FINANCIAL SYSTEM INQUIRY

Responding to the Murray Inquiry

SUBMISSION

Issue date 31 March 2015

Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

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RESPONSE TO FSI FINAL REPORT

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EXECUTIVE SUMMARY

The following table sets out Industry Super Australia (ISA)'s responses to the Inquiry's recommendations.

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Chapter 1: Bank Resilience & Competition		
1	**Capital levels** Set capital standards such that Australian Authorised Deposit-taking Institution (ADI) capital ratios are unquestionably strong.	Support
2	**Narrow mortgage risk weight differences** Raise the average internal risk-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for ADIs using IRB risk-weight models and those using standardised risk weights.	Support
3	**Loss absorbing and recapitalisation capacity** Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian ADIs and minimise taxpayer support.	Qualified support
4	**Transparent reporting** Develop a reporting template for Australian ADI capital ratios that is transparent against the minimum Basel capital framework.	Qualified support
5	**Crisis management toolkit** Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.	Support
6	**Financial claims scheme** Maintain the ex post funding structure of the Financial Claims Scheme (FCS) for Australian ADIs.	Do not support *Recommend:* Instead support ex ante funding structure for the FCS that is not distorted by the too-big-to-fail subsidy

7	**Leverage ratio** Introduce a leverage ratio that acts as a backstop to ADIs' risk-weighted capital positions.	Support
8	**Direct borrowing by superannuation funds** Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.	Support
Chapter 2: Superannuation & Retirement Incomes		
9	**Objectives of the superannuation system** Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.	Support The objective of the superannuation system should be, in conjunction with the Age Pension, *to deliver an objectively comfortable retirement to all Australians*
10	**Improving efficiency during accumulation** Introduce a formal competitive process to allocate new default members to MySuper products, unless a review by 2020 concludes that the Stronger super reforms have been effective in significantly improving competition and efficiency in the superannuation system.	Do not support. *Recommend:* ▪ The government promptly honour its commitment in the Full Federal Court to appoint additional Expert Panel members to Fair Work Commission. ▪ Bank-owned super funds should be required to deliver all profits to super fund members unless they have outperformed; returns to shareholders from a bank's superannuation business must be earned by outperformance ▪ Banks should be prohibited from providing business banking and default fund products to the same enterprise ▪ The proposed Productivity Commission review should focus on addressing the significant inefficiency in the retail choice sector of the superannuation system

		▪ The proposed review should also look at the inefficiency, leverage and tax leakage in the self-managed fund (SMSF) sector
11	**The retirement phase of superannuation** Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.	Qualified support *Recommend:* Comprehensive Income Product for Retirement (CIPR) should be: ▪ a whole of life product and ▪ a true default Legal change to facilitate defined ambition plans, as the UK has in its Pension Schemes Act 2015 UK Treasury should undertake a consultation on structural issues in the retirement incomes system, including the design of an appropriate default in alignment with the objectives of the system. The process should evaluate the options including those outlined by the Inquiry and Collective Defined Contribution (CDC) plans
12	**Choice of fund** Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.	Qualified support Choice should be accompanied by stronger safeguards to ensure that members who exercise choice are not worse off as a result
13	**Governance of superannuation funds** Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.	Do not support recommendations regarding board composition
Chapter 3: Innovation		
14	**Collaboration to enable innovation** Establish a permanent public–private sector collaborative committee, the 'Innovation Collaboration', to facilitate	Support

	financial system innovation and enable timely and coordinated policy and regulatory responses.	
15	**Digital identity** Develop a national strategy for a federated-style model of trusted digital identities.	Support
16	**Clearer graduated payments regulation** Enhance graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority. Strengthen consumer protection by mandating the ePayments Code. Introduce a separate prudential regime with two tiers for purchased payment facilities.	Support
17	**Interchange fees and customer surcharging** Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees. Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.	N/A
18	**Crowdfunding** Graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.	Qualified support
19	**Data access and use** Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.	Support
20	**Comprehensive credit reporting** Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation.	Support Comprehensive credit reporting should be mandated
Chapter 4: Consumer Outcomes		
21	**Strengthen product issuer and distributor accountability** Introduce a targeted and principles-based product design	Support

	and distribution obligation.	
22	**Introduce product intervention power** Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.	Support
23	**Facilitate innovative disclosure** Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.	Support
24	**Align the interests of financial firms and consumers** Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.	Support increased standards and banning powers Do not support recommendation to require that an upfront commission for life insurance advice is not greater than ongoing commissions *Recommend:* ▪ Prohibition on commissions on life insurance ▪ Removal of exemption from ban on conflicted remuneration for stockbroking sector
25	**Raise the competency of advisers** Raise the competency of financial advice providers and introduce an enhanced register of advisers.	Support
Chapter 5: Regulatory System		
26	**Improve guidance and disclosure in general insurance** Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance.	Support
27	**Regulator accountability** Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandate. Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.	Qualified support

28	**Execution of mandate** Provide regulators with a more stable funding model based on periodic reviews, increase the capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic reviews.	Support
29	**Strengthen ASIC's funding and powers** Introduce an industry funding model for Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.	Support
30	**Strengthen the focus of competition in the financial system** Review the state of competition every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross border prevision of financial services and include consideration of competition in ASIC.	Qualified support
31	**Compliance cost and policy processes** Increase the time available for industry to implement complex regulatory change. Conduct post-implementation reviews of major regulatory changes more frequently.	Qualified support
Appendices (Significant matters)		
32	**Impact investment** Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery. Provide guidance to superannuation trustees on the appropriateness of impact investment. Support law reform to classify a private ancillary fund as a 'sophisticated' or 'professional' investor, where the founder of the fund meets those definitions.	Qualified support
33	**Retail bond market** Reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds.	Do not support
34	**Unfair contract provisions** Support Government's process to extend unfair contract	N/A

	term protections to small businesses Encourage industry to develop standards on the use of non-monetary default covenants.	
35	**Finance companies** Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institution deposits.	Support
36	**Corporate administration and bankruptcy** Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.	N/A
37	**Superannuation member engagement** Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance. Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.	Qualified support *Recommend:* Retirement income projections should be mandatory, product-specific, and calculated on a fair and reasonable basis
38	**Cyber security** Update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation, and progress public–private sector and cross-industry collaboration. Establish a formal framework for cyber security information sharing and response to cyber threats.	N/A
39	**Technology neutrality** Identify, in consultation with the financial sector, and amend priority areas of regulation to be technology neutral. Embed consideration of the principle of technology neutrality into development processes for future regulation. Ensure regulation allows individuals to select alternative methods to access services to maintain fair treatment for all consumer segments.	N/A
40	**Provision of financial advice and mortgage broking** Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.	Do not support renaming all general advice *Recommend :*

		Clear labelling of sales activities that attract conflicted remuneration Clear disclosure of ownership structures *Recommend:* Prohibition on conflicted remuneration for mortgage brokers
41	**Unclaimed monies** Define bank accounts and life insurance policies as unclaimed monies only if they are inactive for seven years.	N/A
42	**Managed investment scheme regulation** Support Government's review of the Corporations and Markets Advisory Committee's recommendations on managed investment schemes, giving priority to matters relating to: • Consumer detriment, including illiquid schemes and freezing of funds. • Regulatory architecture impeding cross-border transactions and mutual recognition arrangements.	N/A
43	**Legacy products** Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.	Support subject to appropriate consumer protections
44	**Corporations Act 2001 ownership restrictions** Remove market ownership restrictions from the Corporations Act 2001 once the current reforms to cross-border regulation of financial market infrastructure are complete.	Qualified support

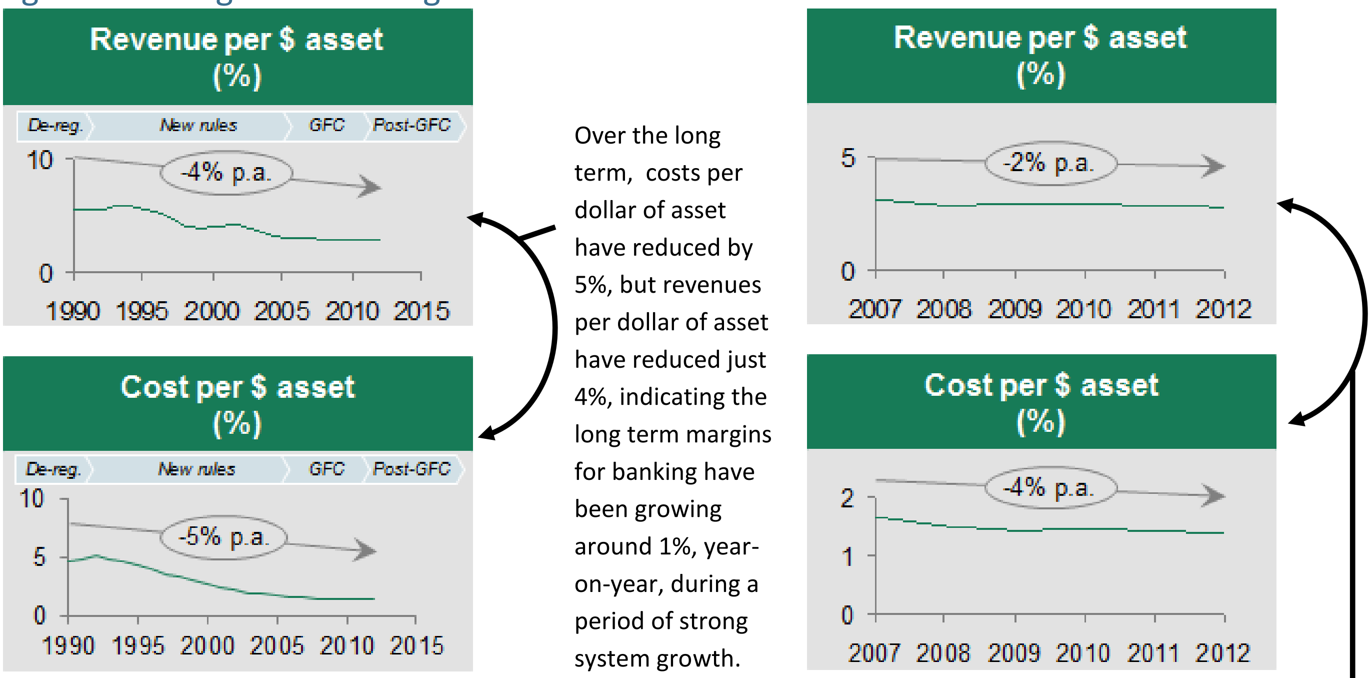
1. Bank Resilience and Competition

1.1 Introduction

Banking is the centre of gravity in Australia's financial system. Currently, banking in Australia is expensive, excessively allocates resources into existing housing stock and is a source of systemic risk. As a result, significant reform is required in order to deliver higher value to consumers, increase economic growth and protect the government and taxpayers from the failure of very large ADIs.

Consumer prices for banking products in Australia carry a larger margin than in other countries. Australia's major banks have the third highest net interest margins and the highest profit rates among large banks in advanced economies.[1] Moreover, the cost-to-income margins of Australian banks are widening (Figure 1). This indicates that the current level of competition is insufficient to ensure cost savings are fully passed on to consumers.

Figure 1 – Margins in banking



Source: BCG analysis, ISA commentary

Since the GFC, the cost-to-revenue margins growth has doubled in size, to 2%, year-on-year. Weaker competition means even less of the cost savings arising from innovation and other factors are being passed on to consumers.

This lack of competition, and associated concentration, is maintained by two policy settings:

- A capital framework which has resulted in large differences in risks weights between banks which use the internal ratings-based (IRB) mortgage risk weights and those which do not

[1] Bank of International Settlements, *Annual Report 2014*, table VI, p 107

- Government has allowed the big banks to become "too-big-to-fail," but has not established regulatory capital levels that are sufficient to fully protect government from the banks' failures, which results in a funding cost benefit enjoyed by the major banks

These two policy settings also inhibit the ability of the banking sector to drive economic growth. The current capital framework has resulted in banks excessively allocating resources to home loans. Housing comprises the majority of bank loans, while bank funding of non-financial corporates has flat lined, suggesting housing credit is crowding out business finance. This is a dampener on economic growth because business finance has a stronger relationship to growth than housing finance does.

Latent systemic risk exacerbates these issues. Major bank leverage ratios sit at, on average, around 35x and, for mortgage loans, about 75x, with very little tier one capital against total assets. Major bank exposures to market risk are low relative to large global banks, but risk levels are growing.

ISA supports the package of recommendations presented by the Inquiry aimed at enhancing the resilience of, and the competition within the banking sector. ISA also agrees with the Inquiry's analysis that the recommended reforms will have a significant net benefit to individuals, the economy and the government. These benefits however, will only be achieved if the recommendations are implemented as a package.

According to the Final Report, "These recommendations [regarding resilience], which reduce the probability of failure and minimise the cost of failure when it does occur, are complementary and should not be seen as substitutes for each other."[2]

The Inquiry's view is that "no system can be bullet-proofed" and that reform can at best minimise the cost of financial failure. This view is consistent with the institutional rather than systems framing adopted by the Inquiry, which emphasises increasing the resilience of current financial institutions rather than rethinking the institutional arrangements that would best enable the system to meet its objective of "supporting economic growth and enhancing standards of living for current and future generations."[3]

The reform package recommended by the Inquiry attempts to minimise the cost of too-big-to-fail institutions, rather than creating a system in which no institutions are too-big-to-fail – a solution which can be achieved through reform such a ring-fencing. In a scenario in which too-big-to-fail institutions are allowed to exist, it is imperative that:

1. The institutions are "unquestionably strong," and therefore the proposed reforms are implemented in full, without dilution
2. An ex ante fund is established in order to effectively price the remaining guarantee that government provides to TBTF institutions and ensure the guarantee does not distort competition or lead to moral hazard

1.2 Bank capital levels (Recommendation 1)

The Inquiry recommended:

- Capital standards for Australian authorised deposit-taking institutions (ADIs) be set such that capital ratios are unquestionably strong.

ISA Position: Support

[2] Financial System Inquiry, *Final Report*, December 2014, p 36

[3] Financial System Inquiry, *Final Report*, December 2014, p xiv

Bank failures and financial crises have significant and often enduring negative impacts on employment, economic growth, and the broader social well-being. The Inquiry was right to analyse the consequences of the most recent financial crisis – a seven percentage point increase in unemployment (900,000 Australians) and a dramatic fall in GDP between 63 and 158 per cent (between $950 billion to $2.4 trillion for Australia in 2013 terms).[4]

In contrast to this, the cost of strengthening banks is estimated to be quite small – a one per cent increase in capital ratios would potentially decrease annual GDP by 0.01 to 0.1 per cent.

This is one reason why ISA strongly supports the Inquiry's position that Australian banks must be "unquestionably strong."[5] An additional reason is that having unquestionably strong banks would also go some way to reduce the competitive distortion created by the implicit government guarantee of the major banks.

The government guarantee is part of the reason why the major banks are able to enjoy some of the highest levels of return on equity (ROE) amongst Australian listed corporates but at the same time post some of the highest credit ratings (major bank credit ratings are uplifted two levels due to the implicit government guarantee).[6]

The value of the implicit government guarantee the major banks enjoy can be observed in a number of ways: (a) a discrepancy between the credit spread on bonds issued by a major bank compared to the higher counterfactual spreads that would attach in the absence of implicit government support, (b) a shortfall may exist between the value of a bank's assets and some "threshold" for minimum capital requirements that would prevent failure at some future time, and (c) ratings agency reports may explicitly include a ratings uplift or support rating to reflect implicit government support. Analysis by the International Monetary Fund (IMF) in its Financial Sector Assessment Program for Australia provides data on Australian banks in relation to approaches (b) and (c) above.[7] In doing so, they calculate what additional capital would be necessary for a bank to be unquestionably strong, which they believe is equivalent to the implicit guarantee.

The IMF uses an expected default frequency (EDF) measure for the probability of a bank's survival during one year. The highest benchmark they test 99.95 (i.e. an expectation of default or failure every 2000 years). While the Inquiry does not quantify "unquestionably strong," it would not be unreasonable to use the IMF's benchmark of an EDF of 99.95 as an equivalent.

According to the IMF's analysis, to achieve an EDF of 99.95, an additional amount of Tier 1 capital of between 0.6 per cent and 2.5 per cent of risk weighted assets (RWA) would be required.[8] In estimating the value of the subsidy, the IMF analysis concludes a consistent but narrower estimate: "to offset 80 basis points worth of funding advantage, additional capital in the range of 1.2 per cent to 1.6 per cent of RWA is required. This rises to a range of 1.8 to 2.4 per cent to offset 120 basis points [the funding advantage during a crisis]."[9]

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[4] Financial System Inquiry, *Final Report*, December 2014, p 33

[5] Financial System Inquiry, *Final Report*, December 2014, p xviii

[6] Industry Super Australia, *Submissions in Regard to the FSI Interim Report*, August 2014, p 10

[7] IMF, *Australia: Addressing systemic Risk Through Higher Loss Absorbency – Technical Note, Financial Sector Assessment Program Update*, November 2012, p 16

[8] IMF, *Australia: Addressing systemic Risk Through Higher Loss Absorbency – Technical Note, Financial Sector Assessment Program Update*, p 16

[9] IMF, *Australia: Addressing systemic Risk Through Higher Loss Absorbency – Technical Note, Financial Sector Assessment Program Update*, p 19

In summary, an indicative range from the IMF assessment for both the capital required to make the major banks unquestionably strong (EDF 99.95) and equivalent to the value of the implicit guarantee (80 bps for the major banks in normal times) is 1.2 per cent to 1.6 per cent of RWA.

With respect to capital requirements, the Inquiry recommended a "baseline target in the top quartile of internationally active banks".[10] It reports Bank of International Settlements data showing that in 2013, the global 75th percentile, i.e. top quartile, for capital ratios was 12.2 per cent Common Equity Tier 1 (CET1). The Inquiry reports a "plausible range for current Australian major bank common equity Tier 1 (CET1) capital ratios of 10.0 to 11.6 per cent."[11]

Applying the IMF uplift (1.2 to 1.6) to the Inquiry's plausible range (10.0 to 11.6) gives a reform scenario range of 11.2 to 13.2. This is consistent with the top quartile estimate of 12.2 per cent. While caution must be taken regarding the comparability and robustness of these figures (see section 1.7), this preliminary analysis at least suggests that the Inquiry's recommendation of top quartile (12.2 per cent) is adequate for both stability and competition concerns.

The advantage of the IMF approach of additional capital to achieve an EDF of 99.5 is that it does not depend on the capital regulation in other jurisdictions. While unlikely, if other jurisdictions reduced their regulatory capital requirements, the major banks might be able to have capital levels in the top quartile, but not truly be unquestionably strong.

Finally, it is essential to understand that these capital ratios are on risk-weighted assets measured by internal models. These models cannot be relied upon and must be supplemented with non-risk weighted measures, such as the leverage ratio outlined in section 1.3, discussed below.[12]

1.3 Leverage ratio (Recommendation 7)

The Inquiry recommended:

- A leverage ratio be introduced to act as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.

ISA Position: Support

ISA welcomes the Inquiry's finding that outputs of internal risk-based (IRB) models should be treated with caution.[13] This conclusion was reached after a review of recent empirical research which finds that IRB models are vulnerable to "model risk" (the possibility that the risks could change), and manipulation due to discretion in the models' parameterisation and the incentive to optimize models to reduce capital levels.

Given the concentration of the Australian banking sector, and the correspondence between this concentration and the banks which use IRB, ISA supports a strong leverage ratio for ADIs. Moreover, as the leverage ratio is to serve as a backstop against the risks of IRB, there is perhaps more reason that this measure also should be set at a level which would ensure the major banks are unquestionably strong.

A number of steps should be taken to ensure that the leverage ratio provides a strong and dependable backstop. Firstly, the capital measure (the numerator in the ratio) should be Common Equity Tier 1 (CET1)

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[10] Financial System Inquiry, *Final Report*, December 2014, p 41

[11] Financial System Inquiry, *Final Report*, December 2014, p 48

[12] See Industry Super Australia, *Submissions in Regard to the FSI Interim Report*, August 2014, p 13-14 and Basel Committee on Banking Supervision, *Reducing excessive variability in banks' regulatory capital ratios: A report to the G20*, November 2014

[13] Financial System Inquiry, *Final Report*, December 2014, p 85

rather than simply Tier 1 capital that includes intangible assets, the value of which is unreliable in times of financial market stress and crisis. Secondly, the ratio should be higher than Basel III, which is a minimum standard. This approach would be in line with the Inquiry's underlying principle of creating "unquestionably strong" banks and that "the minimum leverage ratio should be comparable with Australia's global peers".[14] According to BIS data, under the Basel III Tier 1 leverage ratio, the global median is 4.7 per cent and the top quartile is 6.2 per cent.[15]

1.4 Narrow mortgage risk weight differences (Recommendation 2)

The Inquiry recommended:

- Raising the average internal ratings-based (IRB) mortgage risk weight in order to narrow the difference between the average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

ISA Position: Support

There is clear evidence that the major banks are not subject to strong competition in Australia. Since 1990, long term margins for banking (the spread between cost-per-dollar of asset and revenue-per-dollar of asset) have been growing around 1 per cent, year-on-year, during a period of strong system growth. Since the GFC, the cost-to-revenue margins growth has doubled in size, to 2 per cent, year-on-year (Figure 1). This reflects a weakening in competition, and means even less of the cost savings arising from innovation and other factors are being passed on to consumers.[16] Sustained lack of competition may also lead to greater concentration, increased moral hazard and therefore greater risk in the overall financial system.

ISA therefore welcomes the Inquiry's consideration of competition and the recommendation that the competitive distortion created by the risk weights arising from the IRB models of the major banks and Macquarie be addressed. As noted by the Inquiry, the average mortgage risk weight for banks using IRB models is 18 per cent, less than half the average mortgage risk weight for an ADI using the standardised model which is currently 39 per cent.[17] This is consistent with analysis undertaken by the Boston Consulting Group for ISA in response to the Interim Report (Figure 2). Applying a floor to mortgage risk weights in the IRB models is an appropriate measure to address this competitive distortion.

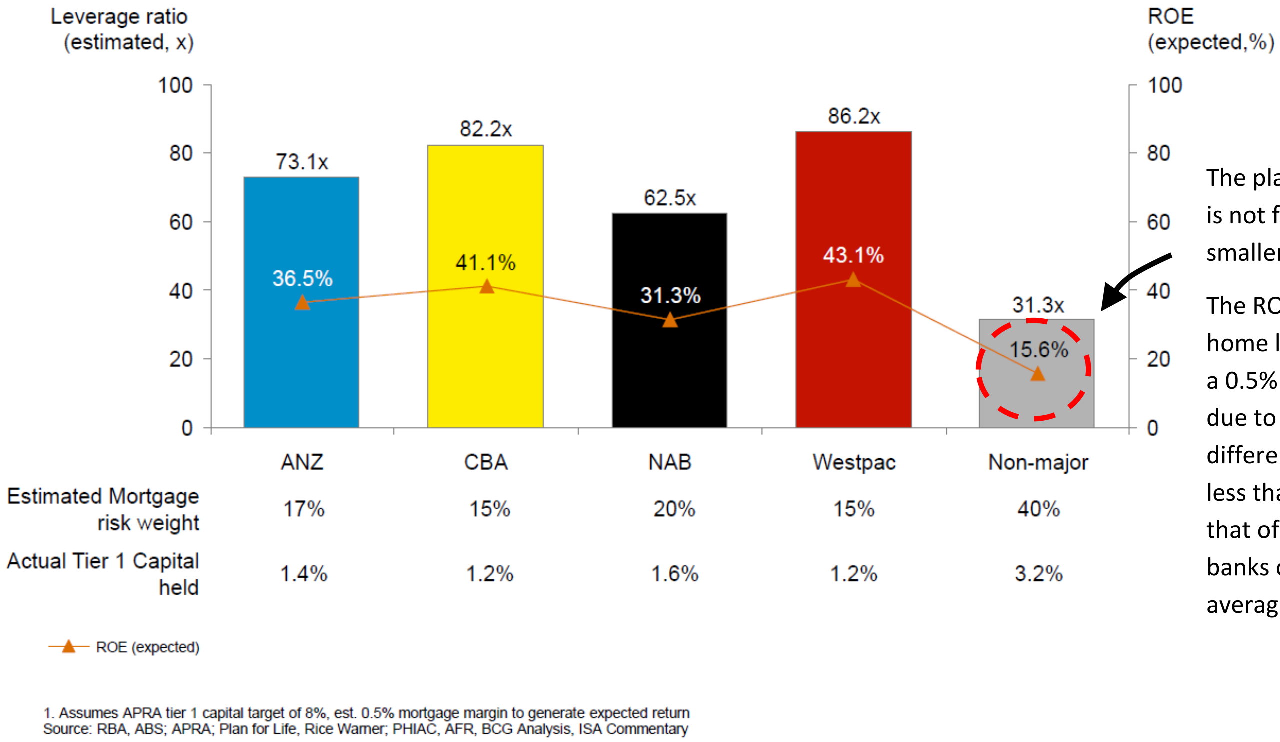
[14] Financial System Inquiry, *Final Report*, December 2014, p 84

[15] Basel Committee on Banking Supervision, *Basel III Monitoring Report*, September 2014, p 42

[16] Industry Super Australia, *Submissions in Regard to the FSI Interim Report*, August 2014, p 10-11

[17] Financial System Inquiry, *Final Report*, December 2014, p 61

Figure 2 – Mortgage regulatory capital differences and effect on expected ROE



The playing field is not fair to smaller banks.

The ROE on a home loan with a 0.5% margin, due to leverage differences, is less than half that of the major banks on average.

Source: BCG analysis, ISA commentary

The objective of improving competition is different from enhancing capital adequacy (appropriately addressed through increasing capital ratios and implementing a CET1 leverage ratio as discussed above). Raising the average IRB mortgage risk weights improves resilience as well as improves competition and prevents further concentration. ISA considers it reasonable to apply risk weight floors to residential mortgages only, as part of a staged process to raise IRB risk weight floors to reduce competitive distortion. Residential mortgages currently constitute by far the majority of bank assets, and, as a measure to enhance competition, a floor on residential mortgages would target the largest part of the market where competitive distortions are occurring.

