



FINANCIAL
SERVICES
INSTITUTE
of Australasia

26 August 2014

Head of Secretariat
Financial System Inquiry
GPO Box 89
Sydney NSW 2001

To whom it may concern:

Re: Financial System Inquiry Interim Report

The Financial Services Institute of Australasia (Finsia) appreciates the opportunity to respond to the Financial System Inquiry (FSI) Interim Report.

Finsia has undertaken consultation and research in a number of important areas to check the validity of observations and test potential policy options set out in the FSI Interim Report. This submission outlines this consultation and research, and discusses the importance of a robust financial services sector and its significance to the Australian economy.

Finsia's members are drawn from across the financial services spectrum. In formulating this response, Finsia has consulted widely with its members.

Finsia established four new Industry Councils in 2013 comprised of senior members and industry leaders to focus on building capability and nurturing talent across our industry. The sectors represented include retail and business banking; institutional markets; financial advice and services; and funds and asset management. This ensures Finsia is well placed to provide the inquiry with an independent, industry practitioner reflection about these important issues.

Industry infrastructure

Investing in our people is critical to maintaining vitality and resilience across the financial services sector. The quality of our education institutions and the enthusiastic interaction between academically-trained researchers and industry practitioners has traditionally been a source of strength. Finsia, through its predecessors, the Securities Institute of Australia and the Australasian Institute of Banking and Finance, pioneered much of the practitioner-focused 'applied finance' education in this market.

Likewise, through Finsia's financial and operational support of the Australian Centre for Financial Studies, we continue to support the development and dissemination of applied research. The Financial System Inquiry has not focused on the so-called 'soft infrastructure' of the financial sector, but it should be acknowledged. Historically, the industry has attracted and developed many of Australia's most distinguished business leaders. Finsia has observed a worrying drift of our tertiary institutions away from providing the technical training and professional development needs of employer-institutions. Finsia understands its role as providing a bridge between these institutions and promote relevant industry research and inquiry.

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Regulatory architecture

Finsia endorses the findings and recommendations of Dr Alex Erskine in his paper *Regulating the Australian Financial System*. This was written as part of the Funding Australia's Future campaign by the Australian Centre for Financial Studies, where Finsia played a role on the steering committee.

In particular, Finsia supports Erskine's proposal that the Council of Financial Regulators (CFR) be strengthened and provide oversight over the other agencies including the RBA, APRA, ASIC and (possibly) ACCC. Finsia also believes that an invigorated Treasury department could assume a more central role in policy development for the sector, and reduce the reliance on regulators whose primary function should be surveillance and enforcement.

In recent years, a number of regulatory review and interventions have taken a limited and piecemeal approach to the industry. Any regulatory system must examine the entire supply chain and the powers (and responsibilities) of market participants. Whereas the reputation of Australia's largest financial institutions fared well in the wake of the GFC, the quality and independence of financial advice has continued to raise community concerns. Finsia believes that an unhelpful obsession with the conduct and education of financial advisers, at the expense of product design and distribution channels, has exacerbated the problem.

In principle, Finsia supports a rebalancing of regulatory focus on both financial advisers and product issuers. Most importantly, Finsia has argued that community concerns about the quality of financial advice could be best answered with an independently-administered industry examination. At a minimum, all financial advisers would be required to pass the examination.

Furthermore, Finsia strongly supports the view that different types of advice should be available — that is, both full, independent financial planning advice, as well as narrow product-based advice. In the case of independent advice, the focus should be on the conduct and obligations of the financial planner, registered with an appropriate professional body. In the case of product advice, the focus should be on the licensee recommending a suitable product to a certain class of investors.

Finsia believes the appropriate regulatory tools can be applied to different types of advice. Provided all providers of financial advice have passed an industry examination and complete appropriate CPD, and that any conflicts of interest arising from ownership or employment structures, be clearly disclosed to clients.

Under the proposed changes to ASIC's powers of enforcement and surveillance, actions would be available against both financial planners and owners of licensees.

Superannuation

Finsia believes there is scope to improve efficiency in the superannuation system, but cautions against regulatory changes that erode confidence in the system. Finsia supports five principles in superannuation system regulation:

- promoting the choice and freedom to invest, both in the accumulation and decumulation phase;
- preservation rules;
- measures to prohibit the use of superannuation savings as borrowing collateral;
- balancing adequacy and affordability; and
- a simplified structure of regulatory oversight.

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As the FSI Interim Report correctly observes there is a lack of strong fee-based competition in the superannuation industry. Finsia believes a major impediment to improving competition is that many Australians are disengaged in their superannuation affairs and simply do not monitor and compare fee options.

The lack of financial advice penetration in the community perpetuates low understanding and interest in superannuation. As a result of this and the mandatory nature of the superannuation guarantee, the same competitive pressures do not apply to superannuation as other industries.

Finsia believes that it is prudent to give the MySuper regime reforms more time to run before reviewing their effectiveness. In addition to the Cooper Review, Finsia's research supports the notion that superannuation funds will further consolidate over time, albeit more slowly than originally anticipated. If this occurs, a more concentrated industry can leverage economies of scale and may result in lower overall fees and a higher degree of competition.

Finsia's own consultation reveals that the focus of the superannuation industry should be on the wealth outcomes individuals over the long term, as opposed to other indicators of performance used by superannuation funds that focus on the short term.

To achieve this, wealth-denominated measures of the performance of superannuation funds should exist in the public domain. The current range of absolute return and peer-relative surveys that are published quarterly are an inadequate reporting mechanism for showing a superannuant's overall retirement adequacy.

