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26 August 2014

Mr David Murray AO
Chairman
Financial System Inquiry

Dear Mr Murray

INTERIM REPORT OF THE FINANCIAL SYSTEM INQUIRY COMMENTS BY THE CORPORATE SUPERANNUATION ASSOCIATION

We refer to the above-mentioned report issued in July 2014.

The Corporate Superannuation Association offers comments, focussing principally on specific areas raised on page 2-115 of the Interim Report.

Background to the Corporate Superannuation Association

Established in 1997, the Association is the representative body for large corporate not-for-profit superannuation funds and their employer-sponsors. The Association represents a total of 27 funds controlling \$75 billion in member funds. In general, these funds are sponsored by corporate employers, with membership restricted to employees from the same holding company group, but we also include in our membership several multi-employer funds with similar employer involvement and focus.

A number of our funds have defined benefit divisions.

Questions raised on page 2-115 of the Interim Report

- 1. Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns? What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there alternative options?***

After fee investment returns

We are concerned by the focus in some industry forums on fee competitiveness without reference to corresponding returns. We believe it is well understood by the Inquiry that there are higher costs associated with certain investments, but that the return after costs remains the important measure.

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The Interim Report notes (page 1-101) that Australian funds do hold higher levels than international average of alternative assets such as private equity and other unlisted investments, which necessarily involve higher costs, but which should result in higher after cost returns.

Competition on basis of fees

We accept that there are other factors affecting costs which include the requirement for a return to shareholders in a “for profit” management structure, particularly in a vertically integrated structure.

Regulation also has increased the cost of operating funds. The cost of compliance has inevitably increased with the proliferation of reporting requirements. New reporting standards need to be understood and complied with. The regulation system has to be funded and this is done to a large extent by fund levies. Our organisation has repeatedly raised issues, in submissions to Treasury on levy methodologies, regarding the equity of the distribution of these levies (which, through “capping”, place a disproportionately high burden on medium sized funds, making competition challenging and threatening their viability). Our view is that the method of funding the Regulations should be neutral so far as competing funds are concerned. We have also raised serious concerns about the the level of SuperStream costs and the allocation of those costs.

Fee auction system for default funds

We are concerned about the potential implications of a fee auction system resulting in one single default fund. It is not clear to us that it is appropriate for funds to compete purely on fees, as this approach may isolate fees from other important factors such as returns and service to members.

The proposal to limit default funds in this way also has the potential to concentrate risk unfavourably.

Insurance costs

In the context of costs, we note that death and disablement insurance is becoming less affordable and the industry is under pressure to provide the cover required. The situation is exacerbated for corporate funds by the recent removal of the ability for most funds to self-insure. Previously, certain large funds had built up a store of specialist experience and expertise in relation to self-insurance which is not replicated in the insurance industry. The result is that when cover is required for these risks in the market, it is obtainable only at significantly increased cost.

- 2. Is the recent trend of greater vertical integration in the wealth management and superannuation sectors reducing competitive pressures and contributing to higher superannuation fees? Are there mechanisms to ensure the efficiency of vertical integration flow through to consumers?***

No comment.

- 3. Are there net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements?***

No comment.

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4. ***Is there an undue focus on short-term returns by superannuation funds? If this is a significant issue, how might it be addressed?***

Portability

We believe that a major issue relates to the liquidity requirements and constraints generated by portability and switching requirements. The effect of increased requirements for liquidity is to reduce the capacity of funds to invest in longer term investments. This is discussed further below.

5. ***Defined benefits: regulator constraints***

Further difficulties arise, for defined benefit divisions, in respect of regulator focus on maintaining VBI of 100% plus. Employers are reluctant to fund to a level with a significant margin above this target, for reasons which include potential disputes over ownership of the surplus. Hence, there is an incentive to fund to an amount very close to 100% VBI at all times. This can constrain the nature of the investments, artificially. Funds invest to match the liability which would arise on immediate wind-up, rather than to match their long term expected liabilities.

Funds therefore seek assets which reduce volatility; and may resort to a higher level of more liquid assets than might otherwise be considered desirable.

6. ***To what extent is there a trend away from active asset management within asset classes in superannuation funds? Is this a positive or negative development for members?***

Anecdotal evidence suggests that there has been a significant trend away from active investment management for MySuper products, in particular. This has been driven by the focus on comparison of fee levels for marketing purposes.

Whilst fees for active management are higher than for corresponding passive or index management, expected returns **net of fees** are also higher (see also previous comments on "After fee investment returns"). The move away from active management may well be to the detriment of members.

7. ***How could funds price switching properly and take into account differences in liquidity between asset classes?***

No comment.

8. ***Could other arrangements be developed to facilitate asset transfers between funds when members switch? Do funds require additional mechanisms to manage liquidity beyond the need for liquidity for portability and member investment switching?***

Portability

Three day portability is simply not practicable, despite best efforts to comply. It is not possible to make the necessary identity checks, and gather the necessary data to provide the appropriate exit information, during that period.

The requirements to provide cash transfers at very short notice also promote the need for a higher proportion of liquid investments, resulting in overall lower returns.

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We would support the Inquiry's option (page 2-114 of the Interim Report) to replace the three-day portability rule with a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress.

9. *Is the trust structure best placed to meet the needs of members in a cost-effective manner?*

Trust structure defence

The trust structure has been effective for many years, and remains highly suitable.

The SIS Act has been developed to encompass the typical trust structure and the rights and obligations implied by the trustee's role. In addition, it has evolved to permit involvement by members and employers in the management of a fund, thus looking to provide representation of the interests of the very parties who contribute to and benefit from the trust. The trust structure can be operated as a mutual organisation without the presence of a "for profit" management structure.

It is our view that where the trustee operates as directly as possible as a representative of member and employer interests, the interests of the members are most effectively protected. Trustee fees are minimised as there is no requirement for profit to pass to a parent body and its shareholders. Trustee costs are made up of directors' fees (for corporate funds, a large element of these is often waived because employee and employer representatives take time out on employer time, or their own time, to attend meetings and review trustee documents).

In corporate funds, administrative and other costs for the trustee are not passed on by employer or any other party at cost plus. This is not necessarily the case in the Retail or Industry Fund sectors.

We look forward to further discussion.

Yours sincerely

Mark N Cerché
Chairman
Corporate Superannuation Association