However, the competitive distortion of IRB should be curtailed in all bank asset classes. The risk weights calculated by IRB for assets other than mortgages also should be raised so that smaller and regional banks can compete. The most important reason is that, if these distortions are not removed, smaller and regional banks would be unlikely to allocate the resources to enter and compete in markets other than mortgages. In addition, major banks could reasonably be expected to focus more on assets other than mortgages if the mortgage market becomes more competitive.

ISA also considers a risk weight floor of 25 and 30 per cent to be appropriate, in line with the Inquiry's discussion.

1.5 Bank loss absorbing capital and recapitalisation capacity (Recommendation 3)

The Inquiry recommended:

- Implementing a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice. Such a framework would be sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.

ISA Position: Qualified Support

ISA recommends that should a framework be developed, caution must be taken considering the nature and concentration of bank debt holders, the reliance on market discipline, and the potential vulnerability of bail in mechanisms to arbitrage strategies.

While Australia's banking system remains highly concentrated with a handful of systemically important or too-big-to-fail institutions, specific measures are required to reduce both the benefit that this affords the large banks due to implicit public guarantee and the direct cost to the taxpayer in the event of a failure.

Two policy measures are appropriate to achieve these outcomes:

- *Ex ante* levy on systemically large banks (discussed in next section)
- Loss absorbing and recapitalisation capacity framework

Loss absorbing and recapitalisation capacity frameworks are being developed to varying degrees internationally.

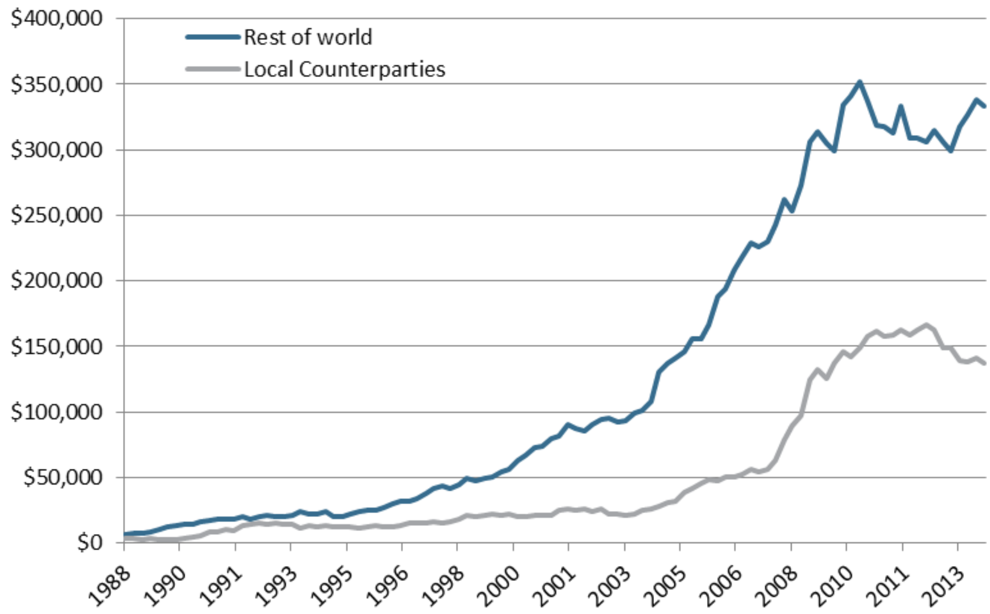
ISA agrees with the Inquiry's finding that development in this "area is complex and evolving."[18] The main areas of development are determining which instruments should be eligible for inclusion in a loss absorbing and recapitalisation capacity requirement, the creditor hierarchy and layers of subordination between classes, the mechanisms and triggers under which creditors will absorb losses, and how to ensure financial stability is maintained in the event of a recapitalisation or "bail in".

ISA recommends that the government proceed cautiously, if at all, with bail in mechanisms. This is because of (i) the nature and concentration of bank debt holders, (ii) the potentially misplaced reliance on market discipline underlying the bail in concept, and (iii) the potential vulnerability of bail in mechanisms to arbitrage strategies. At a minimum, if the government implements bail in instruments in Australia, it should consider adding additional capital buffers if bail in instruments are held by certain counterparties, like other banks and superannuation funds, as well as excluding bail in instruments from a bank's high loss absorbing capital, similar to other jurisdictions.

According to the ABS Financial Accounts, over 60 per cent of bank debt is held offshore as shown in Figure 3. The majority of this debt is issued by major banks.

[18] Financial System Inquiry, *Final Report*, December 2014, p 67

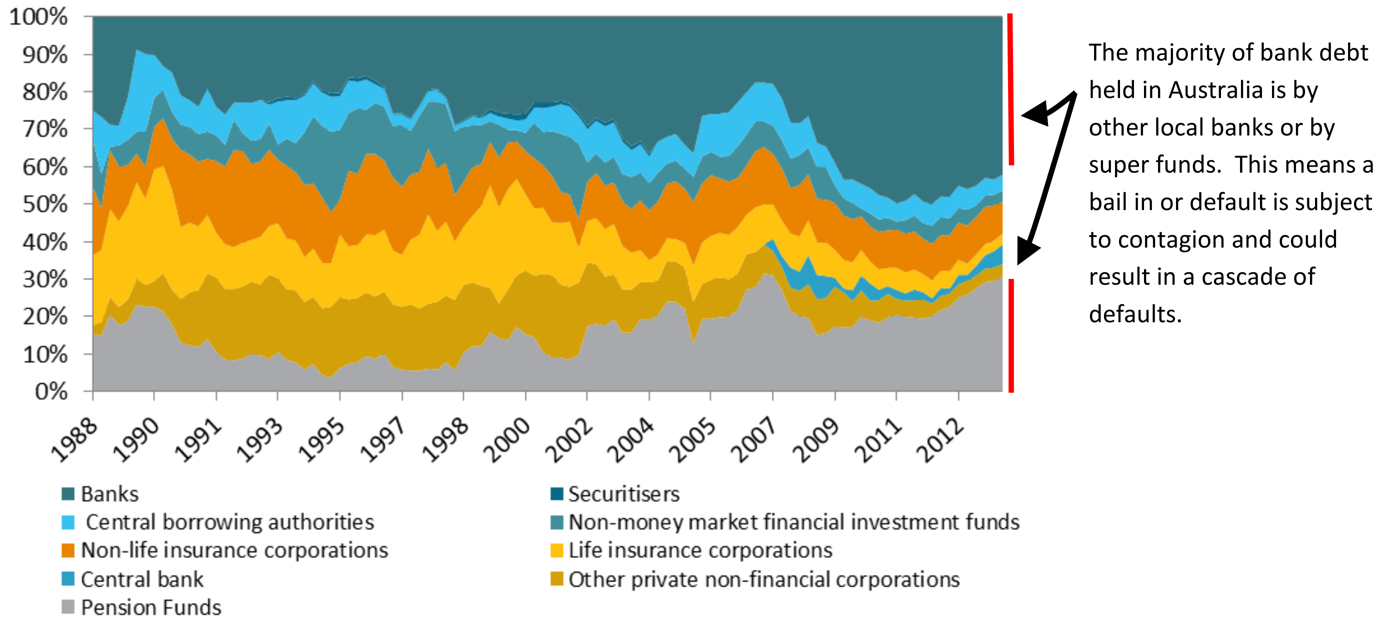
Figure 3 – Australian Bank Debt Outstanding by Counterparty, millions



Source: ABS 5232.0, Australian National Accounts, Financial Accounts, 2014

The major local holders of bank debt are other banks (40 per cent of local counterparties by dollars outstanding) and pension funds (30 per cent of local counterparties by dollars outstanding). Pension funds have grown in market share since the mid-1990s. As shown in Figure 4, this concentration of bank-debt counterparties is a recent phenomenon. The counterparties of bank debt were more diverse both before the GFC and during the time of the Wallis Inquiry. Non-life insurance corporations have maintained a relatively steady market-share of bank-debt since the 1990s and are currently the third largest local holder of bank debt. The fourth largest holder is the Reserve Bank of Australia. This is a new phenomenon since the GFC.

Figure 4 – Australian Bank Debt Outstanding by Local Counterparty, share by dollar value



Source: ABS 5232.0, Australian National Accounts: Financial Accounts, 2014

Based on the above data, the two local contagion risks from a conversion event are other banks and superannuation funds. With respect to banks holding the debt of other banks, the government should further assess the extent of this scenario and address it as appropriate through higher-loss absorbency.

Requiring a buffer of high loss absorbing (HLA) capital above Basel capital requirements and general requirements for D-SIBs, and deducting from this buffer the debt held by other Australian banks will strengthen the effectiveness and credibility of a bail-in mechanism. It is important to note that bank debt held at other banks is still eligible for conversion during a bail-in. An example of an approach to address the risks arising from cross holdings of bank debt is that taken in Canada, where the long-term senior debt of other banks or in a bank's own long-term senior debt are to be deducted from that bank's amount of debt outstanding for the purposes of meeting the HLA requirement.[19] Alternatively, the holding of bail-in convertible bonds could be prohibited under certain financial licenses, or similar hard rules to prevent other banks from holding these instruments.

With respect to superannuation, a bail-in of one or more Australian banks and the conversion of bank debt to equity may cause a significant and rapid shift in the strategic asset allocation of superannuation funds and the asset allocation of the sector more generally. Moreover, although superannuation funds are not mandated to any particular asset allocation, a number of measures are being considered that are likely to increase the extent to which superannuation savings are used to fund banks. In some instances, this result is the explicit intention of the proposed reforms.

It is not clear that superannuation funds are well positioned to weather bail-in events and hold the converted equity until the bank recovers. On the one hand, the superannuation system should be a resilient long-term investor. On the other hand, policy changes in recent years and anticipated in the coming years, particularly around default funds, are likely to cut against the long-term nature of superannuation.

It could be particularly tumultuous if a bail-in occurred, which shifted superannuation funds significantly away from their strategic asset allocation settings, and this caused the funds to rapidly sell down the now excess equity positions in the major banks. This behaviour, which may be individually rational, could nonetheless trigger a cascade of procyclical selling.

It must also be noted that the expectation that superannuation would play a material role in performing a bail-in of stressed banks means that government support is being applied indirectly – a significant amount of the funds in the superannuation system are public tax expenditures. Because these are managed by independent trustees, the moral hazard is not as acute.

In developing a bail-in mechanism for Australian D-SIBs, we recommend that the government carefully consider the impact such a scheme might have on superannuation. Given the contagion risk to superannuation (and that the presence of which may result in the public support of non-viable D-SIBs and therefore undermine the credibility of a bail-in mechanism), the government should consider deducting superannuation holdings, or some proportion of these, from any additional capital buffer for D-SIBS, such as that proposed by the Canadian Government for bank-held bank debt.

A second limitation of a bail-in regime stems from its reliance on market discipline to accurately price debt that is eligible for the bail-in. One of the lessons of the GFC is that market discipline, especially in banking, should not be relied upon without strong safeguards such as ring-fencing and increased disclosure of bank operations and revenues. Additional safeguards which should be considered in relation to bail-in mechanisms are discussed below.

[19] Government of Canada Department of Finance, *Taxpayer Protection and Bank Recapitalization Regime,* Consultation Paper, August 1, 2014

Lastly, bail in could have the unintended consequence of increasing the vulnerability of banks to arbitrage trading strategies. For example, if traders took a short position in a bank's equity and bought its subordinated debt in anticipation of conversion, the effect on market prices of each could accelerate financial distress. If the trigger events of bail-in bonds are opaque to the market, the discipline and warning effects of market participants are lost, but the risk of arbitrage and procyclical jumps to trigger points is reduced.

1.6 Financial claims scheme (Recommendation 6)

The Inquiry recommended:

- Maintaining the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.

ISA Position: Do Not Support

ISA proposes an ex ante funding structure for the Financial Claims Scheme (FCS) as it has the benefits of reducing systemic risk and moral hazard, and ensuring market efficiency through appropriately pricing the benefits of any government guarantee.

ISA believes a funded FCS scheme should only be implemented after the too-big-to-fail benefit of the major banks has been curtailed. Otherwise, the amounts contributed by banks into the scheme, assuming they would be based on credit ratings, will be distorted to the advantage of the major banks.

The provision of a government guarantee on deposits is a common feature of most developed banking systems.

ISA supports the ex ante funded Financial Claims Scheme (FCS) on the principle that it is consistent with the broader policy objectives of (i) reducing moral hazard in the banking industry and (ii) correcting competitive distortions by appropriately pricing deposit insurance.

The current FCS is pre or ex post funded, with the sole purpose of reimbursing depositors in a failed Australian ADI.[20] This has been recognised as a major weakness by the Council of Financial Regulators.[21]

An ex ante scheme with a risk-based levy has the benefits of reducing systemic risk and moral hazard and ensuring market efficiency through appropriately pricing the benefits of the insurance. In addition, as the current explicit guarantee provided under the FCS exists alongside the implicit guarantee of too-big-to-fail banks, a risk-based or tiered fee would be able to appropriately price the level of government insurance enjoyed by the different segments of the banking industry.

The IMF reached a similar conclusion during the Financial Sector Assessment Process in 2012 concluding that "an ex ante funded deposit guarantee scheme…appear to represent the best option for Australia since the infrastructure is already in place' to limit moral hazard in a highly concentrated banking system". [22]

The apparent argument against an ex ante funded scheme in Australia is that due to the high concentration of the banking industry, an ex ante would not raise sufficient funds to cover the losses incurred if one of the

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[20] Turner, Grant, 2011, Depositor Protection in Australia, RBA Bulletin, December Quarter 2011

[21] "In particular, the lack of a deposit insurance fee payable by depositors and the fact that the scheme is not pre-funded and there is no risk-based fee payable by ADIs arguably weakens the defences against the moral hazard of depositors… The FCS is assessed [against Principle 2 to reduce moral hazard] as non-compliant. While the FCS limit remains at its current level, and in the absence of a risk-based fee paid by depositors, the FCS creates a relatively high degree of moral hazard."

[22] International Monetary Fund, 2012, *Australia: Financial System Stability Assessment*, November 2012

major banks failed. Such an argument presumes an ex ante funded scheme is necessary to create a pool of funds adequate to cover losses incurred after the failure of an ADI. This is not the primary purpose of an ex ante funded scheme (which is to reduce moral hazard and ensure market efficiency). The fact that an implicit government guarantee is evident in bank debt pricing and ratings agency reports in part suggests that there is no limit on the government's ability to provide funding in dealing with a failed institution.

Pre-funding for the FCS should take into account the impact on an already concentrated industry. Any levy applied to the industry will have a negative impact on deposit-based funding costs. The extent of the cost borne by the institution vs. depositors depends on the banks willingness and ability to absorb the costs. It is therefore key that the design of the FCS levy take into account the funding mix of the various banking institutions and have regard for impact on competition.

1.7 Transparent reporting (Recommendation 4)

The Inquiry recommended:

- A reporting template for Australian authorised deposit-taking institution capital ratios be developed that is transparent against the minimum Basel capital framework.

***ISA Position: Qualified Support** - disclosures must remain ADI disclosures, not APRA disclosures*

The Inquiry recommended:

- The development of a reporting template for Australian ADI capital ratios that is transparent against the minimum Basel capital framework.

ISA does not support giving APRA responsibility for developing a reporting template for banks. This should properly be the responsibility of the banks. ISA would not object to APRA coordinating and participating in the process of developing a reporting template.

APRA's primary role as a prudential regulator of ADIs is to ensure that each ADI meets the capital requirements set for the Australian banking system. As discussed above, the particularities of the Australian banking system require some measures to be above the minimum requirements under Basel III.

APRA should not prepare or endorse disclosures by regulated firms.

One reason why investors might not ascribe significant weight to the comparability disclosures of the big banks could be the perceived credibility of the big banks.

We do not object to APRA coordinating Australian banks to develop a reporting template for Australian ADI capital ratios that is transparent against the minimum Basel capital framework. We would not consider it appropriate for APRA to create a reporting template.

If the state interest in this matter is to facilitate the ability of overseas investors to assess the relative capital levels of listed Australian banks compared to overseas banks, then ASIC would be the appropriate agency to consult on and establish reporting requirements, of course consulting with APRA.

1.8 Crisis management toolkit (Recommendation 5)

The Inquiry recommended:

- That the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry should be completed.

ISA Position: Support

ISA supports the continued implementation of the strengthened crisis management powers for APRA and the changes to the resolution arrangements and powers for FMI as recommended by the Council of Financial Regulators.

It is important to note that the effectiveness of the enhanced powers and increased pre-planning and pre-positioning is limited by how well the overall resolution regimes and prudential framework address the issue of too-big-to-fail. On their own, enhanced resolution powers and pre-planning and pre-positioning will have a marginal effect on reducing the phenomena of systemically important banks in Australia.

Similar resolution regimes in other jurisdictions have been designed in combination with a number of measures not currently in existence in Australia, nor recommended by the Inquiry. These include:

- Bail-in powers (EU, UK, US, Canada amongst others)
- Additional loss absorbency capital requirements (Canada)
- Ring-fencing of non-retail banking activities (US[23] and UK) and
- Ex ante resolution funds (EU)

In the absence of structural changes to the banking industry which remove institutions considered too-big-to-fail (such as ring-fencing as applied in the US and the UK), ISA again stresses the importance of implementing the recommendations discussed above in full and with unnecessary delay.

1.9 Direct borrowing by superannuation funds (Recommendation 8)

The Inquiry recommended:

- Removing the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.

ISA Position: Support

Superannuation should be savings, not borrowings.

As identified by the Inquiry, direct borrowing within superannuation has undermined, and will continue to undermine the objectives of the superannuation system in three ways. It will implicitly transfer some of the downside risk to taxpayers, who underwrite adverse outcomes in the superannuation system through the provision of the Age Pension. It allows members to optimise superannuation for wealth management rather than retirement savings by circumventing contribution caps. It undermines the ability of the superannuation system to act as an economic stabiliser, an assessment supported by both APRA and the RBA.

ISA supports the Inquiry's recommendation to prospectively prohibit direct leverage within superannuation. Indirect leverage should also be subject to prudent management. For APRA-regulated funds, leverage (including leverage embedded in investments) is already reviewed by trustees and prudentially reviewed. It is not clear how SMSF trustees monitor and manage indirect leverage.

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[23] For example, all of the resolution plans submitted by the 11 largest banks in the US were considered not to be credible by the FDIC and the Board of Governors of the Federal Reserve System. Under the Dodd-Frank Act, section 165(d), in the absence of a credible resolution regime, the FDIC and Federal Reserve can 'impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the [bank] company, or any subsidiary thereof'. Federal Deposit Insurance Corporation, *Selected Sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act* https://www.fdic.gov/regulations/reform/dfa_selections.html#1

Leverage prohibitions should apply prospectively, but grandfathering of previously entered debt positions should be for only a limited duration.

2. Superannuation and Retirement Incomes

2.1 Introduction

The Inquiry observed that in order to provide income in retirement, Australia's superannuation and retirement incomes system must be efficient. It also noted that an efficient system could play an important role in providing long-term funding for economic activity. However, the Inquiry concluded that the existing system is not as efficient as it could be due to a lack of strong, price-based competition, a lack of risk pooling, and an over reliance on individual account-based pensions.

ISA agrees that the system is not as efficient as it could be. This section sets out ISA's response to the Inquiry's recommendations to address this.

The Inquiry's examination of the existing system focused principally on the performance of the default fund part of the system. However, the evidence demonstrates that existing default funds are the strongest performing area of the superannuation system. In contrast, there is significant inefficiency in the retail choice and self-managed super fund part of the system and urgent reform is needed in this area.

Finally, the Inquiry observed that tax policy has a significant effect on the efficiency of the superannuation system. ISA agrees with this observation. ISA's view is that the Tax White Paper should consider ways to better target superannuation tax concessions to ensure that the superannuation system provides an objectively comfortable retirement to all Australians. ISA will be making comprehensive submissions to the Tax White Paper about this.

2.2 Objectives of the superannuation system (Recommendation 9)

The Inquiry recommended:

- That government "Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term."
- That the objective of the superannuation system should be "To provide income in retirement to substitute or supplement the Age Pension".

The recommendation is designed to, among other things, reduce the propensity of short-term, ad hoc policymaking in superannuation.

ISA Position: Support

ISA supports the recommendation to develop and legislate a formal policy objective of the superannuation system. As reflected in the submissions to the Inquiry, there is already substantial and broad agreement about the objective of the superannuation system. While the words vary, all submissions that discussed the objective of the superannuation system, in substance, express the view that the superannuation system should be oriented toward the provision of adequate retirement income or retirement security. In addition, the sole purpose test already provides a clear direction to trustees that superannuation savings are to be used for the primary purpose of providing retirement benefits.

Legislating a formal objective of the superannuation system will only be effective if it is for a clearly enunciated and agreed purpose. ISA's view is that legislating an objective for the superannuation system should be for the purpose of undertaking rigorous assessment of whether:

(a) the superannuation system is delivering on its objectives, and
(b) proposals to change the superannuation system will further, or undermine, the objectives of the system.

The formulation proposed by the Inquiry does not include a measurable goal. Therefore it could not be used to assess the performance of the superannuation system or the efficacy of policy proposals.

An objective for the superannuation system that is not measurable risks becoming a motherhood statement.

ISA's view is that the objective of the superannuation system is, together with the other components of the retirement system, *to deliver an objectively comfortable retirement to all Australians*.[24]

This formulation includes a clear, measurable goal of delivering an objectively comfortable retirement. It is able to be used to determine whether a policy proposal moves the country toward or away from the objective. It can also be used to assess the performance of the superannuation system as a whole.

In addition, because our formulation relies on an objective assessment of comfort, it is limited to fair and reasonable levels of public support. Policies that uplift members from minimal or simply adequate retirement are desirable. Retirement savings which are significantly beyond the level required should not attract the same public policy support. Put another way, our formulation intrinsically focuses policymakers on *targeted* and *efficient* reforms.

Importantly, ISA's formulation recognises that superannuation is a component of the retirement system as a whole. The formulation proposed by the Inquiry also recognises this.

Legislating the objective of the superannuation system should be supported by introducing formal, credible requirements for regular reviews of the performance of the system and assessing proposed changes to superannuation policy against the enunciated objective. The credibility of such a requirement requires that assessment be undertaken by a body that is independent of the government of the day.

The role of the Parliamentary Budget Office in providing independent and non-partisan analysis of the budget cycle, fiscal policy and the financial implications of proposals may provide a model for this function.

Our perspectives on the subsidiary objectives contained in the Financial System Inquiry (FSI) Final Report are set out here:

[24] The source and methodology of the determination of a 'comfortable' standard will be of critical importance. At this time, a principle is sufficient

Table 1 – Subsidiary Objectives

Subsidiary objective proposed by the FSI	ISA's comment
Facilitate consumption smoothing over the course of an individual's life	ISA recognises that consumption smoothing has economic benefits. However, we do not support this as an objective of the superannuation system. The opportunity for people to smooth consumption as a result of achieving an objectively comfortable retirement is better characterised as a consequence of a well-functioning superannuation system. It may be appropriate for private sector advisers and service providers to seek to facilitate consumption smoothing.
Help people manage financial risks in retirement	ISA recognises that people face many risks related to retirement income. The superannuation system may help to manage these risks. Moreover, some risks may not be appropriate for individuals or the private sector to bear; these risks should be transferred to the state rather than privately managed. However, we do not support this proposed subsidiary objective for the superannuation system. The opportunity for people to manage financial risks in retirement as a result of achieving an objectively comfortable retirement is better characterised as a consequence of a well-functioning superannuation system.
Be fully funded from savings	ISA supports this subsidiary objective. Superannuation is wages-based, and therefore it is less effective for those who are on low wages and/or experience long intervals outside of paid work, including many women. For this reason, governments that wish to use superannuation as an alternative to the Age Pension may make early-stage deposits into super on behalf of persons who otherwise would be likely to receive the full pension, so that compounding might result in a higher level of benefits per dollar of government resources. It is important that these government contributions are considered "savings."

Subsidiary objective proposed by the FSI	ISA's comment
Be invested in the best interests of super fund members	We support this as a subsidiary objective of the superannuation system. We agree with the Inquiry's observation that "Superannuation funds are managed for the sole benefit of members, which means the investment focus should be on maximising risk-adjusted returns, net of fees and taxes, over the lifetime of a member. This results in auxiliary benefits to the economy by creating a pool of savings to fund long-term investment." Trustees are currently required to ensure that their duties and powers are exercised in the best interests of beneficiaries under s 52 of the Superannuation Industry Supervision Act 1993.
Alleviate fiscal pressures on government from the retirement income system	ISA acknowledges the fiscal pressures on government from the retirement income system. However, we do not support this as an objective of the superannuation system. The opportunity to alleviate pressures on government from the retirement income system is better characterised as a consequence of a well-functioning superannuation system. Superannuation and the Age Pension should not be traded-off against each other. Instead the expenditures on the social objective of retirement income should be efficient (i.e., as low as possible which achieves the desired objective).

Subsidiary objective proposed by the FSI	ISA's comment
Be simple and efficient and provide safeguards	We agree entirely with the Inquiry's observation that "The system should achieve its objectives at the minimum cost to individuals and taxpayers. Complexity is less appropriate for a compulsory system, as it tends to add to costs and to favour sophisticated and well-informed investors. Given the compulsory nature of Superannuation Guarantee (SG) contributions, the system needs prudential oversight and should provide good outcomes in both the accumulation and retirement phases for disengaged fund members." The superannuation system should provide good outcomes for all fund members, including engaged members such as those who exercise choice. At present, inefficiency in the retail choice sector of the superannuation system is a significant problem. ISA recommends urgent reform to address this: see section 2.3.5. We would include within the notion of efficiency the capacity of funds to aggregate savings for investment. Collective action problems plague efficient investment. Self-managed super funds are particularly poor in this regard, with very little investment in productivity-enhancing capital. They are also poor value for members.

