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Australian Securities & Investments Commission

CHANGING DYNAMICS OF THE AUSTRALIAN SUPERANNUATION INDUSTRY

PRESENTATION FOR ASFA LUNCHEON

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Front piece

So here I am talking to you about the changing dynamics of the superannuation industry; and about some of the opportunities and risks that I perceive from that change.

Perhaps I should start by emphasising the obvious point that ASIC's emphasis will differ from APRA's. Our mandate is primarily dictated towards issues of disclosure and consumer protection, and it will be in that context that most of my comments are made today. The safety of superannuation and its prudential supervision is APRA's role and I of course defer to APRA's assessments on such matters.

However, I will make a brief comment because we have experienced a handful of fund failures that have occupied both regulators and have attracted a great deal of attention. I want to make the point that from ASIC's perspective some of the alarm about superannuation failure has been disproportionate to the size of the problem. Losses in the superannuation sector as a consequence of fraud or misconduct, while significant for affected individuals, hardly register in comparison to the huge investor losses resulting from the corporate failures now being investigated by ASIC.

Of course we must all remain conscious of the risks and be vigilant to ensure that superannuation policy and its implementation includes adequate investor safeguards. We also need to recognise that because superannuation is compulsory, it carries a level of political sensitivity which will ensure that all fund failures attract intense scrutiny. And we must never forget that all failures, whether they be corporate, superannuation or managed investments, have a human dimension which is usually traumatic for the investors and sometimes much worse – causing serious hardship and suffering.

Nevertheless, I think we need to moderate discussion about the incidence of superannuation failure risk and recognise that, with some notable exceptions, the system has stood up well, so far. Considering the massive amount of change that has confronted the industry for more than a decade, its record is good.

What are the changing dynamics?

The past fifteen years have seen an almost constant state of change for the superannuation industry. Superannuation has evolved from an emolument of employment to a statutory right underpinned by award and superannuation guarantee requirements. Taxation concessions provide an incentive for further voluntary investment and increasingly its occupational nexus is being removed. As a consequence, the industry now boasts assets under management in excess of $500 billion[1] with much more to come. From a regulatory perspective, funds have moved from purely taxation-based regulation, first to a 'institutional' regulator in the Insurance and Superannuation Commission and more recently to the current 'twin peaks' regime of prudential regulation by APRA and conduct and disclosure regulation by ASIC. The enormity of

[1] APRA Insight 1st Quarter 2002 p 12: total superannuation assets as at June 2001 were $524 billion, a growth of 7% from the previous year. Total superannuation assets fell by 4.2% to $501.6 billion at the end of September 2001, mainly as a result of asset valuation changes following the events of 11 September 2001.

these changes, driven by policy, economic and market forces, have already resulted in some rationalisation in the number of superannuation funds.

On top of this we are now experiencing a new dynamic which is not only re-defining superannuation products but, perhaps more importantly, is re-shaping the means by which they are originated and distributed. The growth of retail funds at the expense of corporate and public sector funds[2] continues its momentum. Almost 50% of superannuation members are now in retail funds. Superannuation has become a commercial product and increasingly this product is distributed through wealth management networks. Banks, financial institutions and other organisations have integrated roles as the originator/administrator of the product, the distributor of the product and the investment manager of the product. The rise of master funds and wraps was demonstrated in a recent *Australian Financial Review* article that reported $5.9 billion of net inflows in the June quarter.

This changing dynamic has been recognised by the Financial Services Reform Act (FSRA) which was introduced in March. The Government concluded, in my view rightly, that superannuation products were becoming indistinguishable from like products originated elsewhere in the investment market. To carve out such products from the generally prevailing requirements of licensing and disclosure would be to promote unacceptable regulatory arbitrage.

FSRA therefore reinforces the concept of superannuation as a financial product. ASIC's licensing regime applies, with its general focus on issues of competency, disclosure and advice. In recognition of the diversity of the industry, there are specific licensing carve outs for certain segments such as 'wholesale' pooled superannuation trusts, non-public offer funds and self-managed funds. But in terms of disclosure all funds must provide a Product Disclosure Statement which is consistent with disclosure required for like investment products offered elsewhere in the market.

