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ASIC MARKET STUDY CONSULTANCY

FUNDS MANAGEMENT INDUSTRY

TERMS OF REFERENCE

Introduction

1. Australia's funds management sector is substantial, exceeding Australia's GDP, and its performance impacts consumers either directly through their retail investments or through their superannuation, or indirectly through investment-linked insurance premiums. Consequentially, it is important that competition works effectively with services provided so as to add value to the consumer. Government retirement savings policy requires the Australian superannuation system be supported by a well-functioning funds management industry for the efficient accumulation and decumulation of consumer wealth over the period of their working and post-employment life. In particular, since a broad range of retail and wholesale investors utilise fund management services, a lack of competition in this market has the potential to adversely impact the end user[1] [2].

2. ASIC is focussing on five overall threats and harms this financial year, one of which is "poor conduct in financial markets driven by a lack of competition, structural challenges or conflicts of interest".[3] Further, ASIC's external priorities this year include:

    a. "Improving governance and accountability", and

[1] For example, nearly 600,000 investors choose to have self-managed superannuation funds and almost a third of the total ETF market is invested through SMSFs. State of industry 2019, Financial Services Council, August 2019.
[2] In addition, Australia has the 9th largest high net worth market globally. Capgemini 2016 World Wealth Report.
[3] ASIC Corporate Plan 2019-23 (Focus 2019-20).

b. "Protecting vulnerable consumers".

3. In considering these key harms, threats and priorities as they relate to the funds management sector, we are reviewing the state of competition in the market for managed funds. The experience in the United Kingdom[4] suggests that competition may be weak (or at least, sub-optimal). The aim of this study is to understand whether competition is working effectively to enable both retail (in particular) and institutional investors to get value for money when purchasing managed funds.

4. We are assessing the funds management sector to determine the effectiveness of competition and the extent to which competition is producing positive consumer outcomes. The above United Kingdom research indicated competition may not always be as effective as it could be in some areas - including value for money and a clear relationship between charges and gross performance.

5. Since October 2018, ASIC has had an explicit mandate to consider the effects that the performance of its functions and the exercise of its powers will have on competition in the financial system, including the funds management industry[5]. In this context, it is important for ASIC to fully understand the competitive dynamics of the funds management sector before, if necessary, acting to redress any inadequacies. Hence, we consider it appropriate for ASIC to perform a broad assessment and analysis of competition and, if competition is not assessed as effective, to understand why. We consider that the benefits of any improvements in competition could be significant. Given the size of the market and the long-term nature of investments, even a small improvement to the effectiveness of competition could be of substantial benefit for investors.

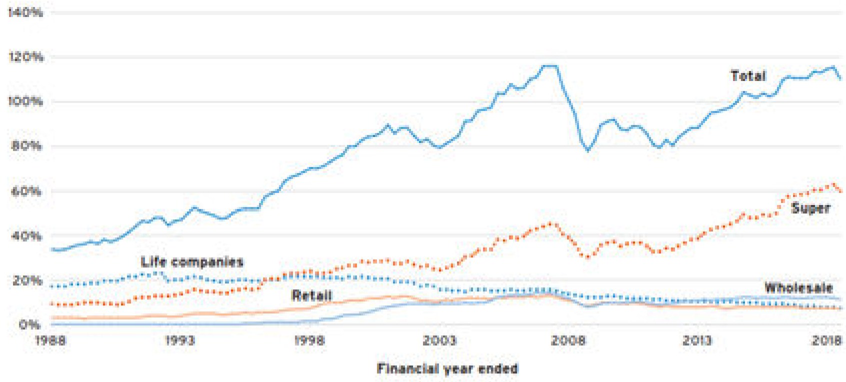
Background

6. There are around $3.6 trillion of assets under management in Australia, including $2.8 trillion from superannuation[6], $381bn in retail investment products and $225bn in wholesale funds[7]. Figure 1 below indicates the very strong growth and significant materiality of funds under management relative to the Australian economy, whilst Figure 2 below indicates the importance of superannuation as a source of funds under management and the diverse range of investors

[4] See UK Financial Conduct Authority Asset Management Market Study 2015 and Investment Platforms Market Study 2019.
[5] ASIC's Corporate Plan 2018-22.
[6] State of industry 2019, Financial Services Council, August 2019.
[7] Australian Bureau of Statistics, March 2019, 5655.0 Managed Funds, Australia.