Superannuation as a source of long- term investment

Australia's infrastructure deficit is conservatively estimated to exceed $200 billion. Compulsory superannuation has generated $1 trillion in savings that would otherwise not have been available for investment. Superannuation assets are predicted to exceed banking system assets in 2033. The opportunity for the superannuation system to be a source of long-term investment in infrastructure and other illiquid assets is an important consequence of a well-functioning superannuation system. Changes to public policy are required to ensure that the capacity of the superannuation system to invest in infrastructure and other long-term investments continues to be facilitated.

An independent authority for retirement incomes

The Inquiry considered and rejected the prospect of establishing an independent authority for retirement incomes. We agree with the analysis and conclusion at this time. In the future, if superannuation policy was fairer, more equitable and sustainable, an independent authority may be better able to perform a stewardship function. Currently, significant reform is required.

2.3 Improving efficiency during accumulation (Recommendation 10)

The Inquiry recommended:

- Introducing a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.

ISA position: Do not support

ISA agrees with the Inquiry's conclusion that a "quality filter" must be applied to ensure that default funds are of high quality. However, an effective quality filter is already in place and is effective. Workplace default funds are currently screened for quality by the Fair Work Commission. The existing default fund selection process has worked well, with default funds out-performing the OECD average and the retail and choice sectors in Australia. The existing quality filter uses substantially the same criteria as those suggested by the Inquiry. ISA therefore does not agree that a new quality filter is required.

Instead, ISA recommends that the retail and choice sectors of the superannuation system require further scrutiny and reform to address consistent underperformance by funds selected through individual choice compared to default funds.

The Inquiry acknowledged the importance of behavioural finance in developing public policy for the financial system. Behavioural finance supports more intervention to structure or restrict choice in the superannuation system.

The findings of behavioural finance also provide support for further consumer protections including prohibiting banks from providing default super fund services where it provides other banking products or services to the employer, and requiring for-profit funds to meet a performance threshold for trustee beneficiaries before profits can be distributed by entities in the superannuation business to the corporate parent. Leakage from the super safety net into SMSFs or collective funds that are not approved by the selection process may also result in broader public costs (tax concessions and higher reliance on the aged pension). These costs can be reduced by requiring individuals who leave the safety net to meet certain eligibility conditions which demonstrate their capacity to safeguard the public interest in their superannuation.

2.3.1 A safety net is required to maintain demand-side competition to benefit members

One of the key seismic philosophical shifts underpinning the findings of the Inquiry (as compared to the Wallis Report) was the acceptance of learnings from the field of behavioural finance.

The key lessons from behavioural finance – that consumers often make seemingly irrational or ill-informed financial decisions, particularly when faced with complex or long-term choices – necessitates a rethinking of regulatory and consumer protection frameworks, and how these frameworks support strong demand side competition.

This "seismic shift" is perhaps most visible in relation to the Inquiry's recommendations regarding how best to drive efficiency in the superannuation sector and in particular, how the system ensures the best outcomes (in the form of maximising retirement income) for Australian members, and particularly the eight in 10 members who do not select their own super fund.

ISA welcomes key recommendations of the Inquiry in relation to how to drive more efficiency and demand-side competition in the superannuation sector.

The Inquiry emphasised the following points critical to the design of demand-side competition in the default superannuation sector.

Table 2 – Design issues to achieve a competitive superannuation industry

Design issues to achieve a competitive superannuation industry	FSI Commentary
Member disengagement means that there is little consumer driven competition in superannuation	*"Australia's superannuation system is different from a traditional competitive market. Compulsory contributions, coupled by a complex system, contribute to disengaged consumers and weak member-driven competition."*[25]
The regulatory framework must facilitate competitive pressure, due to the lack of consumer-driven competition. The purpose of such a regulatory framework is to increase efficiency, to improve member outcomes and reduce future dependence on the Age Pension	*"Government intervention in the superannuation system is warranted to improve the system's efficiency in the accumulation phase. The system lacks traditional market forces, due in part to substantial government intervention. Also, the outcomes of the superannuation system ultimately affect both its members and taxpayers through the level of Age Pension payments."*[26]
Employers are not well placed to select default products for their employees due to the risk of agency issues and employers' capacity in terms of time and expertise	*"Another factor contributing to the lack of member-driven competition is the role of employers in selecting default funds Although the benefits from a fund's performance fully accrue to employees, much of the cost of administering SG contributions are borne by employers. For this reason, the Productivity Commission (PC)'s inquiry into default superannuation funds in modern awards found employers "…might have little incentive to invest time and effort into making choices that are in the best interests of their employees. The PC also found that employers face high search costs, may lack information and expertise to make an appropriate choice for their employees and may choose a fund based on auxiliary benefits specific to the employer, such as low administrative requirements"*[27]

[25] Financial System Inquiry, *Final Report*, December 2014, p 105

[26] Financial System Inquiry, *Final Report*, December 2014, p 108

[27] Financial System Inquiry, *Final Report*, December 2014, p 105-106

Design issues to achieve a competitive superannuation industry	FSI Commentary
The option of allowing employers to select from any MySuper product was specifically dismissed by the Inquiry and the PC, on the basis that APRA approval of MySuper products was not a "quality filter", and that employers would be burdened with the significant compliance costs associated with having to make a selection from the large number of MySuper products	*"The PC's inquiry into default funds in awards found that a 'quality filter' is needed, stating, "The Stronger Super reforms serve largely to standardise features and promote disclosure to improve comparability between MySuper products, rather than filter out any products which may not represent the best interests of employees." The PC made a number of recommendations to improve the effectiveness of this filter, which the Inquiry supports and are yet to be implemented by government."*[28] The option of allowing an employer to choose any MySuper product as their default "*…could also increase employers' compliance costs, particularly new employers, by requiring them to select a fund from a large number of MySuper products that are not easily comparable.*"
The key metric for ensuring selection of high quality products which will serve the best interests of members are expected after fee returns.	*"Criteria for selecting the successful funds should focus on expected after-fee returns based on asset allocation and investment strategy, fees and past performance. This would help avoid fee reductions at the expense of member returns."*[29]
A review of the superannuation system should be undertaken by the PC by 2020, after the Stronger Super reforms have been fully implemented, before proceeding with further reform.	*"Although the Inquiry has some reservations regarding the extent to which the reforms will increase superannuation system efficiency, it recognises the need for full implementation of MySuper to allow it the opportunity to work before embarking on further reform. The outcomes of the reforms should be reviewed after all accrued default amounts have been rolled into MySuper products in 2017, by which time MySuper products will have been in operation for at least four years."*[30]

Source: FSI Final Report

2.3.2 Further evidence of agency problems associated with employer choice

Notwithstanding the very strong findings of both the Inquiry and the previous PC review of default fund arrangements, the major banks continue to press for deregulation of default funds, maintaining that an employer should be forced to choose from any MySuper product.[31]

Since the release of the FSI Final Report, further research points to significant activity by the major banks in providing incentives to employers to switch to a bank-owned default super product.

A survey of 550 small and medium businesses conducted by UMR[32] found that:

[28] Financial System Inquiry, *Final Report*, December 2014, p 111-112

[29] Financial System Inquiry, *Final Report*, December 2014, p 114

[30] Financial System Inquiry, *Final Report*, December 2014, p 111

[31] Loane, S., 2015, State of the Industry, Speech at the Deloitte Leadership Series Lunch 25 February 2015

[32] UMR Strategic Research, 2015, SME Employer Attitudes to Superannuation, prepared for Industry Super Australia, February 2015

- 26 per cent of employers surveyed said that a major bank had approached them about transferring their employees' default superannuation to the bank's own retail super fund in the last year
- Just under half those approached say their bank offered them benefits to change funds
- The most common offers made by the banks involved a direct benefit to the business rather than employees, such as discounts on business banking and insurance products. Some employers report being offered tickets to sporting events
- 33 per cent of employers offered benefits say they were persuaded to switch to a super fund promoted by their bank, and many more (57 per cent) report that they are still considering switching
- Two banks in particular appear to be the most active in approaching employers about switching default super fund arrangements and recommending their own fund

A copy of the research is attached as Appendix 1.

In addition, ISA has obtained legal advice from Arnold Bloch Leibler which confirms that breaches of the key prohibition against such activity, s68A of the SIS Act, does not attract a civil penalty, severely constraining the capacity of regulators to enforce this important consumer safeguard.

A copy of the advice is attached as Appendix 2.

The UMR Research highlights the significant consumer risk posed by the banks' proposal to remove the safety net which protects the interests of Australian members to enable the banks to exploit their market power and provide incentives of benefit to employers in order to increase their market share. The law must ensure that bank-owned MySuper products satisfy a merit based review process that assures the quality and net performance profile of their offerings before they can formally compete as default funds.

In effect, the law in this area is effectively unenforceable, requiring either a bank or employer to admit to entering into an arrangement that breaches s68A of the SIS Act, and then employees taking civil action once they can prove loss. While regulators have some capacity to investigate conduct which might contribute or be associated with s68A breaches, there is no direct regulatory oversight of the conduct of tenders for default superannuation funds. ISA submits that the only effective measure to guard against such anti-competitive conduct is to change the law to also prohibit a bank from providing business banking and default fund products to the same enterprise. We note that while this research reveals an alarming level of incentivisation by banks in order to win default fund market share in the SME sector, detecting this activity in larger businesses with more complex banking arrangements would be almost impossible.

ISA recommendation: Amend s68A to include an additional prohibition against providing business banking and default fund products to the same enterprise.

2.3.3 Will the Stronger Super reforms increase efficiency in the superannuation industry?

The inquiry places significant emphasis on the fact that the superannuation system could be more efficient, and notes that this would deliver significant benefits to individual members and to taxpayers in the form of higher net returns and retirement outcomes, and reduced outlays by future generations on the Age Pension.

ISA agrees with this finding, however, respectfully submits that by focusing entirely on the "default" or MySuper sector, the Inquiry failed to address the most serious and significant inefficiencies in the superannuation industry – the "choice" sector.

Both the Interim and Final Reports of the Inquiry commented on the comparatively high level of fees in Australia, and on how the substantial growth in scale over the past decade should have translated into significantly lower fees for members but that this has not occurred.

The Inquiry also raises concerns about whether the MySuper reforms will be effective in achieving significant improvement in efficiency. ISA agrees that the MySuper reforms alone will be unlikely to improve the efficiency of the superannuation industry – because the products with highest fees and lowest returns (over both short and long term periods) are concentrated in the choice sector, and that many of the members of these products cannot be assumed to be any more adept at making rational, informed decisions about their superannuation than those in default arrangements.

Inefficiency in the superannuation sector resides mainly in the "choice" sector and results from the indefinite grandfathering of commission arrangements in retail superannuation products. We therefore submit that efforts to improve efficiency in superannuation must focus first on the choice sector rather than the default sector.

2.3.4 Not-for-profit (default) funds are the most efficient part of the superannuation sector

ISA reiterates its evidence that the fee, cost and after fee performance profile of the industry in Australia is not heterogeneous and that it is critical to undertake this sectorial analysis in order to address inefficiencies in the superannuation sector.

The Inquiry also noted that a further efficiency yet to be realised by the MySuper reforms was the fact that accrued default amounts do not need to be rolled over into MySuper products until 2017. Contrary to claims about the lack of competition in the past in the default fund sector, 17 per cent of default funds in modern awards are retail funds[33]. As noted in ISA's submission to the Interim Report, historical net return data reveals that the retail products listed in modern awards have starkly underperformed the not-for - profit funds listed in modern awards.[34] However, there is a large number of retail and bank-owned products which act as default funds currently but which are not listed in the modern awards[35]. As of December 2014, $72 billion of assets held by the retail and bank-owned default funds are yet to be transferred into lower cost MySuper products. The slow pace at which the retail sector has transferred accrued default amounts reveals the conflict of interest inherent in the retail business model.

Had the retail sector transitioning members' accrued default amounts to MySuper products immediately (as did the not-for-profit sector) retail fund members would pay $600 million less in fees over the four years to 2017.[36]

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[33] APRA Superannuation Fund-level Profiles and Financial Performance, 2014

[34] ISA's analysis of Superratings data for 46 funds listed in Awards show that retail funds have substantially underperformed not for profit funds. The ten-year performance of retail fund is 5.27 per cent compared to 7.28 per cent of not for profit funds.

[35] A decision by the FWC's precursor, the Australian Industrial Relations Commission (Award Modernisation (AM2008/1-12) Decision 19 December 2008), enabled any superannuation fund that was receiving default superannuation contributions as of 12 September 2008 for the benefit of a single employee to be used by the employer as a default fund.

[36] Rainmaker Information, Cost to retail fund members of delaying the MySuper transition, Research Note, prepared for Industry Super Australia, November 2014

2.3.5 Intervention required in the choice sector if efficiency in the superannuation industry is to be improved

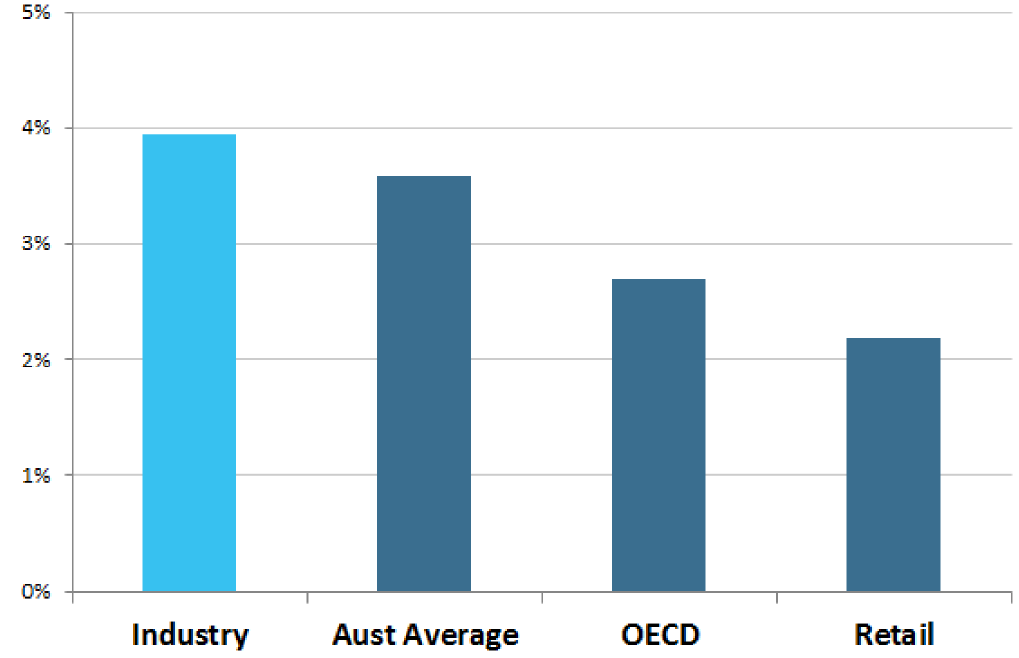
ISA strongly agrees with the Inquiry's findings that a "quality filter" safety net is critical to ensure that the best interests of members and of taxpayers' interest in the system are protected into the future. However, the evidence reveals that currently, the default sector is far more efficient, and that it experiences significantly lower cost and better net performance than the OECD average.

2.3.5.1 The retail choice sector

If we take the retail fund sector as a proxy for the "choice" sector,[37] the evidence shows that it is very inefficient, higher fee/cost and pays much lower net returns than both the OECD average and the average of not-for-profit funds (Figure 5 and Figure 6). The poor performance of the retail "choice" sector has and is likely to continue to drag the efficiency of our entire superannuation sector for many decades to come, unless there is some government intervention.

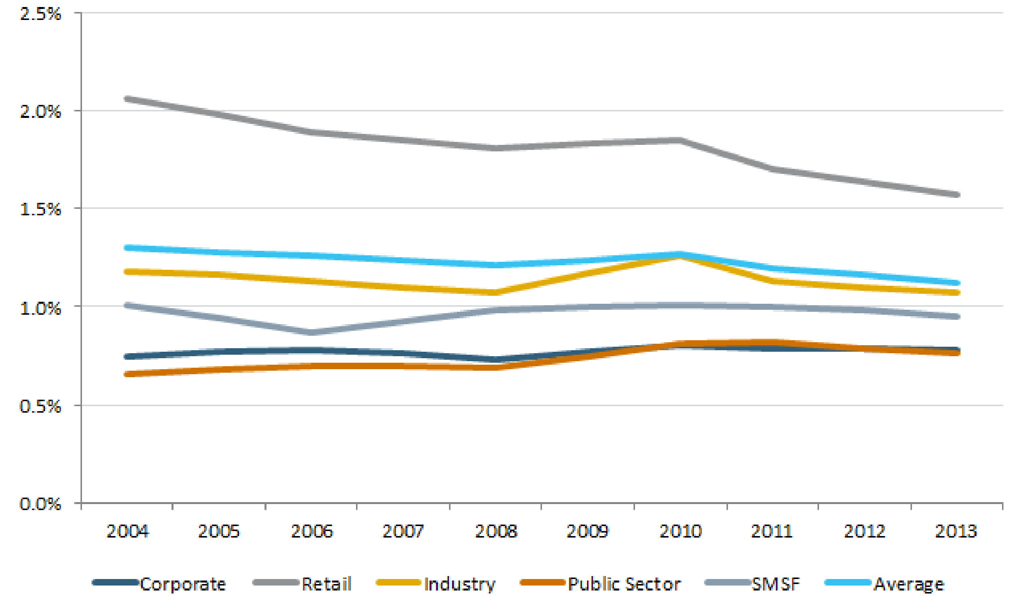
[37] The retail sector is the second largest sector of the APRA-regulated superannuation funds and accounts for 26 per cent of all superannuation assets. The sector also offers the most investment options for superannuation members, with the average of 700 options per funds according to APRA Superannuation Fund-level Profiles and Financial Performance 2014

Figure 5 – Average real returns, through 10 years ended 2013



Source: OECD and Australia Average: Pension Markets in Focus No.10, 2013, and No.11 2014; Industry and Retail: APRA Annual Superannuation Bulletin, June 2013 (revised 5 February 2014) adjusted to real using ABS CPI data

Figure 6 – Total fees



Source: Superannuation Fees Financial System inquiry http://fsi.gov.au/files/2014/12/Superannuation-fees.pdf

While the Inquiry provided extensive commentary and analysis of the default sector in its Reports, there was scant attention or analysis on the poor performance of this sector. The Inquiry made just a few passing comments on the choice sector. The Inquiry noted that one of the factors responsible for downward pressure on fees was the banning of commissions in the Future of Financial Advice Reforms (FoFA), which the Inquiry estimated should reduce prospective MySuper fees by 25 basis points.[38] In addition, in its

[38] Financial System Inquiry, *Final Report*, December 2014, p 107

consideration of potential design issues for a competitive process for selection of default funds, the Inquiry noted: "Outcomes in the default market represent a baseline against which choice products could be compared and could be expected to drive greater competition."[39]

The Inquiry also noted that a focus of the proposed PC Review should be competitive flow on effects of changes to the default fund selection process on the choice market.[40]

ISA submits that the current failings of the retail choice sector requires the most urgent attention by government and that it is misguided to assume that changes in the default sector will 'flow on' to the choice sector.

In our view, the behavioural economic lens should be used to bring into focus the inefficiencies of the choice sector. Retail choice products have been distributed to consumers over the past two decades through financial advice channels incentivised by commissions and other benefits to recommend these products. There is now wide acceptance that the availability of commissions provided an incentive for advisers to recommend underperforming bank-owned and retail products.

The indefinite grandfathering of commissions paid from these products will significantly retard the capacity for efficiency improvements to be achieved, as the agency issues associated with commission remuneration will continue to provide an incentive for advisers to leave their clients in these underperforming arrangements for as long as possible. Unlike the requirement for all MySuper products to remove commissions from 2017, there is no measure which will stimulate better efficiency or demand-side competition in the choice sector. While financial advisers continue to receive grandfathered commissions and indefinite ongoing asset fees, there is no incentive for them to advise their clients to move into more efficient commission-free products.

The retail sector is the largest sector of APRA-regulated superannuation funds with $422.8 billion in assets as at June 2013. This is 26 per cent of all superannuation assets and 38 per cent of all APRA-regulated superannuation assets.

Over the period June 1995 to June 2013, a period which almost matches the existence of universal superannuation, the industry superannuation sector has outperformed the retail superannuation sector by an average 1.69 per cent per year. The average annual return over the period for the industry superannuation sector was 5.80 per cent per, while for the retail superannuation sector it was 4.11 per cent.

The impact for individual consumers and for taxpayers of this gross sustained underperformance is profound. Comparing industry and retail fund returns at the individual level shows how the difference in returns influences an individual's superannuation balance at retirement. The two figures below compare the account balance of an individual with industry and retail fund returns.

Figure 7 shows that a male earning average weekly ordinary time earnings between 1996 and 2013, with an account balance of zero in 1996, would have almost $10,000 more in their superannuation if he earned industry fund returns, compared to retail fund returns. This is an eleven per cent difference based on fund earnings alone. This difference would be exacerbated if the individual made additional contributions above SG throughout this period. Figure 8 assumes a starting balance of $20,000. With industry fund returns the balance would be 17 per cent higher by 2013, compared to if retail fund returns were achieved.

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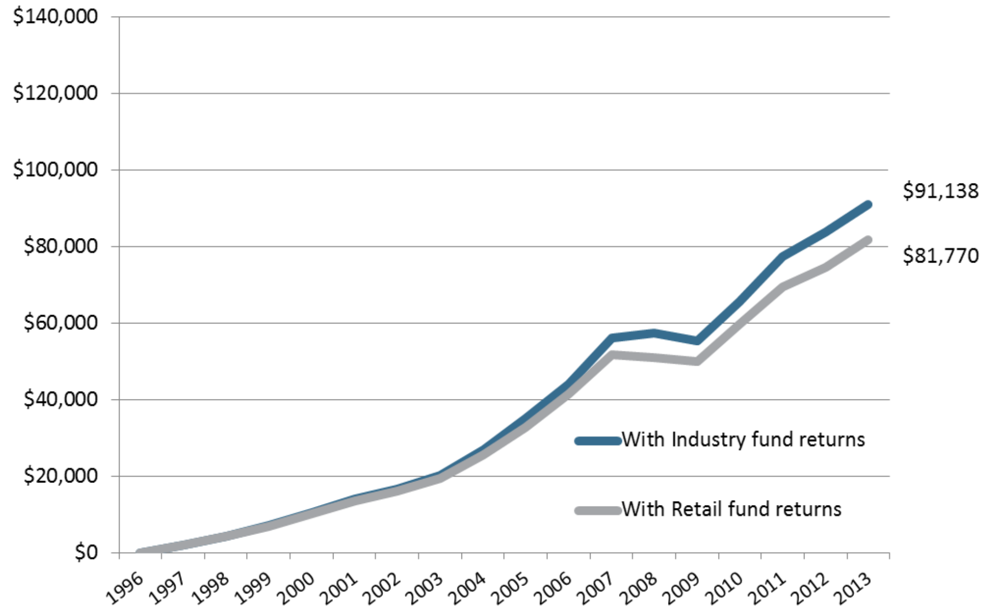
[39] Financial System Inquiry, *Final Report*, December 2014, Table 4, 115

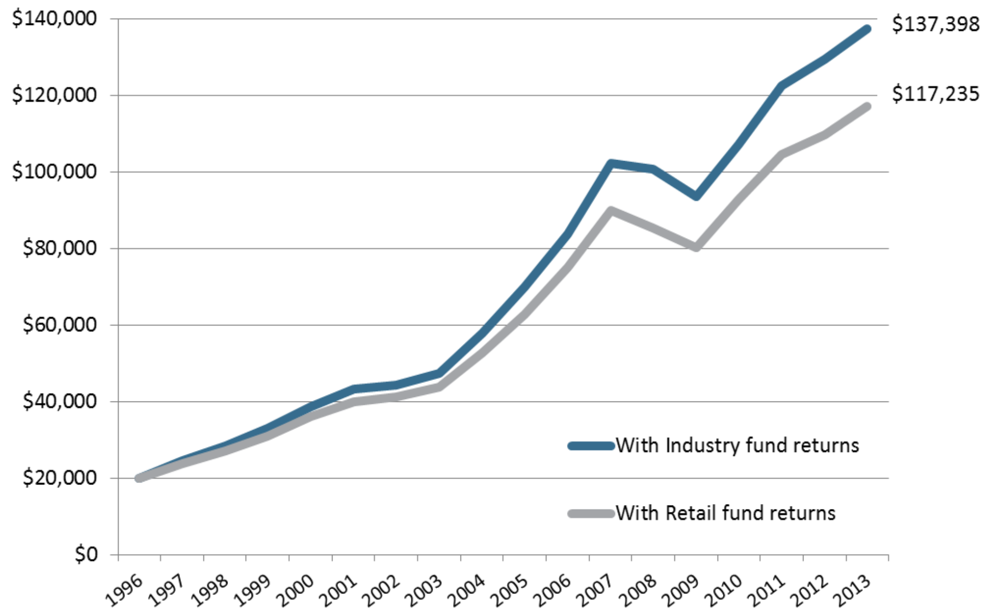
[40] Financial System Inquiry, *Final Report*, December 2014, 113

Figure 7 – Account balance for an individual – industry fund returns versus retail fund returns, starting balance of zero, June 1996 - June 2013



Source: APRA (2004) Supertrends, APRA (2013) Annual Superannuation Statistics.