I believe that these changes are a logical response to the realities of the market dynamics which I have touched upon. Some critics see the legislation as exacerbating a new direction which they dislike – but I think such criticism fails to recognise that market forces have already set that direction and that it is unstoppable. Government has a responsibility to eliminate regulatory arbitrage and to promote, as far as practicable, investor comparisons of like-by-like financial products.

Disallowance of Regulations

When I agreed to speak today I did not anticipate the recent Senate disallowance of the Product Disclosure Statement regulations.

I know from experience that it is dangerous for public officials to even obliquely engage in political issues. So, for the record, let me make it clear that the political debate is a matter for Parliament. However, ASIC has to administer the law and it would be short-changing you if I didn't say something about this matter today.

[2] Retail funds grew 10% from $141 billion at September 2000 to $155 billion at September 2001.

A newcomer to this debate might wonder what the fuss is all about. On the face of it, there appears to be much more common ground than dispute. All parties in the Parliament are strongly advocating full disclosure to investors and I have no doubt that they are all committed to it.

At one level the problem seems to revolve around the mandated disclosure of the On-going Management Charge (OMC). However, one also discerns potential differences of attitude about the extent that fee disclosure should be required in dollar terms and – it must be admitted – also philosophical differences within industry about whether any form of disclosure guidance by regulation or by ASIC is helpful.

So there is probably more to this debate than a casual reading of Hansard would reveal. Differences of opinion on these issues have, of course, been evident for some time. The Government's stated position has been to leave the regulations in place throughout the transition period and to encourage further discussions to develop a longer term consensus.

ASIC has found itself in the position of an 'honest broker' attempting to reconcile differing views. We understood that the regulations responded to a preference by the superannuation industry for additional official disclosure guidance, in contrast to the managed funds industry whose preference is for industry based guidance only.

The Government's position had supported that differentiation, by prescribing regulations specifically directed to superannuation.

ASIC therefore backed away from regulatory prescription across the whole investment sector. But we knew this issue wouldn't go away and we commissioned Professor Ian Ramsay to prepare a report on options for improving the quality and comparability of fees and charges. We are releasing that Report this afternoon and intend to use it as a focus for our discussions with the various industry and consumer groups. I am by no means confident that this 'honest broker' role will successfully identify a broad based consensus across all of the issues. However, we will stick to the course which we chartered before the disallowance and do what we can to build bridges.

In the meantime, how will ASIC interpret disclosure in the light of the disallowed regulations?

The first point to make is that the fundamental disclosure requirements prescribed by section 1013D of the Act remain unchanged. The regulations, in effect, spelt out more specifically how those requirements might be fulfilled.

The second point to make is that the regulations covered many items of information beyond the OMC. There has never been any political controversy in relation to those items as far as I know. I think that Trustees could safely adopt the spirit of the disallowed regulations in relation to all those various matters when complying with section 1013D.

The OMC is a bit more complicated. The question may be not so much whether the OMC is itself defective, but whether additional information on fees and charges is needed to fully satisfy section 1013D. I note that ASFA has identified certain perceived difficulties with the OMC, especially its non-inclusion of entry and exit charges. ASFA has also pointed to certain market testing which has apparently raised concerns about consumer comprehension of the OMC.

Clearly, the disallowance of the regulations means that the OMC is no longer an officially mandated form of disclosure. However, whether it might still usefully be used as part of compliance with the Act (amplified by such additional fee information and example calculations as may be considered necessary) is a matter for issuers.

In making these comments I am attempting to be helpful to those of you who will be issuing Product Disclosure Statements during the transition period. I also want to discourage Funds from deferring transition on the basis that this issue has arisen. While the development of a consensus model of disclosure that optimises comprehension of, and comparability in relation to, fees and charges is a high priority, it is one that will take time. We are committed to participating in ASFA's Comprehension Testing project and to working with other industry sectors as part of our role.