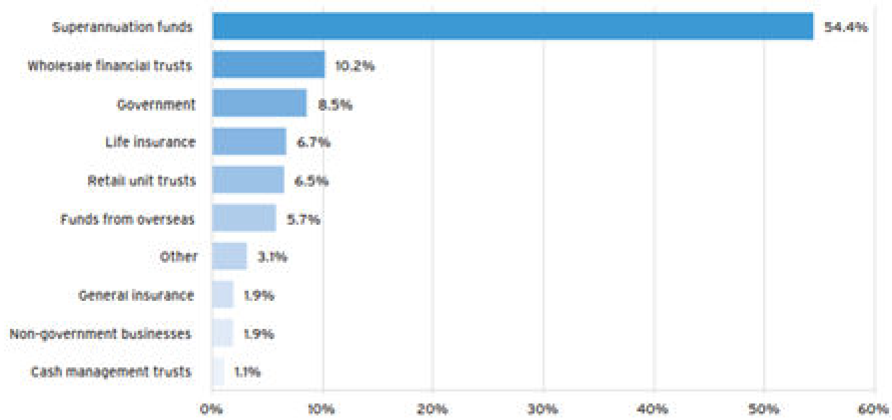
which are serviced by it. Within this, Platforms[8] and similar products, such as Master trusts and Wrap facilities are material, having some $859bn in assets under management[9].

Figure 1 - Australian Funds Under Management as a Share of GDP



Source: ABS Managed Funds, Australia, Table 9; ABS national accounts. Note only some segments of the industry are included in the graph - some omitted categories include friendly societies, common funds, general insurance, non-government trading corporations and charities.

Figure 2 - Sources of Funds Under Management



Source: ABS Managed Funds, Australia, December 2018, Table 9. 'Other' includes charities, friendly societies, common funds and other investment managers.

7. In Australia's context, the funds management sector is primarily represented by Responsible Entities, wholesale trustees and fund managers which are supported in the value chain by fund administrators and custodians. These services provide a vital economic function in bringing together those with money to invest (with the aim of achieving growth or future income) and companies, institutions and governments who need capital for investment, expansion or funding their ongoing operations. These fund managers also provide liquidity and pricing functions in the

[8] "A platform is an online service that allows the direct management of investment portfolios, usually by the financial planner, but sometimes by customers. The platform provider usually allows the adviser/investor complete control over the underlying investments, with limited exceptions". State of the Industry 2019, Financial Services Council, August 2019.
[9] State of industry 2019, Financial Services Council, August 2019.

securities' secondary markets. Managed Funds are issued by a variety of institutions[10]. The industry is represented by businesses which have a projected annual growth rate higher than the overall Australian economy at 2.7% per annum for the 2019-24 horizon[11].

Understanding Competition in our Market

8. Effective competition implies that firms have sufficient incentives to identify and satisfy clients' demands as efficiently as possible and constantly seek to win the business of clients who use rival services. The benefits consumers could expect from effective competition typically include: lower prices, better quality products and services, better access to information, ease of movement between product providers, less complexity in products offered, useful innovation and choice. In particular, improvements in competition that enable greater innovation by providers could result in new product offerings, which better meet investor needs, and better value products, as providers become more efficient in serving investors. These outcomes are goals of ASIC's explicit competition mandate. That said, we note that the peer reviews noted above have found that market behaviour is not always consistent with market theory with respect to fees.