Figure 8 – Account balance for an individual – industry fund returns versus retail fund returns, starting balance of $20,000, June 1996 - June 2013

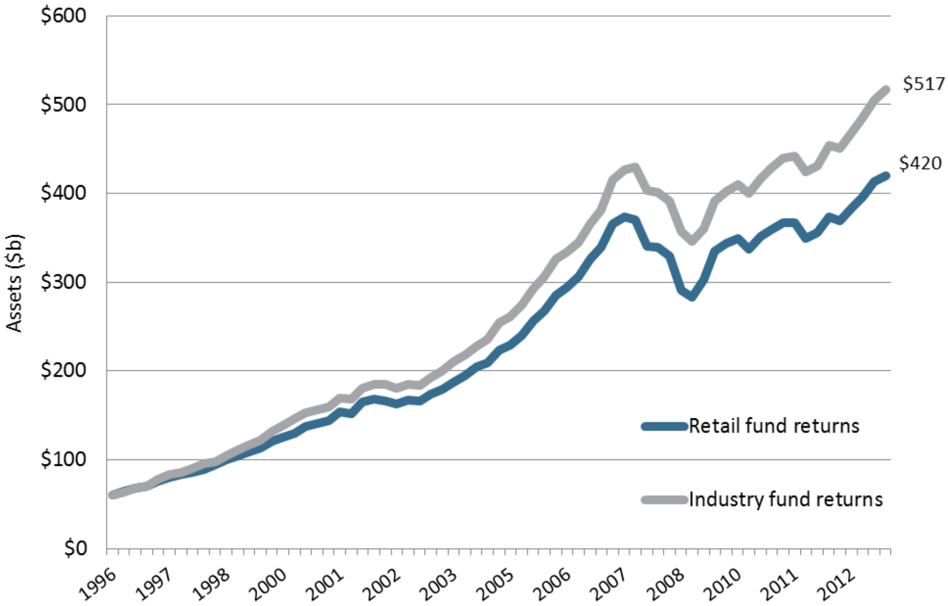


Source: APRA (2004) Supertrends, APRA (2013) Annual Superannuation Statistics

Moreover, each year of underperformance costs Australian retirees and workers billions of dollars in interest income foregone.

Figure 9 illustrates how retail fund assets would have grown if they had earned industry fund returns since 1996. With industry fund returns, the retail sector would have grown to $517 billion by June 2013, an improvement of $97 billion.

Figure 9 – Retail sector superannuation asset growth, with actual returns and industry fund returns, June 1996 - June 2013



Source: APRA (2004) Supertrends, APRA (2013) Quarterly Superannuation Performance

Note: This calculation is based upon APRA's Quarterly statistics which covers funds with assets exceeding $50 million. The total assets of these funds were $420.0 billion at June, 2013, slightly less than the total assets of the retail sector which was $422.8 billion

ISA recommends:

- The proposed PC review should have a central focus on the comparative efficiency of the retail choice sector compared to the default sector, and on developing proposals which will improve retirement outcomes in this sector. One option might be to require all advisers in receipt of ongoing commissions or advice fees on superannuation products to provide a specific advice to clients regarding whether their best interests continue to be served by that product.

2.3.5.2 The self-managed fund (SMSF) sector

Besides the retail choice sector, the self-managed fund sector (SMSF) also represents a major inefficiency issue for the superannuation industry. According to APRA, at September 2013 the SMSF sector was estimated to hold assets of $530 billion, having grown at about 10 per cent per year since 2007, compared to 5.4 per cent per year for APRA-regulated funds during the same period.[41] SMSFs are regulated by the Australian Tax Office (ATO) and hence, subject to a different regulatory framework than the APRA-regulated funds. To date, data released on SMSFs by the ATO are not directly comparable to their APRA-regulated counterparts.

However, recent research is beginning to provide concerning evidence which shows inefficiency, leverage and tax leakage in the sector.

[41] APRA Superannuation Bulletin 2013

Inefficiency

A recent paper by Arnold et al (2014) has shed light into the size and cost of SMSFs.[42] Figure 10 provides a breakdown of income, expenses and tax as a percentage of assets for the SMSF sample from 2008 to 2010, and ranks them by total asset size deciles. The level of expenses varies significantly between asset deciles. The difference in median expense ratio between the lowest and the highest asset decile is large (2.56 per cent). Most of the differences in expenses between the two groups are in insurance premium and management and administration expenses, pointing to the benefits of scale in SMSFs.

Additionally, the evidence points out that the top decile SMSFs (average account balance of more than $2.2 million) also benefit from lower tax expense ratio compared to the lower deciles. The top decile SMSFs only pay a tax expense ratio of 0.87 per cent while the bottom decile SMSFs' tax expense ratios are 3.78 per cent. This difference is driven primarily by tax on contributions and investment income. As SMSFs asset size grows, the ratio of tax on contributions and investment incomes will become progressively lower due to the flat tax rate structure in superannuation.

For most SMSF account holders, the running costs of SMSFs are significantly higher than the average fees charged in not-for-profit APRA-regulated funds (see Figure 11). These expense levels represent a significant leakage from the superannuation system, resulting in lower retirement accumulations for those with SMSFs. SMSF trustees and account holders with assets in this range are likely to qualify for full or part Age Pensions, so reduced accumulations in this range will also result in increased public pension outlays in coming years.

Figure 10 – Breakdown of income, expenses and tax for SMSF sample, % of mean assets, 2008-2010, ranked by total assets size deciles

Decile band		**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Mean as a percentage of total assets (mean) - all years												
Income												
Capital gains	48,234	0.88%	1.04%	1.13%	1.12%	1.17%	1.19%	1.09%	1.08%	1.06%	1.16%	1.12%
Rent	32,560	0.10%	0.15%	0.25%	0.37%	0.53%	0.62%	0.78%	0.84%	0.89%	0.78%	0.75%
Interest received	185,190	1.78%	1.45%	1.35%	1.30%	1.21%	1.20%	1.19%	1.17%	1.22%	1.26%	1.24%
Foreign income	72,899	0.07%	0.09%	0.12%	0.14%	0.15%	0.15%	0.15%	0.15%	0.16%	0.16%	0.16%
Dividends received	120,642	1.04%	1.13%	1.18%	1.20%	1.21%	1.19%	1.12%	1.13%	1.13%	1.13%	1.14%
Concessional contributions received	155,094	26.98%	17.64%	11.53%	11.66%	9.47%	8.60%	7.89%	6.98%	5.89%	3.62%	6.15%
Other income		0.03%	-0.13%	-0.08%	-0.04%	-0.03%	-0.04%	0.06%	0.13%	0.15%	0.25%	0.15%
Total income		30.87%	21.36%	15.48%	15.75%	13.72%	12.92%	12.28%	11.49%	10.50%	8.35%	10.69%
Less: expenses												
Interest paid	19,040	0.13%	0.11%	0.11%	0.09%	0.08%	0.08%	0.08%	0.06%	0.04%	0.02%	0.04%
Depreciation	14,680	0.08%	0.04%	0.03%	0.03%	0.03%	0.04%	0.05%	0.06%	0.05%	0.03%	0.04%
Insurance premiums paid	38,741	1.31%	0.63%	0.49%	0.37%	0.27%	0.21%	0.17%	0.14%	0.10%	0.05%	0.13%
Audit fees	98,532	0.64%	0.31%	0.21%	0.16%	0.13%	0.10%	0.08%	0.06%	0.04%	0.02%	0.06%
Investment expenses	57,923	0.48%	0.30%	0.28%	0.27%	0.28%	0.28%	0.28%	0.25%	0.24%	0.16%	0.22%
Management & administration expenses	177,328	2.85%	1.37%	1.04%	0.86%	0.71%	0.61%	0.51%	0.42%	0.34%	0.20%	0.40%
Other expenses	47,846	0.93%	0.41%	0.28%	0.21%	0.17%	0.15%	0.13%	0.12%	0.09%	0.05%	0.10%
Total expenses (mean)		6.43%	3.16%	2.43%	1.99%	1.66%	1.47%	1.30%	1.10%	0.90%	0.53%	1.00%
Total expenses (median)		*2.92%*	*1.84%*	*1.52%*	*1.28%*	*1.09%*	*0.97%*	*0.85%*	*0.72%*	*0.60%*	*0.36%*	*0.52%*
Net income before tax		24.44%	18.20%	13.05%	13.76%	12.06%	11.45%	10.98%	10.38%	9.60%	7.82%	9.69%
Less: income tax												
Tax on contributions		4.05%	2.65%	1.73%	1.75%	1.42%	1.29%	1.18%	1.05%	0.88%	0.54%	0.92%
Tax on investment income		0.13%	0.35%	0.45%	0.51%	0.56%	0.59%	0.61%	0.65%	0.69%	0.76%	0.66%
Less: franking credits	119,076	-0.39%	-0.44%	-0.46%	-0.47%	-0.47%	-0.46%	-0.43%	-0.44%	-0.44%	-0.44%	-0.44%
Net income tax expense		3.78%	2.55%	1.72%	1.79%	1.51%	1.42%	1.36%	1.26%	1.14%	0.87%	1.14%
Net income after tax		20.66%	15.65%	11.33%	11.97%	10.54%	10.03%	9.62%	9.13%	8.46%	6.95%	8.55%
Net income after tax (excluding contributions)		-2.27%	0.66%	1.53%	2.06%	2.49%	2.72%	2.91%	3.19%	3.45%	3.88%	3.33%
n		*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*209,420*

Source: Arnold, B, Bateman, H. & Raftery, A., 2014, The size, cost and asset allocations of Australian self-managed superannuation funds, Centre for International Finance and Regulation.

[42] Arnold, B, Bateman, H. & Raftery, A., 2014, The size, cost and asset allocations of Australian self-managed superannuation funds, Centre for International Finance and Regulation

Figure 11 – Comparison of superannuation models[43]

		Member Profile				Costs (bps)					Fees[3] (bps)	After Fee returns (bps) (2005-2011)		
		Members (#m)	Assets (A$b)	Avg. Balance (A$k)	Member age : (share %)	Invest.	OpEx	Total	Insurance	Tax		3yr	5yr	7yr
APRA regulated	Retail	15.5	358.2	23.3	<35: 32.6% 35-49: 37.8%	10.9	74.8	85.7	31.1	20.0	146.6	82.9	104.4	410.9
APRA regulated	Industry	11.5	245.6	21.3	<35: 50% 35-49: 30.3%	35.6	48.1	83.7	24.0	11.9	86.8	159.7	298.5	640.0
APRA regulated	Corporate Super	0.53	53.7	95.5	<35: 32.6% 35-49: 40.9%	29.7	29.5	59.3	7.1	1.2	75.4	286.7	280.1	632.4
APRA regulated	Public Sector	2.2	110.3	49.6	<35: 24.6% 35-49: 36.9%	18.6	23.4	42.0	10.7	3.5	74.0	145.0	321.3	650.6
APRA regulated	MySuper[1]	N/A	N/A	N/A	N/A	8.9	74.8	83.7	N/A	N/A	106.0	112.1	119.5	445.4
	SMSF[2] ($500k)	0.96[4]	506.0[4]	524.9	<35: 9.7% 35-44: 23% 45-54: 30.2%	35.0[6]	56.0[4]	91.0	N/A	N/A	93.8[5]	383.4[2]	486.8[2]	787.2[2]
	SMSF[7] (median)	-	-	264	N/A	28	111	139	27	9[8]	175	249[8]	n.a.	n.a.
	SMSF[9] (bottom quintile)			80	N/A	30	223	253	63.00	(9)	307	66[8]		

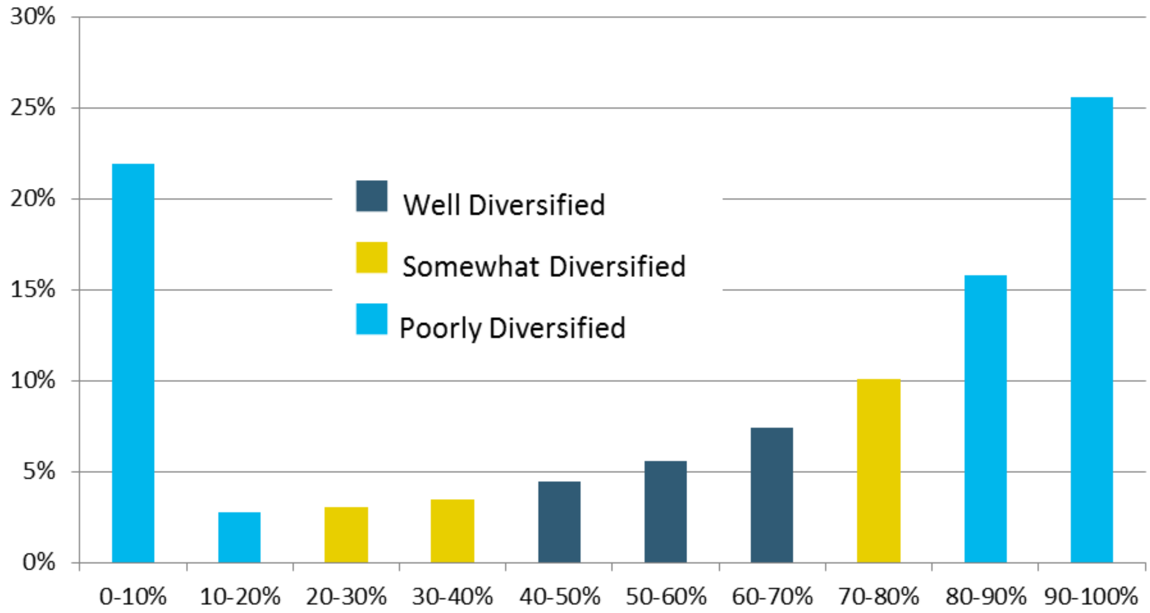
Note: SMSF information is derived from a different source and is not directly comparable. Member profile information for SMSF source ATO June 2013. Information provided for remaining member profile, costs are a 5 year average. derived from APRA fund level data.
1. Based on average retail MySuper fund. Where estimates that pre-date MySuper were required the actual investment returns of the underlying investment option were used. Where estimates post-date MySuper then the historical default investment option returns (as rated by SuperRatings Balanced (60-76) Index) are used 2. SMSF source Rice Warner 2013 3. Retail, industry, corporate, public sector fees calculated on amount charged on $500k investment Superratings data 18/8/2014 4. ATO SMSF Statistical Overview 5. Based on mid range cost of full administration on $500k investment in SMSF fund, Rice Warner 2013 6. Low level investment fee range for SMSF funds, Rice Warner 2013 7. Median SMSF performance, income and expense data based on median (by assets) fund decile from CIFR Research paper (" size, cost and asset allocation of Australian SMSF", Arnold *et al*, July 2014) 8. Excludes tax and income associated with contributions to fund 9. Based on the second decile by fund size from CIFR research paper (Arnold *et al.*, July 2014). For these funds franking credits reported to provide a net tax benefit (vs. expense)
Source: APRA Superannuation Fund-level Profiles and Financial Performance, June 2013 (issued 8 January 2014), Rice Warner Costs of Operating SMSFs 2013, ATO SMSF Statistical review, ISA Analysis, BCG Analysis

Source: BCG & ISA Analysis in ISA Submission to the Interim Report

In terms of asset allocation, SMSFs are poorly diversified, with around two-thirds having the overwhelming majority of assets in either high risk assets or low risk assets, rather than an appropriate combination of the two (Figure 12).

[43] Corporate and public sector funds are not public offer. They are included in the analysis to support the inference that their defining characteristics (distribution and balance size), which are features of the default system, are positively associated with net performance and lower operating costs

Figure 12 – Distribution of asset diversification: percentage of assets held in growth assets, 2010



Source: ISA modelling based on ATO data cited in Raftery (2013)[44]

It is clear from this evidence that only SMSFs with significantly large size will benefit from the efficiency in operation, scale and tax benefits. Figure 11 shows that the typical or median SMSF underperforms APRA-regulated funds on a three-year basis.

Overall, SMSFs can be expensive and poorly diversified options for most account holders except for those with significant account balance. ISA therefore contends that any future PC review should also closely examine the comparative efficiency of the SMSF sector. Furthermore, it may be appropriate to consider additional safeguards to ensure that SMSFs are in line with the purpose of retirement saving.

ISA recommends that members who would like to exit the safety net of default funds into SMSFs would need to meet certain eligibility conditions, such as significant account balance. The account balance can be set periodically following regular review into the efficiency of the sector.

Leverage

As observed in the Interim Report, SMSFs have been increasingly leveraged. In the year to April 2014, the number of SMSFs using geared products increased by more than 11 per cent.[45] The concentration in property is also a concern due to SMSFs taking benefit from negative gearing through limited recourse borrowings. Between 2008 and 2013, SMSF investment in residential property increased from $10.6 billion to $17.5 billion. Including all instalment receipts and borrowings, the SMSF exposure to property is in the order of $85 billion.[46]

[44] Raftery, A., 2013, The size, cost, asset allocation and audit attributes of Australian self-managed supranational funds. PHD Dissertation.

[45] Investment Trends 2014, SMSF Investor Report, April. Note: Based on a survey of 2,163 SMSF trustees

[46] ATO Self-managed super fund statistical report March 2014

ISA support the Inquiry's recommendation to prospectively prohibit direct leverage within superannuation (See Section 1.9). ISA is also concerned about the level of indirect leverage (such as leverage embedded in investments) in SMSFs. APRA-regulated funds' indirect leverage is reviewed by trustees and prudentially reviewed. It is not clear how indirect leverage is managed and reviewed by SMSFs' trustees. ISA recommends that this issue to be considered as part of the PC review.

ISA recommends:

- Prohibiting direct leverage within superannuation
- Reviewing direct leverage practice in SMSFs

Tax Leakage

SMSFs popularity is mainly because it is an effective tax shelter and estate planning vehicle.[47] Tria Investment Partners estimates that SMSFs have been paying no net tax since 2010 onwards (Figure 13). Given that SMSFs account for 31 per cent of total superannuation assets as of June 2013, their net tax paid is low compared to the net tax paid by APRA-regulated funds.

To date, there has been no comprehensive report into the level of tax minimisation strategy employed by SMSFs. However, some of the more popular strategies have been mentioned and described as 'tax leakage' in the press. For example, SMSF account holders who are more than 55 would start drawing a tax-free pension from their funds while tipping their salary to the fund, reducing their marginal tax rate to 15 per cent. Alternatively, some may make voluntary contributions of up to $450,000 (using the three-year roll forward)[48] or pay inter-family loans through superannuation fund.[49] Furthermore, SMSFs benefit from negative gearing through limited recourse borrowing, which is not available to a business entity, or to trusts regulated by APRA. This effectively takes an individual benefit and provides it in a trust environment.

The use of SMSFs as wealth creation, estate planning and tax sheltering vehicles is not in line with the objectives of retirement saving. Tax leakage in SMSFs also presents a pressing issue to improve the equity of superannuation tax arrangements.

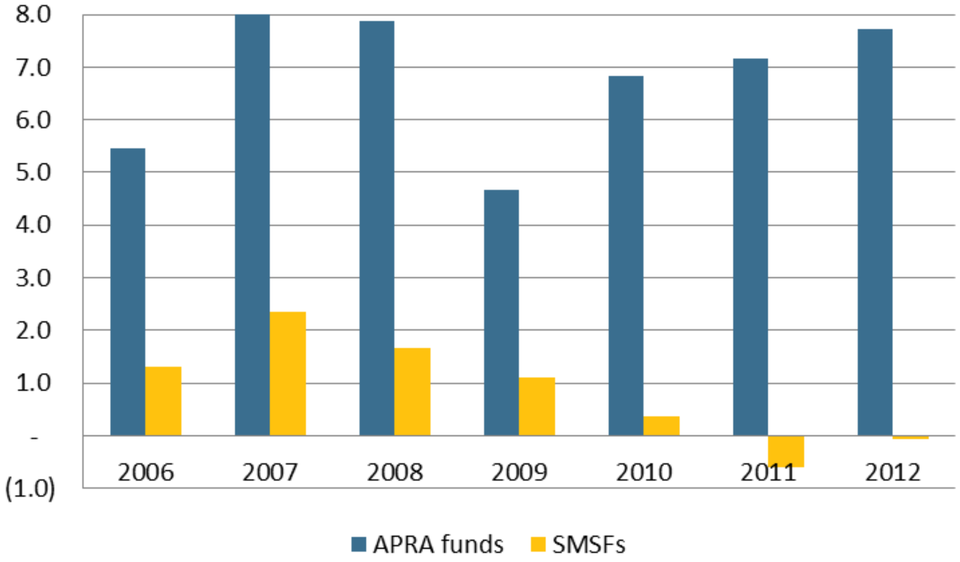
ISA recommends that the equity of tax arrangements in superannuation and how it is exploited in SMSFs should be addressed as part of the current tax reform process.

[47] Based on ATO data, 'SMSFs are paying no net tax – even taking taxable contributions into account - at least for the three years through to 2012.' - Tria Investment Partners, 12 May 2014

[48] The bring forward roll allows a member under 65 to roll forward two years' worth of non-concessional contributions ($360,000) into one year to maximum of $540,000 over three years without attracting a higher tax rate.

[49] King, A., 2014, 'Tax leakage' alarm over super-wealthy SMSFs', the Australian Financial Review, May 21 2014 http://www.afr.com/news/politics/national/tax-leakage-alarm-over-superwealthy-smsfs-20140603-iubtk

Figure 13 – Net tax paid by SMSFs and APRA-regulated funds 2006-2012, billions



Source: Australian Tax Office Statistics 2011-2012. ISA calculation based on methodology from Tria Investment Partners[50]

Note: Net tax paid is calculated as the net of PAYG instalments raised & total amount due or refundable

Data and reporting quality

It is critical that the data quality of the net performance of the SMSF sector is continuously improved to allow proper analysis of the sector and on the retirement outcomes it delivers to members. It is highly desirable that the ATO's SMSF reporting standards should be brought in line with APRA-regulated funds. The data limitations and methodological differences have historically affected the ability to compare SMSFs and other super funds. While allowing for the differences in nature of SMSFs and APRA-regulated funds (e.g. SMSFs do not have contribution fees, buy/sell spreads, insurance premiums and exit fees), it is essential that some major measurements are consistent.

ISA recommends:

- Consistent valuation and accounting practice between APRA-regulated funds and SMSFs. Currently, while APRA funds must report assets at market value, SMSFs are only required to do so in limited circumstances. This may lead to incorrect calculation of returns on assets.
- Consistent treatment of tax. In some SMSFs, taxes are treated on a cash basis while all APRA-funds treat tax on accruals basis. Consistent tax treatment and reporting will ensure that net returns are properly calculated.
- Clearer cost and expenses collection regime for SMSFs. The cost amounts for SMSFs are based on the amounts of deductible expenses in SMSF annual tax returns. The ATO suggests that this may lead to costs being under or overstated. ISA suggests that relevant regulators should work with government to create a more consistent data collection regime to enable better analysis of the efficiency of the SMSF sector.

[50] Baker, A., 2014, 'What's worth $500bn and is paying no tax?', SMSF Adviser, Wednesday 28 May 2014 http://www.smsfadviseronline.com.au/columns/item/196-what-s-worth-500bn-and-is-paying-no-tax

2.3.6 Proposed review to design a new competitive process for default fund selection

The Inquiry recommended:

- That following the full implementation of the MySuper reforms, a PC review be conducted to examine the efficiency and competitiveness of the superannuation system, and to design a new competitive process for default fund selection to replace the role of the Fair Work Commission.

ISA notes our comments in section 2.3 regarding the need for a primary focus of any such review on the least efficient part of the superannuation sector, the choice segment and its concentration of high cost, underperforming products.

ISA also reiterates our strong support for the Inquiry's findings that the retention of a "quality filter" to screen default funds is critical to engineer demand-side competition in the absence of strong consumer engagement (see section 2.3).

Implicit in the Inquiry's recommendations is the expectation that the process to filter default products in modern awards by the Fair Work Commission (FWC) be fully implemented. Indeed, the Inquiry supported implementing the PC recommendations to "improve the effectiveness of this filter".[51] This process is currently awaiting the appointment of additional Expert Panel members to the FWC. ISA recommends that this appointment should be made expeditiously to allow the process to be fully implemented.

However, ISA strongly disagrees with the recommendation to create an alternative process to screen and shortlist default funds, and to enroll new entrants into these default funds. Our reasons are as follows:

- The procedure in the FWC will achieve the primary policy objective, which is to provide a competitive, transparent, impartial to shortlist only the highest quality MySuper products as default funds, and drive funds to compete on the basis of strong long-term returns to members, after fees.
- Given the prior success of the FWC process, and the enhancements made, there is no basis for changing the existing approach.
- While the Inquiry's analysis of the default superannuation market was detailed, there was little focus on why an alternative venue would be superior to the FWC. For this recommendation to have merit, the Inquiry needed to make the case that the existing FWC process has not succeeded or would not be reasonably likely to succeed in the future. The Inquiry did not, and did not even attempt, to make the case that the FWC process is of poor quality. Indeed, the key elements that the Inquiry believed should be included in a default fund selection process are substantially similar to the existing FWC process, including that a core selection criteria is net returns. To the extent that any future review determines that some modifications are warranted, these can be achieved through amendments to the current framework.
- Indeed, the FWC is a unique quasi-judicial tribunal which routinely must adopt a bifocal approach in terms of balancing individual and macroeconomic outcomes. The FWC is experienced in considering competing submissions, and providing the infrastructure for administering a transparent and objective review of default funds according to legislated criteria. It would be inefficient to create another body or process to determine default fund selection which is substantially similar.
- Further, under the current system, by combining default arrangements with other industrial matters, compliance costs for employers are reduced, as guidance on default arrangements are located with other information about their obligations as employers.

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[51] Financial System Inquiry, *Final Report*, December 2014, p 111-112

- Superannuation is one of the major successes of public policy since Federation. It is not just another financial product, but forms a very important component of an employee's entitlements. Opposition to superannuation being dealt with as an industrial issue has no basis, other than ideological.
- The current process facilitates tailored arrangements that are suited to workers in particular industries – e.g. insurance. The demographics of current default funds not only influence their asset allocations but also determine the level of appropriate services such as advice or member communication. For example, funds with younger member base may tend to adapt their communication using new technology. Funds servicing high-risk industry may negotiate to attain the right level of insurance for members.

The existing selection process for default funds in modern awards has worked well, and uses substantially similar selection criteria to those proposed by the Inquiry.

ISA recommends that the government should promptly honour its commitment to appoint additional Expert Panel members to the FWC.