In the interim, the old regulations (while no longer in any sense binding) provide a point of reference for complying with section 1013D, along with ASIC's Policy Statement 168 on product disclosure statements.

My final observation is to note several references in the Parliamentary debate to online fee calculators available in some offshore jurisdictions. Not everyone is enamoured by these calculators, but we have believed for some time that they can play a useful role in assisting consumers. We have been examining the various features of calculators developed by other regulators to determine what would best suit the Australian environment. I am please to advise you that our work is progressing well and that we expect to introduce an online fee calculator to our consumer website early next year.

What are the implications of the changing dynamic?

For someone who wasn't intending to say much about the regulations' disallowance I've said quite a lot.

I'd better return to some of the strategic issues that you came to hear about. I think it is safe to predict that while the size of assets under management will continue to grow, fuelled by superannuation guarantee obligations, fund managers will have fewer 'clients' due to a concentration in the number of funds. The independent fund manager may find it increasingly difficult to remain relevant or competitive.

The convergence of roles which I mentioned earlier presents new challenges for the traditional trust structure and the independence of trustees. The trustee may well be a separate company, but it nevertheless operates within the wider wealth management group. If the group decides to rationalise its superannuation offerings, the trustee may be asked to close the fund. Yet the trustee has a duty to act in the members' best interests, not in the interests of the institution/organisation.

Similarly the trustee may be asked to provide access to its membership for the promotion of other products and services within the group, raising issues about privacy and confidentiality of member data. Alternatively the trustee may be asked to promote other products and services within the group, implying that the trustee endorses those products and services without any opportunity for independent assessment by the trustee.

From the member's perspective the consolidation and vertical integration of the superannuation industry represents a narrowing of options - from diversity in both type and number of funds to the potential for a handful of large funds to dominate the industry. There are potential changes in this, particularly if the disclosure regime is not sufficiently robust in terms of transparency of fees, charges, commissions and other benefits and highlighting the relationships that may exist between entities in the group.

I do not wish to be misunderstood about this. Consolidation in the superannuation sector may of itself be a desirable trend, increasing risk management capabilities, reducing costs and ensuring critical mass against sectoral competitors. It will certainly create opportunities for some existing industry participants and has already strengthened the hand of some institutions who are relatively recent entrants. Against that, depending where you sit in the industry structure or product cycle, it may be a clear and present threat. The emergence of superannuation from its unique and somewhat boutique history into the mainstream of financial markets has unleashed forces that will continue to drive the direction of the industry. Special pleadings will become increasingly difficult to sustain. Those who have studied the evolution of the building societies and credit unions over the past three decades will understand this better than most.

These changes also pose some very real issues for ASIC.

As a conduct and disclosure regulator, we are concerned with the protection of consumers. In particular we seek to ensure:

- that members are fully informed about the operation of their fund and their entitlements,
- that they have sufficient information and education to make appropriate choices; and
- that they are not victims of unscrupulous practices such as 'churning' to generate higher brokerage and commissions, mis-selling as a result of inadequate needs analysis or product knowledge and partial advice due to conflicts of interest.

The trends towards vertical integration and consolidation raise obvious questions about conflicts of interest and the adequacy of disclosure which are likely to become ever more demanding for us.

Even fairly well understood practices may take on additional significance when applied in the context of this new industry dynamic.

For example, successor fund transfers are a common fund merger tool for superannuation funds. Under *the Superannuation Industry (Supervision) Act* ('SIS Act') it is possible to transfer members from one fund to another without member consent if:

- the trustees of the two funds agree that the receiving fund will confer equivalent rights in respect of the benefits transferred; and
- the receiving fund does in fact confer equivalent rights.

APRA has provided guidance to Trustees about assessing the equivalence of rights and in relation to the due diligence processes that must be followed when winding up a fund.

However, ASIC can also be expected to take an interest in the level of disclosure provided in successor fund transfers, particularly where organisational conflicts might be suspected. A transfer from one fund to another is clearly a significant event in terms of Division 2.5 of the SIS Regulations. So while conferral of 'equivalent rights' may be the legislative test for dispensing with member consent in a merger of funds, from a consumer protection perspective, adequate disclosure to members is imperative so that members are in a position to fully appreciate the effect of the transfer.