9. A competitive market brings benefits to industry. For example, good consumer outcomes could lead to greater inflows into Australia's funds management industry and support international competitiveness, including more enhanced export capability[12]. Increases in industry scale can bring economies of scale and scope as well as attract the formation of specialist suppliers. Studies have highlighted the benefits of heightened competition in general, for example: "Firm level data highlight the strong role that these sorts of competitive forces play in driving productivity growth. Innovative activity is generally found to have a positive relationship with competition. In Australia, firms that report having more competitors, that have lower price-cost margins, that export, or that report downward pressure on profit margins are more likely to be innovators." In addition, "international evidence also shows that firms that report that they face more competitors on average report better management practices."[13]

10. We want to understand how competition in the market for managed funds and related investment services operates and whether there are any barriers to entry, innovation, or changing suppliers; in addition to the regulatory requirements that could otherwise be amended to improve outcomes for consumers.

[10] 2017_Australias-Managed-Fund-Update, Austrade.
[11] IBIS*World* Funds Management Services August 2019.
[12] State of the Industry Report, Financial Services Council, August 2019.
[13] Ben Dolman and David Gruen (2012) "Productivity and Structural Change" for both quotations.

11. While the Australian funds management sector may not be considered to be very concentrated, a large number of competitors does not necessarily mean there is effective competition. The top 10 managed funds each have assets of more than $4bn, and the assets of this group are $73.8bn in total. These large funds represent 13 per cent of total assets in managed funds, while the top 10 funds are only 0.3 per cent of the number of funds. In addition, 12 ETFs having a value of over $1bn represent just under half (48 per cent) of all ETF assets[14].

Scope

12. The focus is on competition in the market for retail managed investment products. That is, the review is to examine competition between fund managers to sell their managed funds to retail clients. Due to the significant impact of platforms in the Australian market, this will involve reviewing the role of platforms in relation to how fund managers compete with each other.

13. To the extent that it does not detract from the above and that resources permit, we would also like the review to consider the following (in descending order of priority):

    a) Managed Discretionary Accounts

    b) Listed Investment Companies

    c) Wholesale funds

    d) Segregated accounts

14. What is out of scope:

    a) Competition between superannuation funds

    b) Competition between financial advisers

Key issues

15. The key questions we want considered are:

    a. How do fund managers compete to deliver value?

    b. What are the features of a fund that make it competitive in its type / class?

[14] State of the Industry Report, Financial Services Council, August 2019.

c. How are these features promoted or communicated to potential investors and to what extent do potential investors rely on these features when making investment decisions?

d. How do retail investors choose between fund managers and funds (e.g., on the basis of quality, service or price)?

e. The extent of correlation between fees charged and performance achieved?

f. How does the current market structure and regulation affect competition between fund managers and the funds offered?

   i. How do charges and costs differ along the value chain?

   ii. Are fund managers willing and able to control costs and quality along the value chain?

16. We want to understand the incentives that fund managers have to compete to provide value for money. We anticipate value for money in this sector will reflect a number of factors including: i) the expected rate of return, ii) an allowance for any costs and charges, iii) consideration of a given risk tolerance and iv) take into account the nature of service required by the investor.

17. We expect that fund managers are motivated to compete on expected risk adjusted performance but, as this cannot be known with certainty in advance, fund managers must use proxies for future performance. We want to understand the proxies used by fund managers and investors to identify future performance and whether these lead to good outcomes for investors.

18. We also want to understand whether there are features that investors (and fund managers) prioritise. We recognise that price is not the only factor when assessing value for money. It is, however, a significant determinant of net future performance and is one which <u>can</u> be largely known in advance.

19. Retail and institutional investors can drive effective competition if they are able and willing to compare different products and choose or switch to the one that represents the best value for them. We want to understand the extent to which different types of investors are able to access the right information to make informed choices, assess this information to find the best products for their needs and act on this information to ensure they are getting the best value product for them. (Although the influence of financial advisors may be a part of this dynamic, the competition between financial advisors is outside of the scope of this study). As part of this we want to understand the extent to which switching occurs between funds and the existence of switching

costs which prevent investors from acting in their own best interests. These costs may be real or perceived and can be monetary or non-monetary.