Finally, ISA notes that the existing system has facilitated the capacity for default superannuation funds to invest in infrastructure and other illiquid investments. This capacity has improved returns for members compared with the retail funds, leading to improved retirement outcomes. It has also delivered broader benefits to the economy. Ensuring that default funds can continue to maintain the same focus on long-term investment is critical to maintain strong member returns, improving retirement outcomes and to overcome Australia's infrastructure deficit over the next decade.

ISA recommends:

- ISA proposes that the process recommended by the PC and legislated by government be permitted to be implemented; this requires further Expert Panel members to be appointed to the FWC and MySuper products to be filtered for listing in modern awards.
- ISA supports the Inquiry's suggestion that no further reform be considered until after the current reforms are fully implemented, and a further PC review be conducted to examine the efficiency and competitiveness of the superannuation system with a primary focus on improving the efficiency of the least efficient part of the superannuation sector, the choice segment and its concentration of high cost, underperforming products.
- We also reiterate our strong support for the Inquiry's findings that the retention of a "quality filter" to screen default funds is critical to engineer demand-side competition in the absence of strong consumer engagement.

2.4 The retirement phase of superannuation (Recommendation 11)

The Inquiry recommended:

- That government "Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed."

ISA position: Qualified Support. Recommend that the retirement incomes system includes a strong default. Recommend modifications to the Comprehensive Income Product for Retirement, and regulatory change to facilitate defined ambition plans. Recommend that Treasury should develop a discussion paper on structural issues in the retirement incomes system, including the design of an appropriate default and alignment with the objectives of the system

2.4.1 Introduction

ISA supports the need for changes to the superannuation system to ensure that members are defaulted into a high performing retirement income stream.

The Inquiry separated the superannuation system into an “accumulation phase” and a “retirement income” phase. A system truly oriented toward retirement income has no distinct phases (or only one phase), and the fund structure and products are all oriented toward its purpose. This is clear by looking at structures overseas and in Australia whose purpose has always clearly been retirement income, such as defined benefit plans.

Were the Inquiry given more time, it likely would have detected the tension between its recommendation that the superannuation system should be oriented toward retirement income, on the one hand, and its recommendation that structurally locks in a “retirement product” that is distinct from the rest of the superannuation offering, on the other hand.

Given the Inquiry's recommendation that the superannuation system should be to provide retirement income, superannuation offerings should always be a “retirement product,” and members – and, importantly, trustees – should always design their product with retirement income in mind.

ISA recommends that the retirement incomes system should include a strong default mechanism. The lessons from behavioural finance and the success of the existing default fund process point clearly to the need to adopt a default process for selecting retirement income streams for members.

While the Inquiry’s recommendations regarding regulatory changes to retirement income products should enable Australians to also enjoy the innovative defined ambition plans being developed overseas, such as the “pension income builder” and “collective defined contribution” plans, Australia’s retirement incomes policy settings would also benefit from evaluating retirement structures that have worked or are being developed overseas.

For example, in March 2015 the United Kingdom enacted its Pensions Schemes Act 2015, following several years of study and consultation. A central part of the Pensions Schemes Act is that it enables collective defined contribution plans. The Inquiry should have given due regard to the efforts of other jurisdictions to respond to the inherent problems of defined contribution plans.

Australia’s retirement incomes system is immature. The public policy issues are complex. In July 2014, Treasury released a consultation paper on Australia’s retirement incomes stream regulation. ISA recommends that Treasury should develop a separate discussion paper on structural issues in the retirement incomes system, including the design of an appropriate default and alignment with the objectives of the system. The paper should also evaluate the various options, including the Comprehensive Income Product for Retirement recommended by the Inquiry, taking account of ISA’s recommended modifications which are set out in this section. It should also explore the relative benefits of defined ambition plans, such as collective defined contribution plans. The focus should be on evaluating which products deliver the best outcomes for members. It should also identify what changes to regulatory settings are needed as the retirement incomes system matures.

This process must also include extensive consultation and close examination of international developments.

2.4.2 The Comprehensive Income Product for Retirement (CIPR)

The Inquiry acknowledges that consumers facing the market for retirement income products would find it very challenging. Consumers have poor visibility of their life expectancy, are generally inferior at investing relative to professional managers, have potentially competing objectives between income and stability, and product selection can be sensitive to complex tax law. The difficulties sit on top of the behavioural and cognitive factors identified by behavioural economics researchers.

ISA agrees that the proposed CIPR would help reduce these problems relative to existing policy settings.

Nonetheless, the CIPR could be substantively improved in two ways. Firstly, it requires an express shift by the member and by trustees from accumulation into the retirement phase. This is fundamentally an artificial event in a true retirement income system. It may have harmful consequences, such as undesirable crystallisation of capital gains, and forcing a complex choice to be made at a time when individuals are perhaps less well-suited to make decisions.

Secondly, the CIPR is not a true default. As a result, it will expose everyone to a potential point of sale. The Inquiry "sought to balance the desire to increase system efficiency in providing retirement incomes with a degree of individual freedom and choice. The Inquiry favours an approach that preserves freedom and choice. However, if introducing pre-selected CIPRs does not achieve the intended objectives of this recommendation, government could consider forms of defaults that commence automatically on retirement."

This decision to provide choice, and then seek to wind it back if results were inadequate, is curious because it has proven difficult for governments to reduce choices after they have been provided, even when doing so is in the individual's best interest. This is not necessarily because the vast majority of individuals want to retain choice (though some do who have products which enable tax and regulatory arbitrage), but because financial service providers want to continue to sell products that would not satisfy rational, impartial scrutiny.

ISA recommends the following modifications to the proposed CIPR:

- The product should not be a separate "retirement phase" product, but part of a whole-of-life product, which would better reflect the retirement income purpose of the system.
- The product should be a true default. The superannuation system should not force members to make a financial product choice. Government has determined to outsource a significant component of its retirement security duty to the private sector via superannuation. Accordingly, this system must be designed to accommodate all Australians, including those who – quite rationally – would prefer to simply have their savings allocated and distributed by professionals in their best interest, without micromanagement or sales pressures by private parties. A true default would also facilitate consumer protection: the CIPR inflection point, because it forces a point of sale at a time when members have their highest amount of savings and whose cognitive abilities generally will not be at their peak, might come to resemble the Serengeti river crossing, where voracious crocodiles prey.

2.4.3 Collective Defined Contribution plans

As noted above, on 3 March 2015, the United Kingdom passed the Pensions Schemes Act 2015. A central element of the Act was the enabling of Collective Defined Contribution plans (or CDCs).

CDCs involve fixed employer contributions (as is currently the case in Australia).

Plan assets are pooled, rather than members having a discrete pot of money earmarked solely for them. Investment policy is executed on an aggregate basis, without the need for member involvement. Benefits are conceived of and expressed in terms of pension payments (not accumulated balances).

The key benefits of a CDC include:

- Superior pension payment outcomes: paying benefits from the plan rather than converting discrete lump sums into an annuity enables a greater amount of plan assets to be allocated to investments in higher performing assets. Annuities are typically backed by defensive assets, and deliver suboptimal returns over the long time frames of modern retirement (over 25 years). Paying benefits from the plan rather than an annuity also is far more efficient: there is no profit margin or cost of capital owed to an insurance provider. All assets are put to work for beneficiaries only.

- Superior investment outcomes with less volatility: CDCs enable investment risk to be spread across a larger pool of diverse beneficiaries. Actuarial and investment models enable investment risk to be shared and enjoyed by the pool.

The UK government Actuary found that CDCs "exhibit superior performance on average when compared to conventional DC plans. In theory this improvement is in the order of 20 to 25 per cent, but in the simulation it is as high as 39 per cent for some members. Even when tough conditions are imposed on CDC, the median pension outcome from a CDC scheme is higher than the median outcome for a DC scheme."[52]

Research and analysis of the CDC structure has found that it produces:

- Higher average pension payments relative to defined contribution comparators[53]
- Not only are outcomes better on average, but the variability of outcomes is reduced[54]
- Investment is undertaken by professionals rather than members, giving regard to the substantial evidence that DC plan members are unwilling or unable to make effective, complex investment decisions, and unable to effectively estimate life expectancy
- Easier to realise scale benefits
- A focus on income rather than account balance

The UK consulted heavily on CDCs and ultimately determined to amend its laws to enable them because "Evidence suggests that collective schemes provide a greater degree of stability in pension incomes than individual DC, because demographic and financial risks are pooled across the membership. In recognition of this, the responses received during the consultation period were largely positive."

In addition to a positive overall consultation, CDCs were supported in the UK by employers[55] and consumers.[56]

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[52] Department for Work and Pensions; December 2009, *Modelling Collective Defined Contribution Schemes: A summary of The Government Actuary's Department modelling of collective defined contribution schemes*

[53] Global actuarial firm AON Hewitt modelled the CDC structure's performance against a conservative, a growth, and a lifestyle allocation in a DC plan using historical market data from 1955 through 2012 and found that "the average pension from the CDC plan is bigger than the average pension from all three DC schemes." Note, this analysis also is a comparison of CDC against DC with annuities

[54] See above: (finding that "[T]he CDC plan gives smoother outcomes for members.")

Forward looking projections reached the same conclusions: "The median projected pension for the CDC plan is higher than for all 3 DC scenarios… the distribution of outcomes broken into deciles [shows that] the CDC outcomes are consistently higher at every decile than the DC outcomes. So the distribution of ultimate outcomes may be wider for the CDC plan than its DC comparators – but the unpredictable element is just how much better it will be than the corresponding DC scheme! Furthermore, the CDC plan delivers a smoother ride to members as they accrue benefits in the plan (in spite of the greater exposure to equities)." Id

[55] Steve Johnson, 'Work on CDC schemes could be put on ice despite demand', The Financial Times, March 15, 2015 7:12 am, accessed on 27/03/2015 from http://www.ft.com/intl/cms/s/0/9371f076-c8da-11e4-bc64-00144feab7de.html?siteedition=intl#axzz3UaVkBr4D

[56] 'Collective pension model gains ministerial support', The Actuary, 27 January 2014 http://www.theactuary.com/news/2014/01/collective-pension-model-gains-ministerial-support/

The UK undertook legislative reform so that it could embrace international best practice.

"The collective benefit definition enables a new form of risk pooling among scheme members that can provide greater stability in outcome for members—partly by virtue of scale. Collective pension schemes are a key part of some other countries' pension systems—for example, the Netherlands and some of the provinces of Canada—and they are recognised internationally as being of high quality. As we aspire to develop a pension system that is rated among the world's best—we hope the best—it is only right that the United Kingdom should also have pension schemes offering these types of benefits."[57]

This is an ambition that Australia should share, and Australia should also enable CDCs. If the Australian Government wishes to encourage retirement income policy change in the public interest, it should at a minimum enable the introduction of CDCs in Australia, like the UK has done.

2.5 Choice of fund (Recommendation 12)

The Inquiry recommended:

- Giving all employees the ability to choose the fund into which their Superannuation Guarantee (SG) contributions are paid.

ISA Position: Qualified Support

ISA agrees in principle that everyone should be able to choose where their SG contributions go to.

In considering this issue, it is important to consider the evidence about the reasons why a minority of employees cannot exercise choice. The vast majority of instances in which choice does not operate at a workplace relate to circumstances in which there is a state-based scheme for which the federal government does not have constitutional power. While very significant media coverage has been fuelled by claims that there are many individuals who are denied choice by Enterprise Agreement clauses which mandate a particular superannuation fund, in most cases choice is not available due to other factors. Certainly we would query the reliability of the claim that 20 per cent of employees cannot choose their own fund, given the reliability of sample size and methodology used in the ASFA research.

Another important factor to consider is the impact of choice on those who exercise it and on the superannuation system as a whole.

There is clear evidence that choice is one of the reasons why the cost of the Australian superannuation system is higher than other countries. This is because the availability of choice has resulted in an increase in retailisation activities. Offering choices in financial services leads to expensive activities to attract consumers such as advertising, sales, customer interaction, and administration.

Figure 14 shows the advertising, administrative, and support costs involved in retail financial services. For a major retail banking business, the total costs are roughly in the range of two to three billion dollars per year on average. For retail wealth management, the total costs are roughly in the range of one to one and one-half billion dollars per year, on average. For comparison, the total operational expenses (including advertising, administrative, and similar costs) for an average major not-for-profit super fund are only about ten per cent of this, coming in at under $145 million per year.[58]

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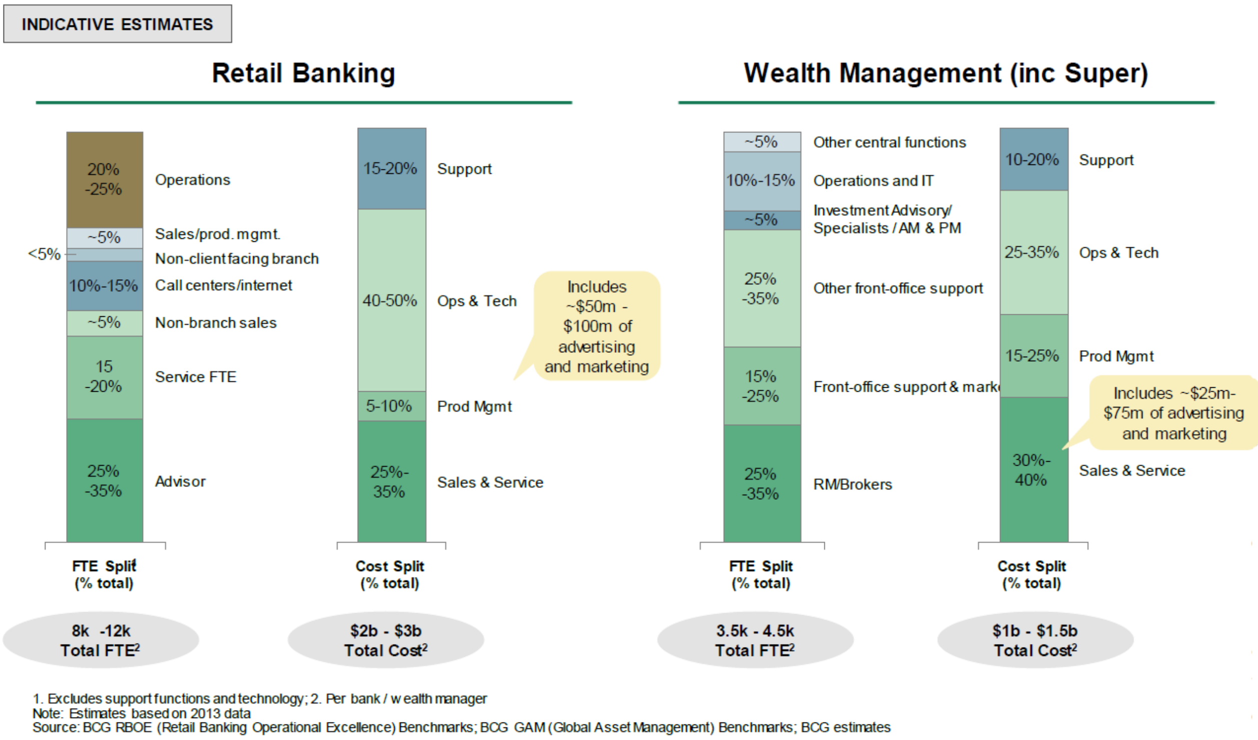
[57] Lord Bourne of Aberystwyth, 2014, Pension Scheme Bill Second Reading, The UK Parliament http://www.publications.parliament.uk/pa/ld201415/ldhansrd/text/141216-0001.htm

[58] See, APRA Fund Level Reports 2012-2013 (operating expenses include expenses incurred which are not ordinarily directly associated with the generation of investment income (i.e. expenses that are not directly related to the investment portfolio of the superannuation entity, but more toward the administration of the superannuation entity))

Figure 14 – Retail financial services costings (average major institution)



Source: BCG

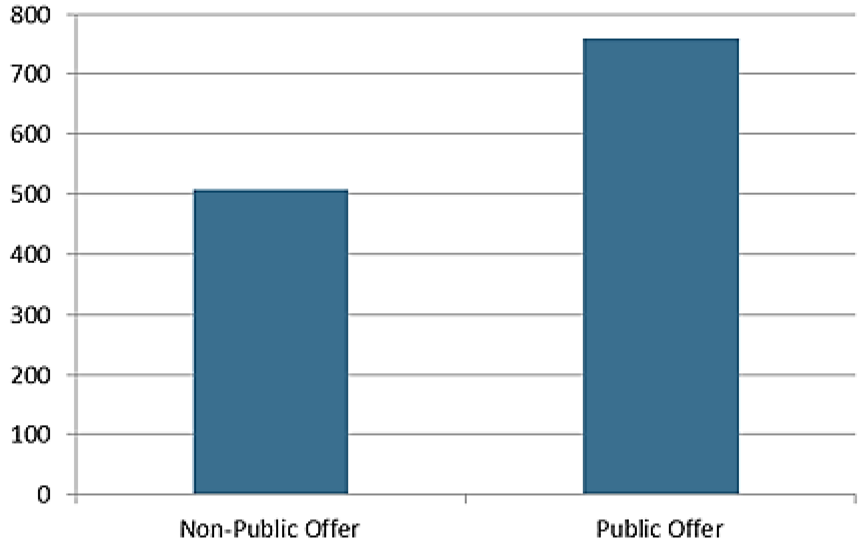
The costs of retailisation in superannuation can also be seen through an analysis of the costs of public offer relative to non-public offer funds. Some superannuation funds are not open to the public and do not compete in a retail environment (but do need to provide quality administration, investment, and other services). By comparing the administrative, operating, and marketing costs of these funds (i.e., non-public offer funds) to funds that are public offer enables an analysis of the costs of retailisation.

Figure 15 shows the average annual fees for similar public offer and non-public offer funds between 2008 and 2013. Public sector and corporate sector funds have been excluded as their fees are heavily subsidised by their sponsoring institution; were they included the disparity between public offer and non-public offer would be even greater. The fees shown are calculated on an account balance of $50,000. The figure demonstrates that the fees (on a $50,000 balance) for public offer funds have been 50 per cent higher than those for non-public offer funds between 2008 and 2013 ($761 per year compared to $507 per year).

Because these operating expenses are not decomposed, it is difficult to make direct comparisons or to specifically identify the underlying reasons for such significant differences between the indicative estimates of an average retail financial institution and an average major not-for-profit superannuation fund.

Insofar as costs are a function of an institution's assets, this may explain some of the differences

Figure 15 – Costs and retailisation



Source: SuperRatings

The Inquiry acknowledged that the introduction of choice of fund has not led to lower fees for members.[59]

It is therefore important to impose appropriate safeguards to ensure that members who exercise choice are not worse off as a result. Funds and advisers should be required to ensure that members that exercise choice are not worse off as a result.

The FoFA reforms introduced a requirement for advisers who give personal advice about superannuation to act in the best interests of their client. ASIC's guidance on this obligation states that:

"When assessing whether an advice provider has complied with the best interests duty, we will consider whether a reasonable advice provider would believe that the client is likely to be in a better position if the client follows the advice."[60]

This provides some level of consumer protection for members who exercise choice on the basis of personal advice. However, additional protections are required.

First, the review by the Productivity Commission into the choice segment of the superannuation system should consider mechanisms to ensure members who seek to leave a default fund will be no worse off. These mechanisms would include personal advice in the best interest of the client and free of conflicted remuneration. For members who seek to leave a default fund without receiving personal advice, the Commission should consider whether a duty should be placed on the default fund or the recipient fund to certify that the member would be no worse off after giving effect to a transfer.

Second, we recommend specific application guidance be developed for the targeted and principles-based product design and distribution obligation recommended by the Inquiry. In particular, providers and/or distributors of superannuation funds that target the choice market should be required to (i) consider whether or not members of default funds would be worse off if they switched, and (ii) develop and implement effective measures to ensure members of default funds who could be worse off are not induced to switch. Alternatively, APRA may consider whether a trustee's fiduciary duty requires a similar responsibility.

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[59] Financial System Inquiry, *Final Report*, p 104-105

[60] ASIC Regulatory Guide 175 at 175.225

2.6 Governance of superannuation funds (Recommendation 13)

The Inquiry recommended:

- Mandating a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; aligning the director penalty regime with managed investment schemes; and strengthening the conflict of interest requirements.

ISA position: Do not support recommendations regarding board composition

ISA's view is that two decades of uninterrupted net outperformance provides empirical evidence of good governance of industry super funds.

The significant and sustained outperformance of the not-for-profit superannuation sector more broadly is no coincidence – it is directly related to representative governance arrangements which ensure the trustee boards have an undivided loyalty to the members of the fund.

The Inquiry's recommendation to mandate a majority of "independent" directors and an independent chair has been made without any evidence that this proposal will improve the governance arrangements in super funds which have a representative trustee structure. It seems ironic that while the retail wealth industry remains mired in controversy and scandal, with a business model that has consistently prioritised the interests of shareholders of parent entities over clients/members, directly resulting in billions of dollars of losses to Australian members and consumers (and ultimately the Australian economy), the governance focus of this Inquiry has inexplicably focused on the sector of the superannuation industry which has delivered most successfully for its members over the past decades.

Industry super funds support strong and effective governance arrangements. Industry super funds were supportive of increased governance requirements imposed through the Stronger Super reforms, and on empowering APRA to work with funds in implementing these higher prudential standards. In particular, the revised Prudential Standards set a higher bar in relation to directors' fitness, skill and expertise, to a board's policies around management of conflicts of interest, transparency, risk management and board tenure (among other revised requirements).

Over the past 20 years, representative trustee boards have developed organically to best suit the needs of the particular demographic of each fund. This has included introducing independent trustees or chairs in instances where the board has considered this will add value to the skills matrix and board dynamics. Many boards have developed processes which allow for independent and expert input into key decision making bodies, such as investment committees. These changes have resulted in a healthy diversity of board models within the industry which best suit the needs of the relevant membership. Representative trustee boards are drawn from diverse backgrounds, are less likely to be blinkered by conventional financial background perspectives, and the balance of employer and employee representation means at its heart the equal representative model is premised on consensus, with members' interests given utmost priority.

In the context of superannuation, good governance is about enhancing the quality of decision making of the trustee such that it produces superior risk-adjusted net returns to members (and otherwise supports good retirement outcomes). Eliminating the conflicts of interest that undermine performance and undercut the ability of the fund to maximise retirement outcomes is a critical part of accomplishing this goal. The representative trustee model is a direct response to this conflict and has produced superior retirement outcomes for members.

A fundamental weakness in the current governance debate insofar as it relates to industry super funds (and other representative trustee funds) is the assumption that because it is desirable to impose independent directors on the boards of a listed company, the same is true of representative trustee boards. However, the public debate has not benefited by any clarity as to who such directors would be independent of, nor by a universally agreed definition of "independent". In the context of listed companies and retail super funds it is clearly independent of management. However, representative trustees have not only demonstrated a track record of superior net performance, innovative investment approaches which have delivered strong returns to members and to the Australian economy and a principled and strenuous objection to conflicted remuneration models in Australia, representative trustee governance arrangements are typical for pension funds through the OECD (see Table 2).

ISA respectfully submits that although the Inquiry seeks to rely on several academic pieces in support of its recommendation, the research referred to does not actually support the thesis that replacing representative trustees with "independent" trustees improves governance or fund performance. In particular, the Final Report cited the research by Ambatchtsheer in 2007 which links good governance and pension fund returns.[61] However, in the updated research in 2008, it is clear that Ambatchtsheer and his co-authors have not included the proportion of independent directors as a measurement of quality governance. Instead, a board's quality is measured by CEO views on trustee skills, experience, appropriate behaviours and the right motivations.[62]

Indeed, it should not be assumed that the imposition of independent directors or chairs will add value in all instances.

Most recently, a study by the McKell Institute examined the relationship between governance structures in the superannuation sector and fund performance. The research found a strong relationship between the existing representative structure of industry funds and the higher levels of returns delivered by the not-for-profit sector. [63]

The research found that the evidence does not support the view that mandating independent directors on not-for-profit superannuation funds would improve fund performance. Instead, research and empirical data suggests strongly that the representative trustee governance structure of industry and other not-for-profit funds is actually the model that most closely satisfies the objectives of meeting the best interests of members and maximising retirement incomes for Australians.

As well as generating higher net returns for fund members, the representative governance model has promoted higher levels of diversity among trustees, and more effectively minimises conflicts.

Further, the research concluded that the most serious structural issues in governance are found in the retail sector. These issues include:

- Greater prevalence of multiple directorships on the boards of retail funds
- Retail fund directors spend much less time of fund matters
- Retail fund directors are commonly employed by the fund or employed by service providers to the fund, creating a conflict of interest
- Service providers to retail funds are much more likely to be related entities to the fund

In addition, a separate study looking at the governance and performance of APRA-regulated funds found no evidence that board independence and chairman independence affect funds' performance.[64] Moreover, empirical research on US public pension funds indicates that the proportion of "outside" trustees on the

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[61] Ambachtsheer, K, 2007, Pension Revolution: A Solution to the Pensions Crisis, John Wiley & Sons, Hoboken

[62] Ambachtsheer, K, Capelle, R. and Lum, H., 2008, The Pension Governance Deficit: Still with Us. Rotman International Journal of Pension Management

[63] McKell Institute, The Success of Representative Governance on Superannuation Boards (2014)

[64] Liu, K., 2014, Governance and Performance of Private Pension Funds: Australian evidence, School of Risk and Actuarial Studies, University of New South Wales, Australia http://papers.ssrn.com.ezlibproxy.unisa.edu.au/sol3/papers.cfm?abstract_id=2484380

board has no significant relationship with funds' excess outperformance. [65] Other research studies undertaken by international and Australian academics also show that the introduction of majority independent arrangements on boards either adds limited or negative value to boards.[66]

There is a stronger argument against the introduction of a level of independent representation on boards. Detrimental outcomes can include a tendency to homogeneous thinking and a transfer of power to company executives. Given the important public policy objective of superannuation, too much is at stake for superficial or theoretical approaches to governance. Governance requirements should rest upon clear empirical evidence; the case for change has not been made.

