Imputation System

AustralianSuper contends that there are substantial benefits in the operation of the present dividend imputation system. The dividend imputation system prevents the double taxation of profits that would otherwise arise at shareholder level, and thus prevents a higher effective rate of tax being imposed on dividend income compared to other types of income.

The imputation system also corrects a bias that may otherwise occur towards investors providing debt financing to corporations which arises from the fact that interest payments (but not dividend payments) are tax deductible to corporations. By preventing such bias towards debt financing, the imputation system cultivates a greater level of resilience within Australia's share market.

The interim report suggests that the dividend imputation system may create a bias for investors to invest in equities, and that this may be a contributing factor to a lack of a deep domestic corporate bond market in Australia. However, there are several reasons why equities, rather than debt financing, may be preferential to investors which are not related to the operation of the dividend imputation system. For example, equity investments are often much more liquid, and may not present the same level of risk as providing debt financing to corporations. Superannuation trustees as fiduciaries must consider such factors in their investment making considerations. In this regard, AustralianSuper contends that broader reasons for any apparent bias among investors towards equities be considered in detail.

Recommendation: That the benefits of the dividend imputation system for all investors be retained, and that any proposals for modifications to the system be carefully considered in this regard, and under full consultation in the Government's Tax White Paper process.

6) The Trust Structure in Superannuation

The Inquiry is seeking views on whether the trust structure is best placed to meet the needs of all members in a cost-effective manner. AustralianSuper believes that the trust structure is the only appropriate structure to cater for a compulsory superannuation system where members are defaulted into a superannuation product as a result of employment.

It is not clear how alternatives such as contract law would apply. Where a superannuation fund member has made no decision about fund membership, they cannot be a party to a contractual arrangement. The fiduciary relationship that a superannuation trustee has with such a member, where they are managing money on behalf of that member, is in the first instance a safer and more accountable structure. Trusts have long been used as an appropriate tool for managing assets on behalf of others.

A higher standard of care is owed by trustees as fiduciaries than is owed by contracting parties that invariably set out to treat each other as equals. Trustees owe a duty to act in the best interests of beneficiaries – a duty that is not owed by contracting parties. In addition, the trust structure in superannuation is overlaid with stringent legislative requirements applying to superannuation trustees under the *Superannuation Industry (Supervision) Act 1993*.

Trustees are also required to keep trust assets separate from their own assets, to prioritize beneficiary interests above their own, and to comply with principles based legal requirements that guide decision making when investing on behalf of another.

There is the argument that some trustee requirements can be legislated and imposed on other legal structures. To retrofit ostensibly similar requirements into a contract relationship by governing legislation will not of itself remedy the fundamental difference in relationship that contracting parties have with each other compared to the fiduciary duty owed by a trustee to a beneficiary. A contract assumes that each party has a relatively equal relationship with each other. This can never be assumed in superannuation.

The Inquiry's interim report has already highlighted the information asymmetry that exists between financial product issuers and their investors, a problem that is even more acute in superannuation where there are disengaged default investors. This information asymmetry feeds into the obligation of trustees as fiduciaries to look after their beneficiaries despite the beneficiaries' lack of knowledge. It is a key structural protection that benefits users of the superannuation framework.

AustralianSuper has not seen evidence that common law trustee duties have increased costs and efficiencies for trustees ahead of any of the following issues:

- The cost of maintaining multiple investment options
- Investment management fees and costs
- The cost of maintaining accrued default amounts in default products that are not MySuper products until 2017, at a significant financial cost to members who continue to pay commissions.

AustralianSuper is concerned however, that to change superannuation from being governed under a trust structure to a contractual structure would allow product providers to charge higher fees than they currently do, as they would no longer owe a fiduciary duty to fund members. This would be a significant backward step for the retirement incomes system in Australia.

Recommendation

Retain the trust structure as the appropriate structure to provide superannuation and retirement benefits to fund members.

1) Liquidity

AustralianSuper believes that the issue of liquidity in superannuation will need to be reconsidered over the long term. More flexibility will be required to manage allocations to illiquid assets and how potentially all investors are impacted by systemic issues affecting liquidity in the superannuation system overall. This issue of liquidity in superannuation

funds will become more pronounced as their operating environment changes in the following ways:

- Demographic change – some funds will go into net outflow as more members take benefit payments than there are contributions flowing into some funds.
- Structural changes to the superannuation system, such as nomination of default funds under Awards, directly affecting the predictability of contributions to funds.
- Systemic issues – severe market corrections in equities and property will affect switching behavior of superannuation fund members.

Superannuation funds are governed by investment strategy requirements applying to the fund as a whole, and then to each investment option within the superannuation fund. The dual requirements lead to liquidity having to be managed not only on a fund by fund basis, but on an investment option by investment option basis as well.

As MySuper investment options are compulsorily diversified, theoretically there should be less concern over liquidity compared to other investment options, but this depends on the 'health' of the MySuper investment option concerned.

Superannuation funds monitor liquidity and may need to rebalance assets where levels of illiquidity are exceeded. It should not be expected that payment of benefits within 3 business days will lead to funds exceeding their level of illiquid assets – this is a largely predictable event. This is not always the case with transfers between investment options and switching between superannuation funds which are less predictable as they are influenced by external market events.

There is a concern that the regular switching behavior of some superannuation fund members is paid for by those members who do not switch investment options. Whilst the superannuation marketplace might demand a number of no-cost superannuation switches, a case can be made for minimum transactional charges to be applied to all investment switches in both MySuper and Choice investment options to avoid cross subsidy between different members.

Recommendation

That the liquidity issue in superannuation be subject to regular review as a component of the intergenerational report to ensure this gets appropriate consideration as economic and demographic changes to the environment take effect.

Further investigation into a minimum standard across the superannuation industry which affects transaction cost-based switching fees across all superannuation investment options be considered. This will reduce cross subsidies and improve efficiencies within the system.

Please do not hesitate to contact Louise du Pre-Alba on 03 8648 3847 if you wish to discuss this further. We are happy to provide further information on request.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Louise du Pre-Alba', written in a cursive style.

for
Ian Silk
Chief Executive