Finsia proposes that the following measurements should be adopted to express fund performance in terms of retirement adequacy:

- money-weighted returns;
- maximum drawdown (in wealth terms);
- terminal wealth (i.e. account balance in dollar terms);
- projected annuity income (i.e. the income stream that could be purchased with terminal wealth over an agreed timeframe);
- projected replacement rate (i.e. projected annuity income divided by projected final salary).

These wealth measures should be the indicators received by investors from their superannuation funds as they shift the focus to adequacy and away from time-weighted returns and peer-relative conceptions of performance. This will have two major impacts on the industry; first, it will change investors' perceptions of superannuation from "lump sum" to "income replacement" thinking. Second, it will increase the engagement and financial literacy in the community by shifting the focus of superannuation from a pot of gold, and instead focusing on securing adequate retirement income..

Finsia believes there is pressing need for more sophisticated methods of managing superannuation funds over the working lifecycle. A whole-of-life approach to fund design reduces the impact of getting the 'worst returns in the worst order'. Finsia's research, *Sequencing Risk — A key challenge to creating sustainable retirement income*, reveals that, contrary to conventional wisdom, it is the realised sequence of returns and not the accumulated average of investment returns which largely determines the sustainability of retirement incomes. As such, superannuation funds should employ investment strategies that match the long-term nature of the superannuation investment.

Impacting on the view that superannuation funds need to focus on longer-term investments, Finsia acknowledges that there is liquidity risk and a need to reassess and explore solutions to the ways in which superannuation funds manage this. Finsia

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believes that further consolidation of the superannuation industry, which is predicted to occur overtime, may provide additional liquidity through scale that will allow funds to invest more easily in long term, large scale infrastructure projects.

Finsia believes that implementing a liquidity facility would be a more effective solution to manage liquidity risk rather than legislative changes to portability requirements. Changes to portability requirements would once again divert attention of superannuation funds away from their primary focus and possibly increase costs on investors. How a liquidity facility is managed and accessed should be further investigated by the industry, although it could be an important mechanism in reducing the over-reliance on liquid asset investments by superannuation funds and encouraging longer term infrastructure investment.

Retirement income

Finsia supports the panel's observation that the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees. Finsia's own research, *How Safe are Safe Withdrawal Rates in Retirement? An Australian perspective* clearly identifies the impacts of longevity risk and the fact that many retirees will be on a full government pension sooner than they believe. This, combined with rising health and aged care costs, pose a serious risk to the effectiveness of the superannuation system in meeting its own objectives. The answer remains in balancing sequencing risk with longevity risk and managing the risk trade-off that retirees are willing to apply to their savings.

Choice and freedom to invest are central pillars in Australia's superannuation system during both the accumulation and pension phases and any further tinkering or mandating will undermine confidence in the system. Finsia does not support compulsion of longevity risk products, particularly the option of mandating an annuities-style investment in the pension phase. Once again, this impacts the integrity of the system in the eyes of the public. Although annuities form part of the answer, they are not the full answer.

For the future, we need to move from a silver bullet approach (such as the 4% Rule) to a veritable arsenal of weapons (based on dynamism: withdrawal rates; asset allocation; planning horizon; fees and after-tax management; scenario testing; risk management; investment governance) to assist retirees in managing and mitigating the asset–liability mismatch in retirement.

- Michael Drew and Adam Walk, *How Safe Are Safe Withdrawal Rates in Retirement: An Australian perspective*, p. 39.

The primary reason why the vast majority of retirees take an account-based pension is for flexibility and control and Finsia does not believe defaulting an income stream product is in-step with this philosophy.

Finsia believes that financial advice and planning options should be made available as a superannuation account converts from accumulation to transition to retirement or pension phase. These are services that are becoming more accessible by utilising technology opportunities. This advice should not reflect a technical focus on various financial products, but should emphasise financial outcomes and income replacement. While the provision of outcome-orientated and holistic financial advice at each life stage is preferred, Finsia recognises that this is difficult, if not impossible, to achieve. Where improvements can be achieved is at the point where superannuation funds are converted into pension phase and outcome-orientated goals can be decided.

As in the accumulation phase, new products and services will come to the market to meet the needs of retirees in the pension phase. Although removing impediments to product development is important and should be undertaken, investors will ultimately decide on the best products that meet their needs. Combining this with improving the

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provision of financial advice for those entering the retirement phase will ensure an open and free market where decision making and financial literacy is enhanced.

Capability — an investment in people and research

One of the core objectives for members of Finsia's four Industry Councils is to examine the change drivers in the institutional and retail market sectors, and the impacts on skills and career trajectories. The landscape for today's recruits has changed substantially. Graduate recruitment programs have dropped markedly and postgraduate numbers have been in decline among domestic students.

Finsia believes it is vital for the future of the industry that we invest in our financial services talent, not only to make a larger contribution to national wealth, but also for the industry to become an exporter of talent that is recognised on the world stage. Education and professionalism, including both technical and professional competence, must be culturally supported by industry associations and driven by industry participants. To deliver this, it is essential that we have strong education institutions teaching applied and relevant curriculum. Finsia remains concerned about the drift away from practitioner-led teaching with an emphasis on transferring knowledge, skills and experience.

Strong institutions and associations presenting relevant and applied research are essential to building a robust industry. In addition to our own in-house thought leadership research, Finsia supports the work undertaken by the Australian Centre for Financial Studies (ACFS) that brings together regulators, industry and academia to identify innovation and areas for reform. These provide important mechanisms for the industry in assisting to develop our soft infrastructure, while also producing events and forums for people to advance, connect and strengthen their careers.

Finsia is grateful for this opportunity to respond to the Financial System Inquiry Interim Report and looks forward to receiving the final report later in the year. 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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