Furthermore, the inclusion of more independent directors on superannuation fund boards will lead to a rise in the cost of board fees. An analysis of board fees in the top 20 not-for-profit funds show that the average annual fees for an independent director are $83,820, which is 62 per cent higher than the fees for representative trustee directors. This translates to an additional cost of $3.5 million per year to the sector if the boards of super funds are required to have a majority of independent directors.[67] Such cost increase is not justified, given that the benefits of independent directors are not supported by solid empirical evidence. ISA proposes changes that will continue to facilitate and encourage the organic process of governance change in a manner that ensures that governance structures adopted are consistent with a trustees' obligation to make decisions, including governance decisions, which are in the best interests of beneficiaries.

Government should seek to retain the strengths of the representative trustee system and work with the superannuation industry to continue to enhance governance arrangements to ensure the industry keeps up with, or is ahead of community expectations. This submission proposes a process to achieve this outcome:

ISA recommends:

- Consultation regarding an appropriate definition of independence, recognising that the relevant ASX Corporate Governance Principle could be a starting point for consideration

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[65] Harper, J., 2008, Board of Trustee Composition and Investment Performance of US Public Pension Plans. International Centre for Pension Management

[66] Frederick Tung of the Boston University School of Law (2011) suggested that there was no solid empirical evidence to suggest that independent directors add value

Fischer and Swan (2013) concluded that the introduction of independent directors resulted in large and statistically significant falls in performance indicators. The study compared the performance of 969 Australian companies over the nine years to 2011, including 561 that changed their board structure following the introduction of the ASX's "if not why not" guidance. The work found that the application of the five per cent rule that determines a board member not to be independent if they hold more than five per cent of the companies wealth combined with the adoption of ASX guidelines for majority independent directors has "destroyed considerable shareholder wealth in the order of $69 billion or more."

Wheeler (2013) questions the value of board independence. She suggested that structural rules on board independence "fail on all account" since board tends to choose "people with the same professional training and experience base as themselves. […]So you don't get the cognitive diversity that comes from different perspectives and experience, you just get more of the same. It doesn't address relationship conflict."

[67] Estimate is calculated using a survey of the largest 20 public offer industry funds regarding trustee director remuneration in 2013/14, and a conducted in 2012 of 28 public offer not-for-profit funds survey regarding trustee size. The surveys found that independent trustee directors on public offer not-for-profit boards are paid on average $32,000 more than representative trustees on public offer not-for-profit boards, and that an additional 112 independent trustees would be required if all public offer representative trustees were required to have a majority of independent directors

- The strengthening of the existing obligation on boards to annually review their skill, performance and procedures for renewal. This could be strengthened by placing a positive obligation on boards to consider if appointing an independent chair and/or independent directors (up to one-third of total board membership) may be in the best interests of fund members. The outcome of this review of board composition, supported by an account of the reasoning that led to the outcome, would be reported to APRA. Indeed, even the ASX governance guidelines incorporate some flexibility for boards to best determine appropriate governance arrangements, through the concept of "if not, why not" justifications around board composition
- The removal from the SIS Act of any restrictions on the ability to appoint independent directors and the removal of any restrictions on a trustee director being a member of a fund they oversee
- To further increase disclosure requirements, particularly around related party and outsourced arrangements, as proposed by ISA in its 2012 Governance and Disclosure Proposal

The adoption of an arrangement that would require or encourage a majority of independent directors is not supported. It would ultimately have a negative impact on fund members as it would remove the driver of outperformance of industry super (and other representative trustee) funds in the industry.

Table 3 – Representation in occupational pension fund governing boards[68]

Country	Pension Fund Trustee Model
Australia	Either equal employer/employee representation, equal representation with an independent chair, or a third/third/third - employer/employee/independent.
Austria	Representation from both employer and employee groups.
Belgium	Equal representation of employers and employees.
Brazil	Minimum of one third employee representation.
Canada	Multi-employer plans typically have equal representation.
Germany	Supervisory board has employee representation, with a maximum of equal representation.
Hungary	Mandatory pension funds must have member representatives in their board of directors.
Iceland	Equal representation of employers and employees.
Italy	The general assembly and the board of directors must each have equal representation of employers and employees.
Japan	Board of Representatives must have equal representation of employers and employees.
Netherlands	Equal representation of employers and employees.
Norway	The board must have at least as many employee as employer representatives.
Poland	Supervisory board needs to have no less than half employee representatives
Spain	The majority of the control commission must be selected by plan members and beneficiaries.
South Africa	At least half of trustees must be elected by plan members.

Source: OECD Working Papers on Insurance and Private Pensions No.18 Pension Fund Governance Challenges and Potential Solutions (Stewart, Yermo, 2008 pages 17-18)

[68] OECD Working Papers on Insurance and Private Pensions No.18 *Pension Fund Governance Challenges and Potential Solutions* (Stewart, Yermo, 2008 pages 17-18). Adapted for this submission

3. Innovation

3.1 Introduction

Progress and innovation go hand-in-hand, but not all innovation leads to progress. Financial services has been characterised by significant innovation for the past several decades, with mixed results for consumers and the economy.

The Inquiry observed that innovation has the potential to deliver significant efficiency benefits and improve system outcomes, but also brings risks. Consumers, businesses and government can be adversely affected by new developments, which may also challenge regulatory frameworks and regulators' ability to respond. The Final Report included several recommendations that seek to harness the potential of innovation, particularly digital technology, and manage the risks arising therefrom.

ISA is broadly supportive of these recommendations, but cautions the need to ensure that consumer protection is not compromised in the process of regulatory reform designed to support innovation.

3.2 Collaboration to enable innovation (Recommendation 14)

The Inquiry recommended:

- The establishment of a permanent public–private sector collaborative committee, the "Innovation Collaboration," (IC) to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.

The Inquiry's rationale for establishing an IC was that the dispersed nature and rapid pace of technology-enabled innovation requires a unique model of engagement between government, regulators, innovators and the broader public. The IC is proposed to provide a forum from which to promote awareness of innovation, coordinate action, and make coherent submissions to government and regulators.

ISA Position: Support

ISA is supportive of the idea to establish an "Innovation Collaboration" to encourage innovation within the financial system and the timely and coordinated regulatory responses to such innovation. A public–private collaboration should be able to overcome some of the collective action barriers associated with otherwise developing innovative and widely used payments systems.

A key weakness of the proposed collaboration is that it seeks to facilitate innovation "within" the financial system. What is perhaps more important is innovation that refocuses the financial system on transforming savings into economically productive capital, and allocating capital to its highest and best uses.

Innovation funding agencies and development banks are an effective and increasingly common policy measure for combining public and private funding for investment in innovation or critical sectors.[69] Such institutions can also increase the overall allocative efficiency of the finance sector by developing human capital that moves into the private sector. For developed economies such as Australia, state funding agencies and development banks offer the following benefits:

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[69] Heinz P. Rudolph, *State Financial Institutions: Mandates, Governance, and Beyond, Policy Research Working Paper 5141, Financial Systems Department*, The World Bank, November 2009

- Accelerate an economy's adaption to new sources of financing. Currently, developed economies globally are experiencing a shift away from bank funding towards pension funds, sovereign wealth funds and other long-term investors
- Provide funding for sectors that have been persistently underserved or for which finance is absent or restricted due to market failures or historical contingency
- Consolidate government initiatives promoting innovation, R&D, commercialisation and national competitive advantages.
- Protect public programmes which support economic development from the more short-term political cycle

Examples of existing agencies in comparable economies to Australia include the British Business Bank, the Business Development Bank Canada, and the New Zealand Venture Investment Fund. In 2013, the Secretary of State for Business, Innovation and Skills announced the British Business bank citing that, at that time, the UK was the only G8 country which did not have such an agency and that this absence was putting the UK economy at a competitive disadvantage.[70] Importantly, the economies of many of Australia's trading partners such as China and South Korea are benefitting from the existence of such agencies operating at the national and multination level.

ISA supports in principle the role of funding agencies and development banks in pursuing collaboration within the finance industry aimed at increasing the efficiency of the sector and funding innovation and other crucial capital investment.

ISA also notes that ASIC plans to build an innovation hub during the 2015/16 financial year to assist fintech start-ups and navigate the regulatory system. [71]

While we support ASIC's initiative, we argue that the proposed benefits of streamlining some regulatory procedures with respect to innovation should not be restricted to start-ups, as the development and roll-out of innovative services and products will also be undertaken by existing licensees including industry superannuation funds.

ISA recommends that existing licensees should also have access to ASIC's innovation hub.

3.3 Digital identity (Recommendation 15)

The Inquiry recommended:

- Development of a national strategy for a federated-style model of trusted digital identities. The objective of this recommendation is to improve efficiency of digital identity processes in the financial system.

ISA Position: Support

ISA agrees with the recommendation to develop a national strategy for a federated-style model of trusted digital identity, in particular the choice of federated model over a syndicated model.

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[70] Department of Business, Innovation and Skills, *Building The Business Bank: Strategy Update*, March 2013

[71] Greg Medcraft, *Opening address: Creating confidence to grow*, speech by ASIC Chairman, Australian Securities and Investments Commission ASIC Annual Forum 2015, 23 March 2015

ISA strongly believes consumer interests and protection must be structurally included in any national strategy. This is particularly important because the development and implementation of the strategy is likely to be dominated by financial services firms, yet the outcomes will have significant impacts on consumers, including in respect of privacy issues.

As ISA and consumer advocates have previously argued, control of consumer data should be with the consumer, and the value of the data should inure to the benefit of the consumer. In the context of this recommendation, ISA believes that consumers should have easy and full access to the data that forms their digital identity, and maintain the right to establish which parties have access to it.

Currently, there are many situations where financial services providers require consumers to give them their data before the provider gives the consumer a quote. If the consumer does not purchase a product from the provider, the provider still acquires the consumer's data. One option for ensuring that the value of data inures to the benefit of the consumer would be to establish a mechanism whereby consumers receive a payment from a firm that wants to access their data.

3.4 Clearer graduated payments regulation (Recommendation 16)

The Inquiry recommended:

- Enhancing graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority, mandating the ePayments Code and introducing a separate prudential regime with two tiers for purchased payment facilities.

The objective of these recommendations was to simplify the regulatory framework and improve consumer protection.

ISA Position: Support

ISA is broadly supportive of the recommendation to graduate payment regulation, provided consumer protection is maintained and remains a key priority of any change.

Efforts to lower regulation to facilitate new entrants risk creating opportunities for regulatory arbitrage (whether in respect of consumer protection regulation, prudential regulation, or business conduct regulation). It is important that any move to graduated regulation guards against this.

Equally, graduated regulation should in no way be a path to lower overall levels of consumer protection. The appropriate level of regulation for new payment systems can be difficult to determine early in a product's life cycle. Bitcoin and PayPal are two possible examples where graduated regulation early in their life could have led to lowering of consumer protections.

ISA also supports mandating the ePayments code since it provides important protections to consumers especially in the areas of stolen debit and credit cards and accidental electronic transfers when using online banking services.

Furthermore, ASIC's funding must be commensurate with the greater responsibilities it will have to monitor and enforce the ePayments code. Some anecdotal evidence suggests that whilst the ePayments code is generally accepted by industry it is only lightly monitored and enforced by ASIC.

3.5 Interchange fees and customer surcharging (Recommendation 17)

No comment.

3.6 Crowdfunding (Recommendation 18)

The Inquiry recommended:

- That government should continue its current process to graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.

The objective of this recommendation is to facilitate public offers of securities to a potentially large number of people (the "crowd"). The risks associated with crowdfunding investments would require some adjustments to consumer protections, including capping individuals' investments and clearly communicating the risks.

ISA Position: Support

ISA cautiously supports this recommendation, provided that consumer protection is not compromised.

More broadly ISA supports innovative ways that can expand the funding options for SMEs. However, crowd funding and a graduated approached to its regulation to encourage it is by no means the only (or even best) solution to SME financing constraints.

Other solutions include development of an SME finance database to reduce information asymmetries, or a public provider of SME credit risk analysis to support lending by superannuation funds and other non-bank providers.

Also, the emergence of new and innovative funding sources should not, alone, be a reason to graduate regulation around crowd funding products. New and innovative funding products can be the source of regulatory and taxation arbitrage such that a cautious approach should be taken establishing regulation for new products and financing methods. "The exploitation of regulatory inconsistencies is a major impetus for financial innovation. Indeed, it might be the primary impetus."[72]

From a consumer protection point of view, it is often "trendy" untested, complex and hard to understand products that create problems for consumers and a lack of regulation around them can contribute to the problem. Similarly, because new financial products are allowed to be sold without an ex ante review (unlike innovations in medicine and other fields), it is not until new financial products have demonstrably harmed consumers that government, regulators and users become aware of the risks and an appropriate level of regulation can be established.

An obvious example of this was the substantial regulatory reform of OTC derivative markets across the G-20 after the GFC. In terms of retail financial products, there are a host of "innovative" products whose complexity ultimately contributed to significant consumer harm, and where scrutiny occurred only after losses started to mount. Some examples in recent years include auction rate securities[73] and reverse convertible mortgages and other structured products[74] in the US, and, in Australia, contracts for difference,[75] as well as debentures and notes.[76]

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[72] Michael S Knoll, The Ancient Roots of Modern Financial Innovation: The Early History Of Regulatory Arbitrage, 87 Or L Rev 93 at 94. See also, Eric Posner and E Glen Weyl, An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First Century Financial Markets, University of Chicago Public Law & Legal Theory Working Paper No 382 (2012) (Proposing a model similar to pharmaceutical innovation regulation, pursuant to which, when firms invent new financial products, they be forbidden to sell them until they receive approval from an agency that tests the product for social utility and how the product is likely to be used).

[73] U.S Securities and Exchange Commission, *Rate Auction Rate Securities,* (accessed March 30/03/15) http://www.sec.gov/investor/ars.htm

[74] Eaglesham, J., *Complex Bonds Faces Regulators' Scrutiny: Reverse Convertible Notes' Can Tumble Along With Stock,* The Wall Street Journal, March 2011 http://www.wsj.com/articles/SB10001424052748703461504576231043052075256

Therefore, a more important aim is to ensure that new products or funding mechanisms have regulation for them developed in a timely fashion with a focus on consumer protection. Such an approach would likely require extra funding to ensure ASIC can monitor and implement regulation on innovative products in a timely manner. Or, the development of regulation around new products can be directed to be a key output of the “Innovation Collaboration” as outlined in Recommendation 14.

3.7 Data access and use (Recommendation 19)

The Inquiry recommended:

- That the Productivity Commission should review the costs and benefits of increasing access to and improved use of data.

ISA Position: Support

ISA supports this recommendation.

Any changes to data access and use should ensure that the control of the consumer data is in the hands of the consumer. One of particular concern is the access of data by third parties. Consumers need to be well informed and should have complete and ultimate control over whether their data is shared with third parties (in addition to ensuring that the original collection and use is known and voluntary).

Also, ISA recommends that the PC assess methods by which consumer access to data about themselves can be increased, controlled and simplified, in particular their credit history.

3.8 Comprehensive credit reporting (Recommendation 20)

The Inquiry recommended

- That industry should continue to implement the new voluntary comprehensive credit reporting regime. The objective of this recommendation is to reduce information asymmetry between lenders and borrowers, and improve access to and reduce the cost of credit for borrowers.

ISA Position: Support

ISA agrees with the Inquiry’s recommendation to support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime, and that if, over time, participation is inadequate, government should consider legislating mandatory participation. ISA suggests that the credit reporting regime should become compulsory.

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https://www.sec.gov/news/studies/2011/ssp-study.pdf

[75] Australian Securities and Investment Commission, *RG 227 Over-the-counter contracts for difference: Improving disclosure for retail investors,* ASIC Regulatory Guide, August 2011

http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-227-over-the-counter-contracts-for-difference-improving-disclosure-for-retail-investors/

[76] Australian Securities and Investment Commission, *12-262MR ASIC taskforce to review Banksia and regulation of unlisted debentures,* ASIC Media Release, October 2012

http://asic.gov.au/about-asic/media-centre/find-a-media-release/2012-releases/12-262mr-asic-taskforce-to-review-banksia-and-regulation-of-unlisted-debentures/

A voluntary system will only be signed onto if there are clear and private benefits of doing so. However, some the benefits are likely to flow to those (for example, SMEs and consumers) who have no choice in the matter. Or, put differently, there are likely to be positive externalities and public goods when all relevant market participants are involved in a compulsory system. For this reason, the Inquiry's recommendation to implement comprehensive credit reporting on a voluntary basis at first, with government involvement only after demonstrated recalcitrance, could be a second-best approach.

The idea that "positive" credit history should be reported or shared along with "negative" credit events is strongly supported since it should lower the cost of accessing much needed finance to invest in a productive capacity for small and medium businesses.

Increased data sharing could also lower the cost switching and help promote competition in relevant lending markets.

4. Consumer Outcomes

4.1 Introduction

The Inquiry concluded that, to build confidence and trust, and avoid over-regulation, the financial system should be characterised by fair treatment. ISA agrees with this conclusion.

The Inquiry views the current framework as insufficient to ensure that consumers experience fair treatment. ISA agrees with this.

The more significant problems relate to disclosure and financial advice.

While the Future of Financial Advice (FoFA) changes are likely to address some of these shortcomings, they do not completely address the problem of unfair treatment of consumers. In particular, widespread problems with the standard of adviser competency remain. In addition, many products are directly distributed. Consumers who purchase products directly from product issuers do not receive the protections introduced by FoFA.

4.2 Strengthen product issuer and distributor accountability (Recommendation 21)

The Inquiry recommended:

- Introducing a targeted and principles-based product design and distribution obligation.

The recommendation seeks to address:

- Consumer detriment from financial investment failures
- The current quality of product design and distribution controls
- Deficiency of disclosure

The concerns with disclosure, questionable product design, and questionable sales behaviour by financial product issuers and designers ultimately is an outgrowth of financial institutions that have determined that their profit interest can be maximised without offering products and services in the best interests of their customers. This is prima facie evidence of a market failure.

The Inquiry's recommendation to strengthen issuer and distributor accountability would establish obligations in three stages of the sales process, namely product design, distribution and post-sale review:

- During product design, product issuers should identify target and non-target markets, taking into account the product's intended risk/return profile and other characteristics. Where the nature of the product warrants it, issuers should stress-test the product to assess how consumers may be affected in different circumstances. They should also consumer-test products to make key features clear and easy to understand.
- During the product distribution process, issuers should agree with distributors on how a product should be distributed to consumers. Where applicable, distributors should have controls in place to act in accordance with the issuer's expectations for distribution to target markets.
- After the sale of a product, the issuer and distributor should periodically review whether the product still meets the needs of the target market and whether its risk profile is consistent with its distribution. The results of this review should inform future product design and distribution processes. This kind of review would not be required for closed products.

ISA Position: Support

ISA agrees that product regulation is needed to improve consumer outcomes in financial services. As recognised by the Inquiry, history has shown that disclosure and retail competition is not in itself sufficient to drive good outcomes in the sector.

ISA cautions against issuers and distributors who may be driven by commercial imperatives and administrative burdens, and therefore adopt a tick-a-box approach to satisfying this obligation.

It is therefore important to ensure that issuers cannot satisfy a product design and distribution obligation by implementing tick-a-box compliance processes.

ISA further cautions against conflicts between issuers and distributors. One substantial conflict is the widespread existence of vertically integrated issuer and distribution channels. Another substantial conflict is the payment of commissions by product issuers to distributors. While the FoFA reforms introduced a ban on sales commissions, commissions continue to be widespread as a result of extensive grandfathering and numerous exemptions.

To reduce consumer detriment, and improve the current quality of consumer outcomes, ISA reiterates the importance of a legislative framework that ensures conflicts of interest between product issuers and distributors are effectively managed or, where necessary, eliminated.

4.3 Introduce product intervention power (Recommendation 22)

The Inquiry recommended:

- Introducing a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.

The objectives of a product intervention power are to:

- Reduce significant detriment arising from consumers buying financial products they do not understand
- Limit or avoid the future need for more prescriptive regulation

- Build consumer confidence and trust in the financial system and, in turn, improve efficiency through increased consumer engagement and participation

This power would allow ASIC to require or impose:

- Amendments to marketing and disclosure materials
- Warnings to consumers, and labelling or terminology changes
- Distribution restrictions
- Temporary product banning

The Inquiry recommended that ASIC use the power as a last resort, or pre-emptive measure where there is a risk of significant consumer detriment.

ISA Position: Support

As noted in ISA's Submission to the Interim Report, the Inquiry agrees that ASIC's powers should be expanded to ensure effective consumer protection in financial services.

ASIC should be able to require issuers to amend marketing and disclosure materials for retail financial products, so that they are consistent and avoid potential misleading information. ISA expects that over time, industry standards on disclosure more broadly would be improved and standardised through the exercise of this power in relation to particular products.

However, as recognised by the Inquiry, history has shown that disclosure is not in itself sufficient to drive competition or good outcomes in financial products and services.

ISA therefore also supports ASIC being empowered to restrict the distribution of certain products or classes of products. For example, ISA supports ASIC being empowered to ban the distribution of extremely complex and/or risky products to retail consumers.

The Inquiry recommended that this power should be available to ASIC where there is a risk of significant detriment to a class of consumers. It is important that ASIC be enabled to not only act quickly where the risk of detriment is modest at the individual consumer level, but also where the class of consumers affected is large. In these situations, the total consumer detriment can be substantial.

ISA recommends that ASIC be empowered to restrict the distribution of certain products or classes of products in all cases where the aggregate risk of consumer detriment is significant.

It is important to note that the Inquiry had essentially two options to structure a product intervention power: (i) a *light touch option* in which the regulator bears the burden to affirmatively determine to restrict a product, and (ii) a *pre-market assessment option* where products may only be offered after review by the regulator and an affirmative determination that the product, marketing approach, and disclosure are appropriate.

The pre-market assessment option is similar to the regulation of therapeutic goods by the Therapeutic Goods Administration, which requires registration and regulatory approval. The Inquiry adopted the light touch option without a cost-benefit analysis of the pre-market assessment option. The light touch option is superior to existing policy settings, but the government may wish to consider a pre-market assessment approach, particularly if consumer harm persists under the light touch approach.

4.3.1 Banning power

The Inquiry recommended:

- That ASIC be given a power to ban financial products on a temporary basis and the government should be empowered to permanently ban financial products.

ISA supports the Inquiry's recommendation for temporary and permanent product banning powers. This power would need to be subject to appropriate checks and balances, including judicial review.

Either government or the regulator could be endowed with a permanent banning power.

If the permanent banning power rested with government, ASIC would need to establish mechanisms to monitor when bans were about to expire and to assess and make recommendations to government for permanent banning orders where an issuer intended to reissue a product that had been temporarily banned without changes to the product design and/or distribution channels that overcame the regulator's concerns.

ISA also notes that the cost of a product intervention power would be significant for ASIC, other regulators (with whom ASIC would be required to consult) and industry. A product intervention power will only be effective if ASIC is adequately funded in order to allow for these expanded powers.

ISA expects that, over time, if ASIC is adequately resourced to exercise a product banning power, the exercise of the power would improve the quality of product design across the financial services sector broadly.

4.4 Facilitate innovative disclosure (Recommendation 23)

The Inquiry recommended:

- Removing regulatory impediments to innovative product disclosure and communication with consumers, and to improve the way risk and fees are communicated to consumers.

The Inquiry notes:

- Disclosure has evolved to be less complex however consumer biases and commercial disincentives limit its effectiveness
- The need for efficient communication of information to consumers in a way that responds to technological advances and changing consumer preferences
- Risk and fee disclosure remains variable and consumer understanding low. Industry should develop consistent standards to improve disclosure of risk and fees

The Inquiry submits that change should occur in two phases:

- By ASIC giving individual exemptions from the law through its current pilot project to allow innovative communication of mandated product disclosure information
- By implementing a broader exemption through legislation, taking into account the effectiveness of innovative disclosure under ASIC's pilot project

Industry should develop standards for disclosing risk and fees, and, if significant progress is not made within a short time frame, government should consider a regulatory approach.

ISA Position: Support

ISA agrees in principle with this recommendation.

As recognised by the Inquiry, history has shown that disclosure is not in itself sufficient to drive competition or good consumer outcomes in financial products and services.

However, even if disclosure is not, on its own, effective at protecting consumers, our financial system should adhere to high standards of disclosure and transparency. There is value in improving disclosure requirements to ensure accountability, informed oversight and overall trust in the financial system. There is a community expectation that financial institutions will make clear, digestible information easily accessible, even if the majority of consumers are not engaging with this information. Transparency is central to trust and confidence, particularly in the case of superannuation, because it is compulsory and subject to tax concessions. Improved disclosure will:

- Assist those consumers who do engage
- Enable informed oversight, for example, by independent research organisations and peer review
- Ensure trust in the system – even among consumers who choose not to engage

Improvements to the disclosure regime should reduce complexity, and increase focus on providing consumers with information that empowers them to make decisions in their interests, rather than adopting a disclosure regime which is merely a tick-a-box process for product providers and their representatives.

Importantly, innovation in disclosure should not increase risks to consumers by allowing products issuers to obscure information that is not in the interests of the product issuer to disclose, or by allowing issuers to selectively disclose information.

ISA supports an effective and high quality disclosure regime underpinned by legal obligations on product issuers to disclose relevant information. Legal requirements to resolve supply side conflicts of interests are also essential.

A focus on consumer disengagement, lack of financial literacy and behavioural/cognitive factors, places the onus on the consumer. A focus on product complexity and supply side conflicts lies with product providers and regulators.

While attempts to address the "consumer onus" issues through education and improved disclosure should continue, fair treatment of and good outcomes for consumers can ultimately be achieved only by regulating products and product provision. Improving the focus of issuers and distributors on serving the best interests of consumers is far more realistic and a far more efficient way of achieving good consumer outcomes than measures directed at consumers. Issuers and distributors are in a better position to make improved disclosures and adopt better business practices, relative to consumers developing better abilities to sift through poor disclosures and wade through conflict-laden business practices. In addition, costly changes to consumer activities are repeated on every single transaction consumers contemplate, whereas a reform at the issuer or distributor level only has to be taken once and can benefit every consumer interfacing with the reformed process.