20. There may be aspects of the way the funds management market is structured which affect the way both investors and fund managers behave and impacts the way competition works for these services. We would like to understand the extent to which structural features and regulation of the fund management market affect the incentives and/or ability of fund managers to compete effectively with each other (e.g., barriers to entry).

21. We want to understand the charging structures and underlying costs for providing fund management services to different groups of investors and for different types of funds. These are likely to differ based on the class of investor, the type of product such as active verses passive and the distribution channel.

22. Fund managers commonly outsource some support services, such as custody, securities lending and fund administration services to other firms. Fund managers may also purchase some products and services from third party providers which are typically needed to carry out their investment management function e.g. market research, benchmarking data or trade execution services. Some of these services are paid for by the fund investors, while other costs are borne by the funds management firm. When purchasing these services on behalf of investors, there is potential for the interests of the fund manager (acting as 'agent' in the relationship) to differ from those of the investors ('principal'). We want to understand the extent to which fund managers are willing and able to control and scrutinise costs when purchasing services on behalf of the fund or, in the case of segregated accounts (discrete mandates), paid from the assets managed. Further, we want to have explored whether the level of scrutiny differs depending on the nature of the cost, the service provider, the end investor (e.g., retail or institutional) and the information that is provided to investors on the cost.

Data collection and analysis

23. The consultancy will need to do an analysis of long-term trends undertaken for:

    a. Fund fees and costs

    b. Fund Performance relative to objective

    c. Fund manager revenues and expenses (and profitability measures such as cost to income ratios)

    d. Segregated account fees and costs (desirable)

24. The project will involve an analysis of the profitability of the funds management sector to inform the overall analysis. Firms in a competitive market would generally be subject to competitive forces which bring profits down to a normal rate of return. Normal rates of return are typically proxied by the firm's cost of capital for that activity. Where firms in a sector or industry generate profits above a normal rate for that activity over a sustained period, it may indicate that competition is not working effectively for those services. Profitability of the funds management sector appears to be quite high globally.

25. The consultant will need to seek data from a selection of industry participants, research firms and information providers to build this data set.

Deliverables and next steps

26. The consultant will deliver:

    a) Data collection and analysis

    b) Monthly updates of progress

    c) An interim report

    d) A process for consultation with stakeholders to provide feedback (e.g., written or oral submissions, or roundtables)

    e) Final Report which will be publicly released under the consultant’s name.

27. Timing – completion within 12 months from execution of a consultancy agreement.

28. Throughout the study we are keen for all market participants to be able to share their experiences. The consultant will seek and consider feedback from stakeholders, potentially through meetings or roundtables. We will potentially attend these meetings.

29. We will be appointing a consultant to conduct the study and prepare the report in line with our objectives, scope and data requests and addressing our key issues. If necessary, a consultant may need to design a data request (including appropriate sample size, questions, etc.,) for ASIC to issue under its compulsory powers.

30. We expect the consultant to prepare an interim report within six months, setting out their analysis and preliminary findings and recommendations to address any concerns identified. After considering stakeholder feedback, the consultant will prepare a final report with their final findings and recommendations within 12 months.

31. An objective of the study is to identify where competition is and is not effective, and why. Without pre-empting the outcome of any survey and analysis, if competition is not working well, we may intervene to promote effective competition. We can do this through proposing law reform to Government, revising our Regulatory Guides and instruments, proposing enhanced industry self-regulation, or taking supervisory or enforcement action. We could propose the removal of existing rules that create barriers to entry or innovation which are not justified.

32. We may also decide to take no further action. This could be because we do not identify any concerns that need addressing or we consider that any concerns we identify are likely to be addressed by upcoming legislative measures or action by the relevant firms. In such cases, we may continue to monitor the market in case our concerns are not addressed