The timing of such reporting may also be important. There may well be circumstances where a transfer from one fund to another might be considered adverse, despite the conferral of generally equivalent rights. There could be features of the receiving fund, such as its investment strategy, crediting rate policy or unit pricing policy, that adversely impact on the amount or even the security of the benefits transferred. In such cases, the law requires members to be informed earlier rather than later, yet we are aware that some trustees take the view that members need not be informed until the next annual report.

It is predictable that issues of this type will take on greater significance as the structure of the superannuation industry changes. It is the sort of issue one might expect to confront in a climate where investment returns are under pressure.

Current public policy proposals

There are a number of recent public policy initiatives that both respond to the changing dynamic of the superannuation industry and may contribute to accelerating that change.

In particular today I will comment briefly on:

- the interim report of the Superannuation Working Group chaired by Don Mercer; and
- the re-introduction of choice of fund legislation.

Obviously I cannot do full justice to these proposals in the time remaining. I also stress that none of these policy proposals has been finally resolved.

Superannuation Working Group

1. <u>APRA licensing</u> - Currently only approved trustees of public offer funds are subjected to a form of APRA licensing. The working group's recommendations extend this requirement so that all APRA-regulated trustees would need to be licensed by APRA (in addition to any Australian Financial Services licence they may need to hold under the Corporations Act). It is likely that the conditions of the APRA licence would include demonstration of adequate risk management, governance and compliance processes.

   I realise that this prospect of dual licensing is a serious concern for some funds. I can only assure you that the two regulators will liaise and cooperate to minimize any regulatory overlap arising from dual licensing. ASIC is committed to a single gateway for the licensing assessment process to reduce the need for applicants to provide the same information to two licensing authorities. Only where the licensing objectives are themselves different will separate information be required. This means, for example, that ASIC will accept APRA's assessment of risk management capabilities for the purpose of an AFS licence.

2. Capital requirements – Under the working group's interim recommendations public offer funds would be required to hold capital assessed on a sliding scale starting at $100,000 and rising, at 0.5% of assets, to a maximum of $5 million. The ability to satisfy Net Tangible Asset requirements via a custodian would be removed which will be an important change for some. It appears that non-public offer funds will not be subject to the capital requirement. There will be no doubling up of capital requirements for entities which act both as approved trustees of public offer funds and as responsible entities under the Corporations Act.

3. Compliance plans – Under the recommendations, superannuation funds would be required to prepare compliance plans, which will include documenting measures for meeting the fund's investment strategy.

4. Enhanced disclosure - trustees would also become subject to increased disclosure obligations in relation to related party transactions.

Most of these measures are already familiar to ASIC in terms of our regulation of managed investment schemes. However we recognise that, traditionally, superannuation has been regulated more as an employee benefit rather than as a collective investment scheme and these recommendations reflect the new realities that I have spoken about today. There is no doubt that for some at the smaller end of the market these new requirements will be difficult to meet, adding further impetus to consolidation.

Superannuation Choice of Fund

On the subject of Choice there is not much I can add that hasn't been said already by others. However, I did want to make the point that Choice of Fund should be seen in the context of the unstoppable commercial dynamics that we have been discussing. This was brought home forcibly to me in a speech delivered by Senator Coonan a fortnight ago to the Australian Banking and Finance Magazine. If you haven't already read it, I think you should. Importantly, in describing a package of measures, Senator Coonan commented that … "it moves a step closer to breaking the nexus between superannuation and employment".

That, I think, is the inevitable consequence of having superannuation as the central plank of our national savings policy. The gradual evolution of the industry from a relatively obscure ancillary of employment to centre stage of household savings carries with it requirements for transparency, market competitive performance, and risk management expectations at least matching those elsewhere in the investment sector.

It also opens up viable commercial opportunities for big players and poses serious threats to all but the most ingenious of small ones. In the process, it presents new opportunities for consumers as well as new challenges for their protection.

End piece
Thank you