4.5 Align the interests of financial firms and consumers (Recommendation 24)

The Inquiry recommended:

- Amending the law to require that an upfront commission for life insurance advice is not greater than ongoing commissions. If level commission structures do not address the issues in life insurance, government should revisit banning commissions.

ISA Position: Do not support recommendation to require that an upfront commission for life insurance advice is not greater than ongoing commissions. Recommend phasing out all commission based remuneration

ISA accepts that level commissions may be required temporarily as the industry transitions away from commission-based remuneration models. ISA does not support replacing upfront commissions for sale of life insurance policies with level commissions as a permanent solution. This will not address the problem of widespread poor quality advice and product churning. ISA strongly supports banning all commissions in life insurance, in light of the detrimental impact they may have on the quality of advice.

As noted in ISA's Submission in response to the Interim Report, in the market for life insurance, commission structures do not just lead to biased advice. Commission structures result in excessive churn of life insurance policies, with clients often recommended into more expensive polices with no increase in cover and with a risk of loss of cover and denial of claims. There are documented instances in which this was found to occur without the client's personal circumstances being taken into account and often executed through the falsification of client information.[77]

According to the estimates of members of the Financial Services Council (FSC), "around one in six (and as many as one in three) new business applications for life insurance may be existing policies moved from one insurer to another." [78] Moreover, "this practice is not in the best interest of consumers as it inevitably leads to an overall increase in the cost of insurance for all policyholders".[79]

In October 2014, ASIC released Report 413, *Review of Retail Life Insurance Advice*. Thirty seven per cent of the advice ASIC reviewed did not comply with the laws relating to appropriate advice and prioritising the interests of the client. ASIC further found that the way an adviser was paid had a statistically significant bearing on the likelihood of their client receiving advice that did not comply with these laws.

Conflicted remuneration structures are the primary cause of poor advice in Australia, and feature in all the major advice scandals spanning the last decade. Conflicted remuneration, if allowed to remain in any guise, will continue to undermine the quality of advice and insurance outcomes for clients.

ISA recognises the problem of underinsurance, and supports measures which increase insurance coverage and the access to affordable financial advice that is in the client's best interest.

A transition towards phasing out all commission-based remuneration is the only long-term sustainable solution compatible with a professional financial advice industry.

ISA supports appropriate transition measures to assist the industry, align the interests of advisers and their clients and ultimately professionalise the industry as a whole.

Transition measures canvassed in ISA's recent submission to the Life Insurance and Advice Working Group set up by the FSC and AFA to respond to the ASIC Report include:

- Flat or level commissions. This will effectively grandfather existing trail commissions, and by reducing new upfront commissions to appropriate levels will assist consumers in purchasing appropriate and durable insurance plans and avoid being churned by advisers incentivised by large upfront commissions.
- Capped commissions which are paid until the cost of advice has been 'repaid', better reflect the level of advice provided. This will assist the commission structures wind down, while ensuring consumers are receiving greater value for money when purchasing an insurance product.
- Robust enforcement of the existing requirement for financial advisers to provide a strategic justification for advice prior to and separately from a product recommendation. This will assist advisers and advice dealerships to move towards providing advice which is separate from product recommendations.

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[77] Peter Kell, 2013, *FoFA and the new reality*, speech at Money Management and Financial Services Council (FSC) Breakfast Series, 12 March 2013

[78] Financial Services Council, *Consultation Paper: Replacement Business Framework*, 3 April 2012, p 3

[79] Financial Services Council, *Consultation Paper: Replacement Business Framework*

- An annual shadow shop review of insurance advice conducted by an independent body and funded by the industry. The purpose of an annual review is to track the progress of the industry during the transition period. Given the significant losses caused by poorly incentivised financial advisers, it is appropriate that the cost of tracking industry progress is funded by the industry rather than the public.

The appropriate duration for a transition period for these measures is five to 10 years, depending on the measure.

On March 26 The Trowbridge Report was released in response to ASIC's Review of Retail Life Insurance and Advice (discussed above).
While the report's proposals deal with the most obvious situations of churn, it fails to tackle the fundamental conflict caused by the existence of commissions in retail life insurance.

The report's recommendations highlights a reluctance on the part of the life insurance industry and the financial advisers involved in selling life insurance to accept the fact that life insurance would operate better in an environment free of commissions.

Conflicted remuneration clearly creates a disincentive to provide quality advice. If advisers only get paid when they sell life insurance products bearing commissions, they are less likely to provide strategic advice, such as that a client should keep their current level of cover or take up group cover through superannuation.

A transition towards phasing out commission-based remuneration is the only long term sustainable solution compatible with a professional life insurance advice industry and the best interests of consumers.

4.6 Banning individuals from managing a financial firm (Recommendation 24)

The Inquiry recommended:

- Giving ASIC a power to ban officers and individuals from managing a financial firm. This should also include individuals who are license holders or authorised representatives, or managers of a credit licensee.

ISA Position: Support

ISA is strongly supportive of the proposal to give ASIC additional powers to ban individuals from managing a financial services business.

This will overcome the practice of people involved in giving poor financial advice moving into or staying in management roles, in the same or different businesses, beyond the reach of ASIC.

ASIC will require additional funding to exercise this power.

4.7 Effect of grid commission structures for stockbrokers (Recommendation 24)

ASIC is reviewing the effect of grid commission structures for stockbrokers on the quality of consumer outcomes.

The Inquiry recommended:

- If ASIC's review raises significant concerns, ASIC should advise government on the need to remove the sector's exemption from the ban on conflicted remuneration introduced by FoFA.

ISA Position: Do not support.

ISA recommends immediate removal of exemption from the ban on conflicted remuneration enjoyed by the stockbroking industry

ISA supports acting now to remove the stockbroking sector's exemption from the ban on conflicted remuneration introduced by FoFA. Australia and the United States are the only jurisdictions that use a grid commission structure. In most other major financial centres, stockbrokers are paid a salary and discretionary bonus.

Commissions create a conflict of interest for stockbrokers, incentivising brokers to give clients advice that results in transactions over other advice. This is inconsistent with the provision of advice that is in the best interests of the client.

This also contributes to the problem of short termism which undermines the efficiency of the financial system.

4.8 Raise the competency of advisers (Recommendation 25)

The Inquiry recommended:

- Raising the competency of financial advice providers to require individuals advising on Tier 1 products to hold a relevant tertiary degree, competence in specialised areas, such as superannuation and ongoing professional development.
- Introducing an enhanced register of advisers.

ISA Position: Qualified Support. Higher competency standards should not extend to individual providing general advice on Tier 1 products.

ISA supports lifting the level of competency of financial for advisers giving personal advice on Tier 1 products as follows:

- A minimum degree requirement for advisers giving personal advice. Consideration needs to be given to the rollout of this requirement, in order to create clear transition guidelines for existing advisers and those considering a career in advice
- A national exam for new and existing financial advisers with mandatory competencies including ethics and conduct
- A mandatory Continual Professional Development (CPD) requirement for all financial advisers
- A mandatory period of monitoring and supervision for all new financial advisers

Consideration needs to be given to the rollout of these requirements, in order to create clear transition guidelines for existing advisers and those considering a career in advice.

ISA does not support extending these requirements for individuals giving general advice on Tier 1 products.

Increasing education and training standards alone will not address the structural tensions and regulatory gaps that have consistently failed to protect consumers in the financial services market. This also requires:

- Banning all forms of conflicted remuneration
- Imposing a principles-based duty on advisers to act in the best interests of clients
- Making the adoption of a uniform code of professional practice and ethics or an approved code of conduct compulsory for all financial advisers. Any code must impose higher standards than, and operate in conjunction with, legislative conduct requirements. The code must be independently approved, monitored and enforced

- Enshrinement in law of the term financial adviser
- Clearer labelling for independent advisers
- Establishing an enhanced public national register of financial advisers, which provides clear disclosure of adviser remuneration

4.9 Register for financial advisers (Recommendation 25)

ISA Position: Support

In October 2014, the government announced its intention to create a central register for financial advisers. The purpose of the register is to enable investors, employers and ASIC to verify the credentials of financial advisers and be confident that they are appropriately qualified and experienced. Following consultation (in which ISA participated) the register will commence at the end of March.

ISA welcomes the implementation of an enhanced Financial Adviser Register, which will improve transparency of all financial planners offering advice to retail clients, facilitate ASIC's capacity to supervise the industry and lead to enhanced consumer confidence. ISA submits that the public disclosure of information about financial advisers will play an important role in raising the professional standards in financial advice.

The Register requires that advisers disclose:

- their recent advising history
- their educational qualifications and any training courses completed by them
- relevant membership of professional bodies
- the firm that controls the licensee who authorises the adviser
- details of bans, disqualifications or suspensions

ISA submits that the Register should be promoted to raise consumer awareness and engagement with the disclosures the Register provides. It may be appropriate for the FSG requirements to be amended to refer consumers to the Register for more detailed information on the advice provider they propose to engage.

Given the significant impact that remuneration practices have on the quality of financial advice, ISA strongly recommends that a requirement to disclose the means by which an adviser accepts payment (remuneration options) would strengthen the functionality of the register as a tool for consumer protection.

While the reinstatement of FoFA bans many types of prospective conflicted remuneration, the legislation and grandfathering provisions include a number of very significant exemptions and concessions to various parts of the industry.

Disclosure of any incentive is particularly relevant at the time a consumer is checking a financial adviser's credentials prior to engagement. This disclosure could be as simple as various fields including hourly service fees received from the client only, percentage-based fees received from clients only, remuneration received from clients and product providers, and other benefits received from product providers.

4.10 Improving guidance and disclosure in general insurance (Recommendation 26)

The Inquiry recommended:

- Improving guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance

ISA Position: Support

ISA does not object to this recommendation. However, as the Inquiry concluded, disclosure alone cannot completely overcome information asymmetry between consumers and financial services providers.

Information asymmetry and inequality of bargaining power are particularly acute in the context of general insurance, where insurers offer standardised policies on a take-it-or-leave-it basis and in some cases no insurer offers a policy that will provide an adequate level of cover.

ISA is not confident that improved disclosure of these terms will address this consumer detriment.

5. Regulatory system

5.1 Introduction

The Inquiry does not recommend major changes to the overall regulatory system.

The Inquiry is comfortable with the current arrangements under which APRA and the RBA are responsible for macro-prudential oversight.

ISA notes that macro prudential concerns are not explicitly part of the regulators' main roles. In our view, at least one regulator should be expressly responsible for managing systemic risks, with this responsibility set out in the Statements of Expectations. It is not obvious that an institution-by-institution regulator such as APRA is well-placed to not only monitor systemic risks, but to balance the potentially competing regulatory interests of systemic and institutional prudential oversight. It is also not obvious that the RBA is well-placed to perform macro-prudential regulatory functions (for the same reasons that institutional prudential regulation is not housed in the RBA).

ISA Position**: **Recommend that responsibility for macro-prudential supervision be explicitly recognized in the Statements of Expectation for a new macro-prudential regulator

5.2 Regulator accountability (Recommendation 27)

The Inquiry recommended:

- Creating a new Financial Regulator Assessment Board to advise government annually on how financial regulators have implemented their mandate
- Providing clearer guidance to regulators in Statements of Expectation (SOE) and increase the use of performance indicators for regulator performance

ISA Position: Qualified Support

ISA supports this in concept. However, implementation challenges will need to be resolved for this recommendation to be effective.

The Inquiry suggests that the Assessment Board can be supported by a separate secretariat housed in Treasury. The staff can be sourced from the industry, and need to have regulatory expertise. The pool of people with industry and regulatory expertise in financial services in Australia is relatively small. ISA queries whether it is possible to achieve an "independent board" to assess the regulators in this context. It is also important to ensure that the assessment board does not become an opportunity for the sector to resist regulation it objects to, or become beset by actual or perceived conflicts of interest.

ISA also believes that the work of the Assessment Board has the capacity to provide values and different perspectives to current programs such as the Financial Sector Assessment Program (FSAP) by the International Monetary Fund (IMF). The FSAP provides an annual review on systemic issues of each country, including Australia. It also focuses on how the country complies with international codes and standards. In doing this, the FSAP occasionally assesses and makes recommendations to improve regulators' performance. The Assessment Board's work should be broader, focusing on all relevant issues to the regulators' mandate and systemic issues are only one of the key areas.

To have an effective accountability framework, clear guidance in the Statement of Expectations for each regulator is necessary. ISA believes that macro-prudential duties should be explicitly mentioned in the mandate for a new regulator. This is in line with international regulatory practice and development. The US, EU and UK have all set up an explicit structure for macro-prudential regulation purposes.[80]

5.3 Execution of mandate (Recommendation 28)

The Inquiry recommended*:*

- Providing regulators with a more stable funding model based on periodic reviews, increasing the capacity to pay competitive remuneration, boosting flexibility in respect of staffing and funding, and requiring them to undertake periodic reviews
- Revising the funding arrangements for ASIC and APRA: funding to be set based on three-year funding review and should be sufficient to meet the objectives of the agency. This is to ensure that regulators have enough funding, staff and regulatory tools
- Capability reviews: For APRA and ASIC, a six-yearly cycle would allow capability reviews to be aligned with every second funding review, allowing the two reviews to take place concurrently

ISA Position: Support

ISA generally supports these recommendations. Improved regulator performance also depends on maintaining independence from industry and being supportive of public interests. It is essential that regulators maintain a strong working culture even though their staff is not covered under the Public Service Act.

5.4 Strengthen ASIC's funding and powers (Recommendation 29)

The Inquiry recommended:

- Introducing an industry funding model for the Australian Securities and Investments Commission (ASIC) and providing ASIC with stronger regulatory tools
- For funding: government to set the budget in the three-yearly review before implementing industry funding model

ISA Position: Support

[80] Kern, Steffern and Lantz, Sarah, 2012, *'Macro-prudential financial supervision in the US. The Financial Stability Oversight Council'*, Deutsche Bank Research, 2012

ISA is generally supportive of the industry funding of ASIC. It is important to ensure that the funding model does not interfere with the regulator's independence. For example, regulated firms should not be permitted to withhold funding. It is also important that the funding model does not prevent competition between regulated firms.

The process should clearly define the types and amount of fees paid by firms and how fees are raised. This may involve a consultation process with the industry. Furthermore, there needs to be a clear accountability framework for the regulator to operate in. This should detail the regulatory body's responsibilities, reporting duties and also outline criteria for a periodic auditing process.

The Financial Conduct Authority (FCA) in the UK has adopted this practice and may provide a practical example of the process.[81] The FCA charges fees to all authorised firms that carry out activities that it regulates, as well as other bodies such as recognised investment exchanges. In terms of accountability, Treasury can appoint independent auditors to examine the FCA's actions and process.

5.5 Strengthen the focus of competition in the financial system (Recommendation 30)

The Inquiry recommended:

- That government review the state of competition every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross border provision of financial services and include consideration of competition in ASIC.

This is motivated by the Inquiry's belief in the benefits of competition and concerns regarding the high concentration and increasing vertical integration in some sectors.

The Inquiry also recommended that regulators should consider competition explicitly in their policy and annual reports. Government also should commission a periodic external review of competition in the financial sector every three years.

ISA Position: Qualified Support

While competition is often a powerful driver of innovation and efficiency, competition does not always equate to good outcomes. In financial services, reforms to encourage competition have often failed to deliver desired outcomes because the necessary conditions for a functioning, competitive market such as human cognitive limitations, time and information availability, and behavioural biases, do not and cannot reasonably be expected to exist.

There are well-known cases documented by the Inquiry where market failures exist and undermine the ability of competition to drive good outcomes. For example:

- Competition has failed to provide good financial advice and protect consumers' outcomes in the financial advice industry. FoFA regulations were brought in to ensure consumer protection.
- In superannuation, Choice legislation was brought in to promote competition. However, it has failed to have a positive impact on price and efficiency; it has resulted in the opposite

Policy is important not only to ensure that firms are competing vigorously, but also that they are competing in the right way to deliver the right outcomes. The importance of public policy to ensure competition around desirable outcomes is elevated where cultural norms are poor or not well-established.

[81] Durie, J., 2013, ASIC eyes radical funding rethink on UK lines, The Australian July 24 2013 http://www.theaustralian.com.au/business/opinion/asic-eyes-radical-funding-rethink-on-uk-lines/story-e6frg9io-1226683984845

For this reason, the regulators should not only consider whether a sector is competitive, but whether it is competing in the right way, or whether the strategies for success naturally have consumers' best interests at heart, or are subject to strong imperfections. All core objectives of the regulators, including the benefits of competition, should be assessed periodically.

5.6 Compliance cost and policy processes (Recommendation 31)

The Inquiry recommended:

- Increasing the time available for industry to implement complex regulatory change. Conduct post-implementation reviews of major regulatory changes more frequently.

ISA Position: Qualified Support

ISA generally agrees that the implementation of policy needs to be considered carefully. However, it is important to note that measuring the potential effects of regulation is very difficult. To date, most analyses have focused on the costs of regulation, including compliance costs, while giving far less attention to economic benefits. Furthermore, no consistent and reliable measures of "regulatory burden" have been developed.[82]

To consider policy implementation effectively, it is important to develop independent measures of costs and benefits. The measures should be reasonable, taking into account necessary costs and benefits due to compliance. This will provide a good basis to conduct post-implementation review.

[82] Parker, D. and Kirkpatrick, C., 2012, *The Economic Impact of Regulatory Policy: A Literature Review of Quantitative Evidence*, Expert Paper No. 3, August 2012

6. Significant matters

6.1 Impact investment (Recommendation 32)

The Inquiry recommended:

- Exploring ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery, provide guidance to superannuation trustees on the appropriateness of impact investment, and supporting law reform to classify a private ancillary fund as a “sophisticated” or “professional” investor, where the founder of the fund meets those definitions.

ISA Position: Qualified Support

ISA does not object to the development of impact investment markets, provided that the method does not involve public subsidisation of the social objectives of wealthy investors. Instead, public support should be made for the public interest.

The sole purpose test imposed under s 62 of the SIS Act is sufficient guidance for superannuation funds in this area. The sole purpose test does not prohibit impact investing, when it is reasonably related to the delivery of retirement benefits. This is an appropriate standard and no further guidance is needed for superannuation funds. Guidance would be additional red tape, as entities interested in making these investments would need to not only conduct their internal review and analysis, but also review the guidance.

6.2 Retail bond market (Recommendation 33)

The Inquiry recommended:

- Reducing disclosure requirements for large listed corporates issuing ‘simple’ bonds and encouraging industry to develop standard terms for ‘simple’ bonds.

ISA Position: Does not support

The Inquiry’s proposal would reduce disclosures to retail investors. While large listed corporates will benefit from cost reduction, the benefits for retail investors are not clear.

Reduced disclosure will reduce investor protection, and shift the cost of the collection and digestion of information from the issuer to the investors. This approach has never increased investor appetite over the long term, because it shifts costs onto those less able to bear them.

Retail investors have enough trouble analysing disclosure without making them trawl through historical documents released under continuous disclosure requirements. The issuer is in a much better position to collect the needed information into a single document. Simply because disclosure is not, in and of itself, sufficient investor protection does not mean it should be reduced.

6.3 Finance companies (Recommendation 34)

The Inquiry recommended:

- Clearly differentiating the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institution deposits.

ISA Position: Support

ISA supports this recommendation which is designed to make it easier for consumers to differentiate between deposit products offered by ADIs and other, more risky products that are not issued by ADIs. Debentures or products offered by finance companies should not be branded similarly to ADIs since they will mislead consumers to believe that they are safe. Clear differentiation is required and it should be accompanied by general information and education to consumers.

ISA also notes that, as the Inquiry has concluded, disclosure alone cannot completely overcome information asymmetry between consumers and financial services providers. Therefore, it is essential that other aspects of the consumer protection regulatory framework, such as FoFA legislation, are strengthened.

6.4 Superannuation member engagement (Recommendation 37)

The Inquiry recommended:

- Publishing retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance
- Facilitating access to consolidated superannuation information from the ATO to use with ASIC's and superannuation funds' retirement income projection calculators

ISA Position: Do not support

In a compulsory system, it is imperative that members understand what their retirement income will be.

Therefore, ISA support requiring funds to prepare retirement income projections for members.

Projections must also enable funds to inform fund members and the public of superior performance compared with other funds.

ASIC Regulatory Guide 229 Superannuation Forecasts gives super funds relief from the licensing, conduct and disclosure regime for projections that are prepared using a prescribed methodology.

The methodology assumes:

- An investment earnings rate of 3 per cent per year until the member retires
- The actual administration fees charged in relation to the member over the last 12 months will continue until the member retires
- The member's contributions over the last 12 months will continue at the same rate until they retire
- The member will retire at age 67

The guidance was updated in November 2014 to permit funds to include in projections an estimate of the member's entitlement to the Aged Pension. Including the Aged Pension is not mandatory.

This is a welcome development given that the majority of people will receive a full or part Age Pension for the foreseeable future.

The prescribed methodology for calculating the amount of the Aged Pension assumes that the member has a partner, they own their own home jointly with their partner, that their partner has the same amount of superannuation and that the couple do not own any other assets.

To date, very few funds have chosen to rely on the relief.

One reason for the low level of reliance on ASIC's relief is a concern that the methodology for calculating projections prescribed by ASIC means that projections lack integrity, do not allow funds to demonstrate the impact of making additional contributions and inhibit the ability of high performing funds to inform fund members and the public of superior performance compared with other funds.

For example:

- The prescribed investment earnings rate of 3 per cent understates actual performance for industry funds in many cases
- It overstates the actual performance of conservative investment options. This is of particular concern to funds that have identified younger members invested in the fund's cash option
- Where a member has made a large one-off contribution during the last 12 months, the fund is required to assume that they will make the same contribution every year until retirement, which inflates the projection and is misleading
- Funds that choose to include the Age Pension in projections are required to assume that the member has a partner, even where they know that this is not true for a specific member
- Funds that choose to include the Age Pension in projections are required to include this as a single figure in the first year of retirement. This is misleading where it is projected that a member will receive a part Age Pension that will increase over time as the member's superannuation account balance decreases and the income test takes precedence over the assets test
- The projection must be expressed as a single dollar figure. In reality projections are estimates. Therefore, expressing the projection as a range is less likely to be misleading

Many funds are also concerned that projections prepared using the prescribed methodology will differ from projections provided to members in other contexts, for example projections prepared by advisers, or by the member using an online calculator. Depending on the methodologies used, these differences may be significant. There is a risk that members who experience these discrepancies will become cynical about the value of projections, calculators, advice, and engagement with super generally. This would undermine the objective of using projections to increase member engagement.

While ISA supports mandatory projections, it is clear from the low level of reliance on ASIC's relief to date that further work is required to resolve these methodological deficiencies.

ISA recommends that funds should instead be required to prepare retirement income projections on a fair and reasonable basis. The focus of projections should be on the member's projected retirement income, rather than their superannuation lump sum balance at retirement.

Achieving fair and reasonable projections requires that projections are product specific. In particular, projections should be based on actual fund performance and actual fees, over a representative time frame, to prevent gaming.

We recognise that preparing retirement income projections for all members would involve significant cost. There may be scope to rely on standardised assumptions about the individual variables used to calculate projections, such as the member's balance and contributions.

ISA would welcome the opportunity to participate in a design process for mandatory retirement income projections that balances the objectives of member engagement, accuracy, comparability and efficiency.

The process should include consumer testing to ensure that retirement income projections achieve the objectives of member engagement and comparability.

6.5 Provision of financial advice and mortgage broking (Recommendation 40)

The Inquiry recommended:

- Requiring advisers and mortgage brokers to disclose ownership structures.

ISA Position: Qualified support

ISA supports this recommendation on the basis that it will improve consumers' ability to understand the conflicts of interest that drive advice.

As recognised by the Inquiry, history has shown that disclosure is not in itself sufficient to drive competition or good outcomes in financial products and services.

As noted above in relation to commissions for advice about life insurance, phasing out all commission-based remuneration is the only long-term, sustainable solution to addressing the problem of poor quality advice and consumer mistrust of advisers.

For this reason, ISA recommends that the proposed disclosure should be accompanied by a prohibition on conflicted remuneration. During the period before such a prohibition becomes effective, brokers should disclose remuneration arrangements as well as ownership structures.

The Inquiry concluded:

- That the term general advice is misleading. It recommended that this activity should be relabelled more accurately.

ISA Position: Do not support

The Inquiry characterises general advice as 'guidance, advertising, and promotional and sales material highlighting the potential benefits of financial products' (p 271)'. The Inquiry observes that consumers may misinterpret or excessively rely on these activities.

ISA agrees that the regulatory setting should discourage consumers from excessive reliance on activities which are designed to sell financial products, rather than deliver advice that is in the best interests of consumers.

A feature of these activities is that they attract conflicted remuneration, including volume-based sales incentives.

However, general advice also includes a wide range of activities that are valuable to, and in the best interests of, consumers.

For example, during the GFC, superannuation funds answered many phone calls from members seeking advice about whether to switch from their existing investment option within the fund into the fund's cash investment option. In many cases, funds advised these members that switching to cash would leave members worse off in the long term. Many funds delivered this advice under a general advice model.

Industry SuperFunds continue to deliver beneficial general advice to members through a range of channels including over the phone and face-to-face general advice, member educational materials, and online tools such as retirement income calculators and superannuation comparators.

General advice is an efficient way for super funds to deliver relatively simple, modular advice to a high volume of members with similar characteristics facing similar issues.

Industry funds do not pay conflicted remuneration for these activities.

Many of these members would not obtain personal advice if it was the only option available to them due to need, cost, inconvenience, or other reasons.

ASIC has recently released guidance giving industry comfort that it will not take action where a provider gives personal advice, merely because they give general advice using personal information about a client's relevant circumstances to choose general advice that is relevant and useful to them: see ASIC, Regulatory Guide 244, *Giving Information, General Advice and Scaled Advice*. This is designed to further facilitate the provision of useful general advice that is tailored to members with particular characteristics.

The real problem is that some industry participants use the broad definition of advice to cloak sales activities as advice.

Forcing all activity that is not personal advice to be labelled as sales activity does not accurately reflect the nature of benign general advice; it would undermine consumer confidence in useful general advice and would result in less useful general advice being provided.

The solution to the problem identified by the Inquiry is to:

- Tighten the definition of general advice, so it excludes advertising and sales activities
- Re-label advertising and sales activities that attract conflicted remuneration as sales information
- Require staff that are eligible to receive conflicted remuneration or sales activities to clearly disclose this to consumers
- Require sales advisers to clearly explain to consumers their relationship with product issuers in a way that consumers understand

ISA recommends law reform to address these problems.

6.6 Legacy products (Recommendation 43)

The Inquiry recommended:

- Introducing a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.

ISA Position: Qualified Support

ISA supports the introduction of a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors. We note that legacy superannuation products do not appear to be included in the Inquiry's recommendation. ISA submits that a mechanism to facilitate the rationalisation of legacy products in superannuation should be implemented as well. In support of this position, we refer to the evidence presented in Section 2.3.5.1, demonstrating the significant costs to consumers of legacy retail superannuation products.

To protect the interests of consumers, the mechanism should be subject to a "no worse off" or an "overall better off" test.

In some situations, in order to meet such a test, issuers will need to compensate consumers being migrated out of legacy products.

6.7 Corporations Act 2001 ownership restrictions (Recommendation 44)

The Inquiry recommended:

- Removing market ownership restrictions from the Corporations Act 2001 once the current reforms to cross-border regulation of financial market infrastructure are complete.

ISA Position: Qualified Support

ISA recommends a cautious approach to relaxing ownership limitations on core financial market infrastructure (FMI), such as stock exchanges.

FMI, in particular exchanges and clearing houses, are natural monopolies which make them different from other entities in the financial sector. The government has an important role to ensure that these entities are directed towards delivering the right outcomes.

There is little evidence that increased competition in FMI is beneficial. John Kay, chair of the *Kay review of UK equity markets and long-term decision making*[83] has argued that financial exchanges suffer from a "paradox of contestability": when an exchange abuses its monopoly power and begins to pursue shareholder value, competition for these profits and high wages follows with more exchanges entering the market.[84]

[83] Kay, John, 2012, *Kay review of UK equity markets and long-term decision making*, July 2012

[84] Kay, John, 2006, 'A giant's strength is valuable – if not used like a giant', *The Financial Times,* 28 November 2006

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APPENDICES

Appendix 1

SME Employer Attitudes to Superannuation

December 2014

Industry Super Australia

UMR strategic research

Executive Summary & Strategic Insights

- UMR interviewed 550 employers and key decision makers from a representative range of industries across the country from the 28th November to the 15th of December 2014.

- The research provides evidence that banks are already actively promoting their "house brand" super funds to their SME employer customers. It's clear that certain banks are more active than others.

- Slightly less than half of those who've been approached say their bank has offered benefits for them to change. Discounts on fees within the superannuation and lower insurance premiums for their business appear to be the most frequently offered, followed by free financial advice.

- Lower insurance premiums are both desired by employers, and more frequently offered by banks. Discounted interest rates and fees on banking products have strong appeal, but are less frequently offered. Fee discounts on superannuation products themselves are a little less desired, but frequently offered.

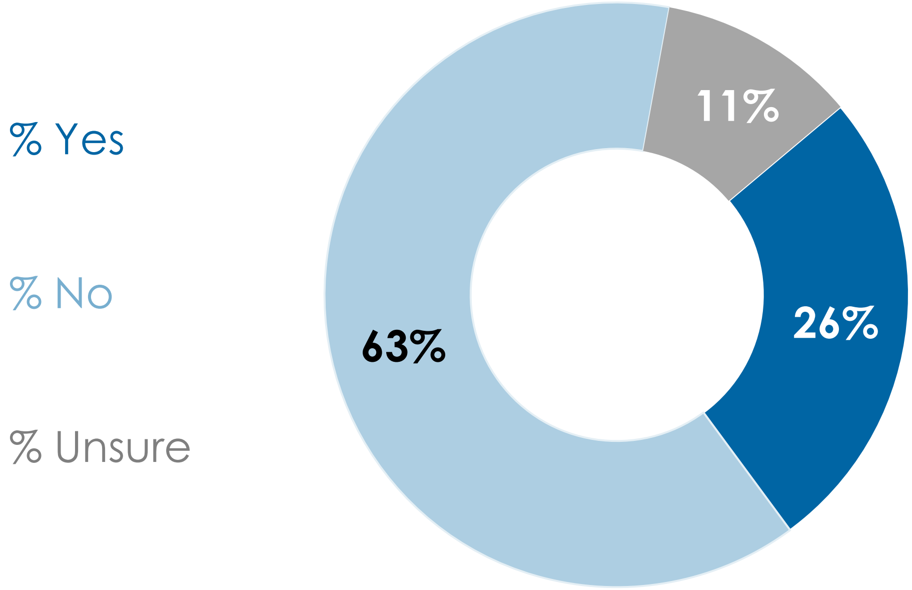
- Given many employees still tend to go with default funds rather than actively choosing their own funds, such activity could potentially affect superannuation outcomes for many Australians. While a minority of employers overall, a substantial proportion (33%) of employers who *say they have been made offers by their bank* admit they have changed their default funds as a result. Many more (57%) say they are still considering switching.

UMR strategic research

Main Findings

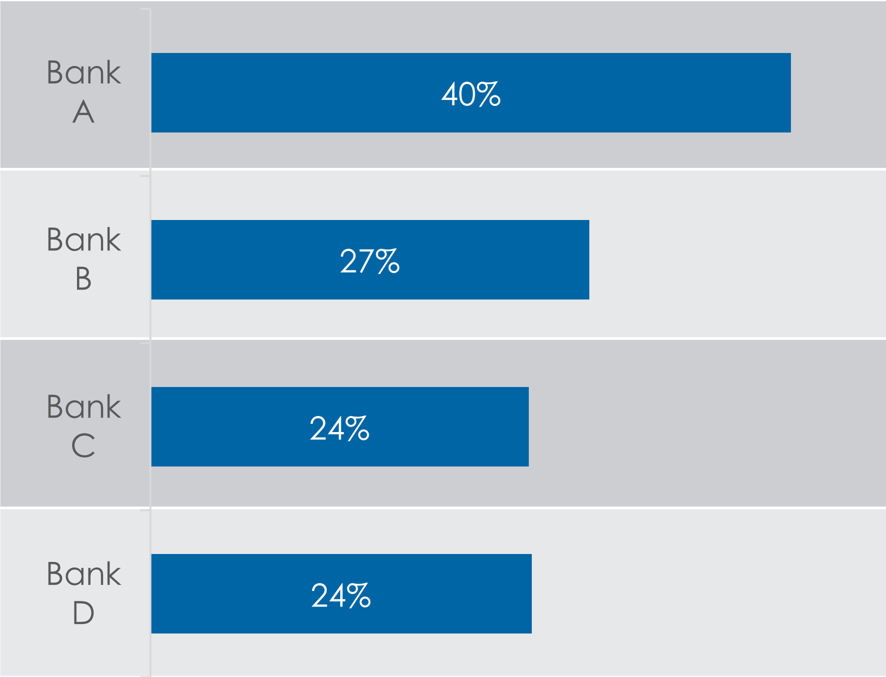
Some evidence of banks cross-promoting super funds

Has your main bank recommended or offered a superannuation fund to you as your businesses default fund?

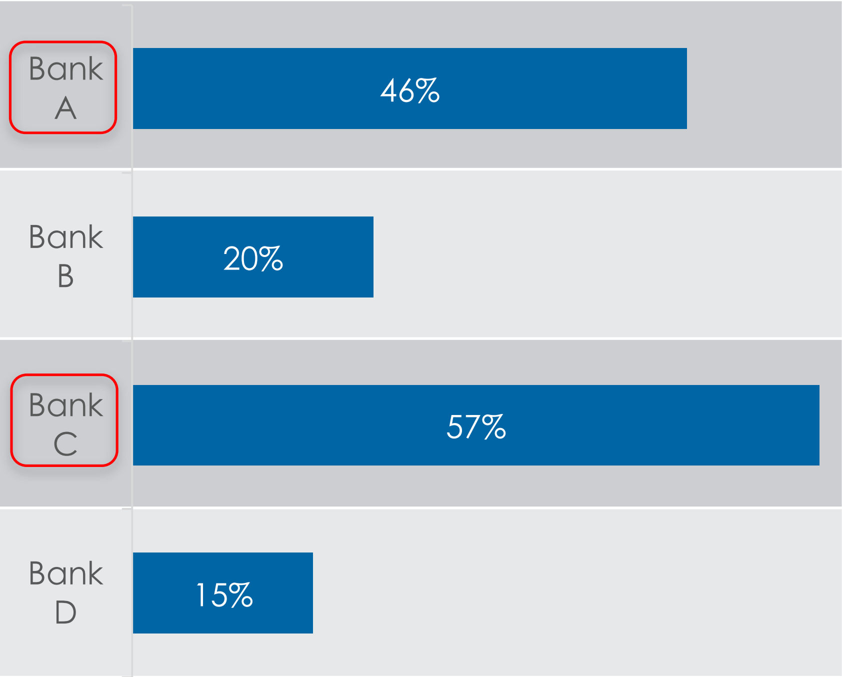


Two major banks are more active than others

Has your main bank recommended or offered a superannuation fund to you as your businesses default fund?

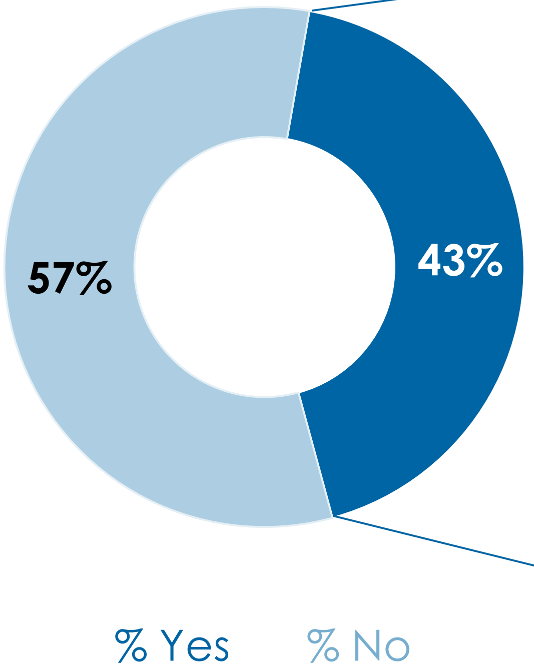


OF THOSE WHO SAID YES: Proportion who say they were recommend that bank's owned fund



Banks appear to be offering incentives

Did your bank offer any benefits for you to change your default super fund?



What benefits did your bank offer?

Some discounts on fees within the superannuation	**38%**
Lower insurance premiums for your business	**37%**
Free financial advice for your employees	**32%**
Discounted interest rates or fees on your business	**25%**
Free financial advice for your business	**24%**
Free or discounted IT products for your business (like an iPad or business software solutions)	**22%**
Free tickets to sporting events or corporate hospitality	**22%**

Base: Those whose bank has recommended a fund

UMR strategic research

*Most frequent deals offered by major banks**

Did your bank offer any benefits for you to change your default super fund?

	Bank A	Bank B	Bank C	Bank D
Most common offer	Lower insurance premiums for your business	Free tickets to sporting events or corporate hospitality	Free financial advice for employees	Some discounts on fees within Super products
Second most common offer	Free or discounted IT products for your business	Lower insurance premiums for your business	Free financial advice for your business	Free financial advice for employees
Third common offer	Discounted interest rates or fees on your business accounts	Free financial advice for employees	Lower insurance premiums for your business	Lower insurance premiums for your business

***Very small samples, indicative only**

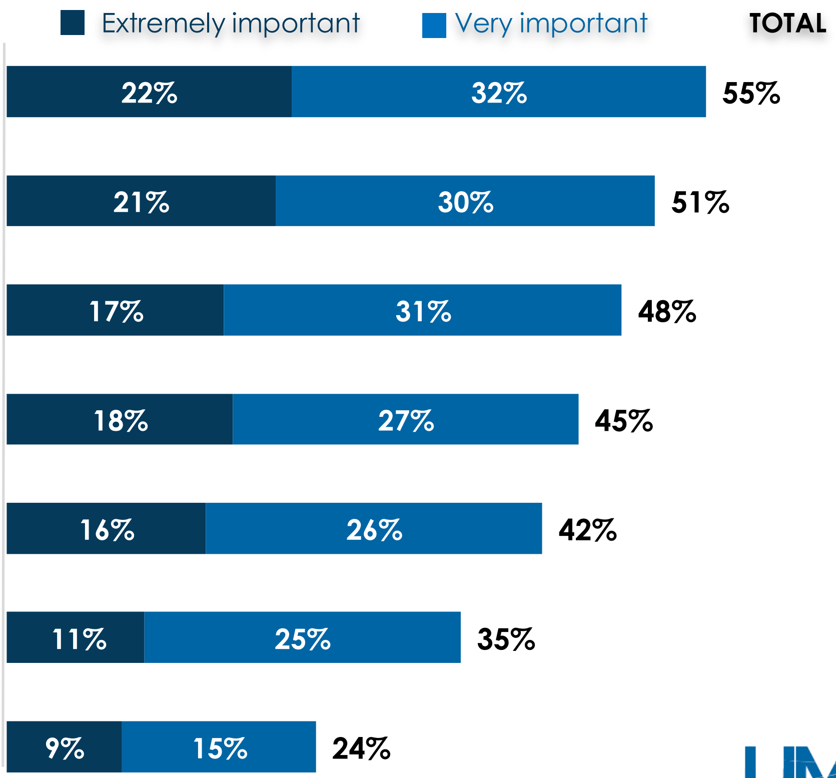
Base: Those who say they were offered benefits to switch default funds

UMR strategic research

Offers and incentives can influence employer decisions

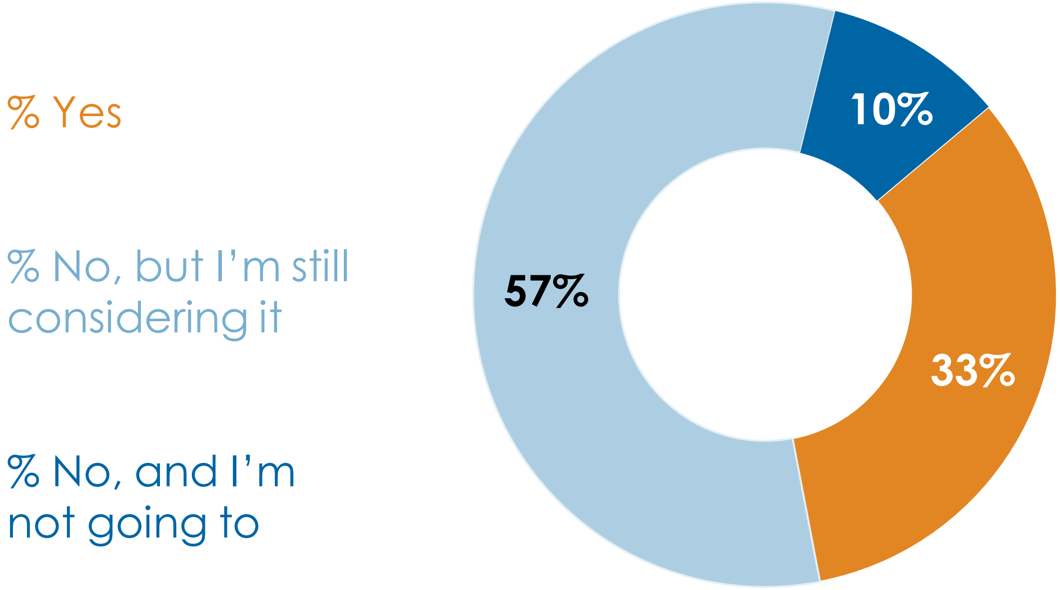
How important would each of the following benefits be in deciding whether to change your default super fund?

1. **Lower insurance premiums for your business**
2. **Discounted interest rates or fees on your business accounts (like loans, overdrafts or credit cards)**
3. Some discounts on fees within the superannuation product
4. Free financial advice for your business
5. Free financial advice for your employees
6. Free or discounted IT products for your business (like an iPad or business software solutions)
7. Free tickets to sporting events or corporate hospitality



Among those who've been made offers, many have switched their default fund or are considering doing so

Did you change your business's default super fund after these benefits were offered?

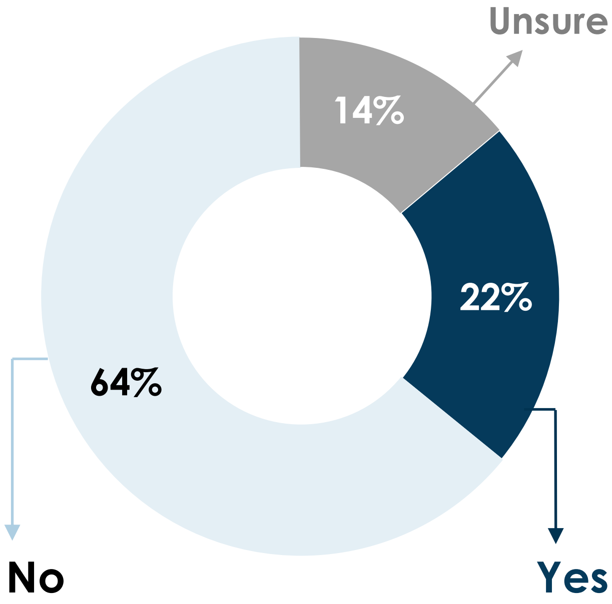


Base: Those who say they were offered benefits to switch default funds

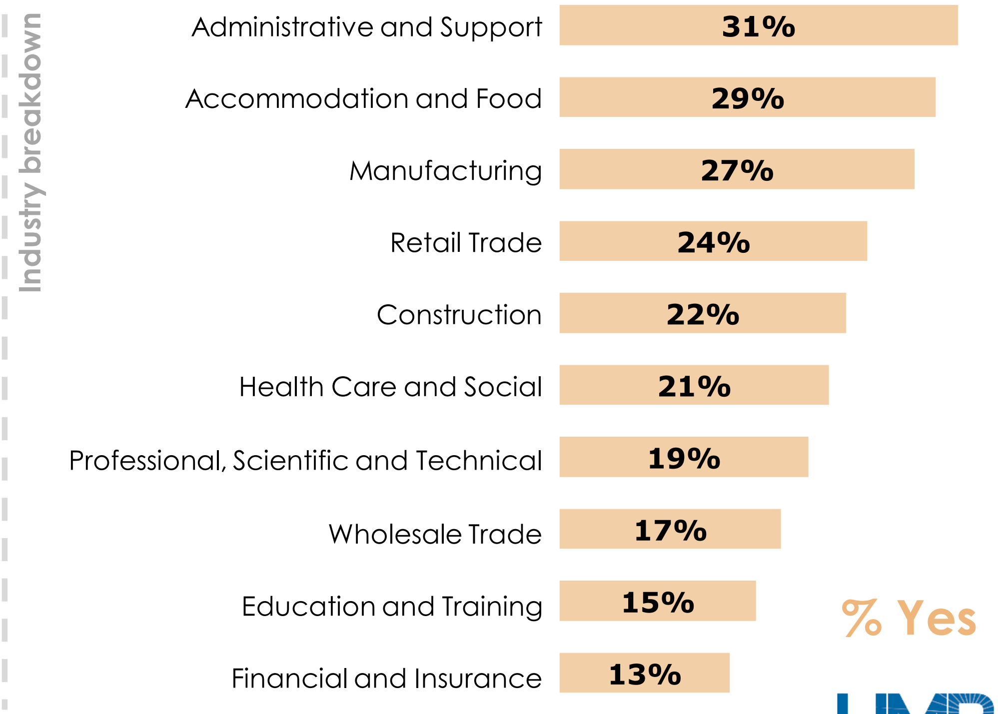
Most employers say they're not restricted in their choice of funds

Is your business covered by an award or workplace agreement (e.g. an EBA) which specifies what default super funds you can choose from?

TOTAL



*Small samples, indicative only



Methodology

Methodology

- n=550 interviews; nationwide; interviewed online
- Business owners with at least one employee, with quotas in place for geography & business size.
- Fieldwork: **28th November – 15th December**
- Data is weighted according to geography, business size and industry so the sample matches ABS census data to ensure a representative sample
- Online panel members are primarily recruited offline and by invitation only

About UMR

UMR is a public opinion consultancy that helps Australasia's and Asia's Corporate and Political Leaders make strategic decisions about their organizations and the issues of the day, based on cutting edge research techniques.

UMR specialises in designing strategic research for clients that operate in highly competitive, often challenging environments. Our focus is on the social and political factors which impact corporate and organizational reputation.

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UMR strategic research

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6 March 2015

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Dear Ms Campo

Section 68A of the *Superannuation Industry (Supervision) Act 2003* (Cth)

This letter sets out our advice on section 68A of the *Superannuation Industry (Supervision) Act 2003* (Cth) (**SIS Act**).

We **enclose** a copy of the full text of section 68A, which is known as the "no kick back rule". In broad terms, section 68A(1) prohibits a trustee of a regulated superannuation fund and the trustee's "associates" (as defined by the *Corporations Act 2001* (Cth)) from offering or providing goods, services or discounts to an employer on the condition that one or more employees of the employer will be members of the fund. Section 68A(3) contains a similar prohibition in respect of refusing to provide the employer with goods, services or a discount because one or more employees are not a member of the fund.

Under section 68A(2) and (4), the regulations may prescribe exceptions to the prohibitions in section 68A(1) and (3), however, those exceptions are not relevant for present purposes.

Contravention of section 68A(1) or (3) may result in civil liability under section 68A(5). That sub-section provides that a person (the "victim") who suffers loss or damage because of a contravention of section 68A(1) or (3) may recover the amount of the loss or damage by an action against the person who contravened section 68A(1) or (3) (the "offender"). In order for the offender to be liable to pay compensation, the victim must bring proceedings and establish that he, she or it suffered loss or damage because of the contravention.

A broad range of other remedies would apply under the SIS Act if section 68A were a "civil penalty provision".

Examples of civil penalty provisions under the SIS Act include:

- section 65(1), which (in broad terms) prohibits a trustee or investment manager from using the resources of the fund to give a loan or other financial assistance to a member of the fund or a relative of a member; and
- section 67(1), which (in broad terms and subject to certain exceptions) prohibits a trustee from borrowing money.

Contravening a civil penalty provision has a number of consequences under Part 21 of the SIS Act. Under section 196, a court may make a "civil penalty order":

- declaring that a person has contravened a civil penalty provision; and
- ordering the person to pay the Commonwealth a monetary penalty not exceeding 2,000 penalty units (currently, $340,000).

However, the court will not order a monetary penalty if the court considers that contravention is not serious or if the person has already been ordered to pay punitive damages because of the contravention.

Only ASIC or APRA (depending on which has responsibility for the relevant civil penalty provision) may apply to the court for a civil penalty order (section 197). On such an application, the court may also order, under section 215, that the contravener pay compensation to a regulated superannuation fund that has suffered loss or damage as a result of the contravention.

Further, under section 202, contravention of a civil penalty provision is a criminal offence, punishable by imprisonment for not longer than five years, if the contravention was committed:

- dishonestly, and intending to gain an advantage for the contravener or any other person; or
- intending to deceive or defraud someone.

However, section 68A is not a "civil penalty provision" under the SIS Act. That is clear from section 193 of the SIS Act, which lists the provisions of the SIS Act that are civil penalty provisions. Section 68A is not listed in section 193. Further, unlike most of the civil penalty provisions listed in section 193, there is no subsection of section 68A that states that a prohibition in that section is a civil penalty provision.

As sections 68A(1) and (3) are not civil penalty provisions, contraventions of sections 68A(1) and (3) are not liable to declarations or monetary penalties under section 196 or criminal penalties under section 202. That is not to say, however, that conduct which contravenes sections 68A(1) and (3) might not have other adverse legal consequences for the contravener, in addition to the potential for civil liability under section 68A(5). Section 68A(7) specifically states that section 68A does not affect any liability under any other provision of the SIS Act or under any other law.

Please do not hesitate to contact us if you have any further queries.

Yours sincerely

Zaven Mardirossian
Partner

Matthew Lees
Partner

Enc

68A Conduct relating to fund membership

(1) A trustee of a regulated superannuation fund, or an associate of a trustee of a regulated superannuation fund, must not:

(a) supply, or offer to supply, goods or services to a person; or

(b) supply, or offer to supply, goods or services to a person at a particular price; or

(c) give or allow, or offer to give or allow, a discount, allowance, rebate or credit in relation to the supply, or the proposed supply, of goods or services to a person;

on the condition that one or more of the employees of the person will be, or will apply or agree to be, members of the fund.

(2) However, subsection (1) does not apply in relation to a supply of a kind prescribed in the regulations for the purposes of this subsection.

(3) A trustee of a regulated superannuation fund, or an associate of a trustee of a regulated superannuation fund, must not refuse:

(a) to supply, or offer to supply, goods or services to a person; or

(b) to supply, or offer to supply, goods or services to a person at a particular price; or

(c) to give or allow, or offer to give or allow, a discount, allowance, rebate or credit in relation to the supply, or the proposed supply, of goods or services to a person;

for the reason that one or more of the employees of the person are not, or have not applied or agreed to be, members of the fund.

(4) However, subsection (3) does not apply in relation to a supply of a kind prescribed in the regulations for the purposes of this subsection.

Civil liability

(5) If:

(a) a person (the ***offender***) contravenes subsection (1) or (3); and

(b) another person (the ***victim***) suffers loss or damage because of the contravention;

the victim may recover the amount of the loss or damage by action against the offender.

(6) The action must be begun within 6 years after the day on which the cause of action arose.

(7) This section does not affect any liability that the offender or another person has under any other provision of this Act or under any other law.