Financial Systems Inquiry 2014

Interim Report July 2014

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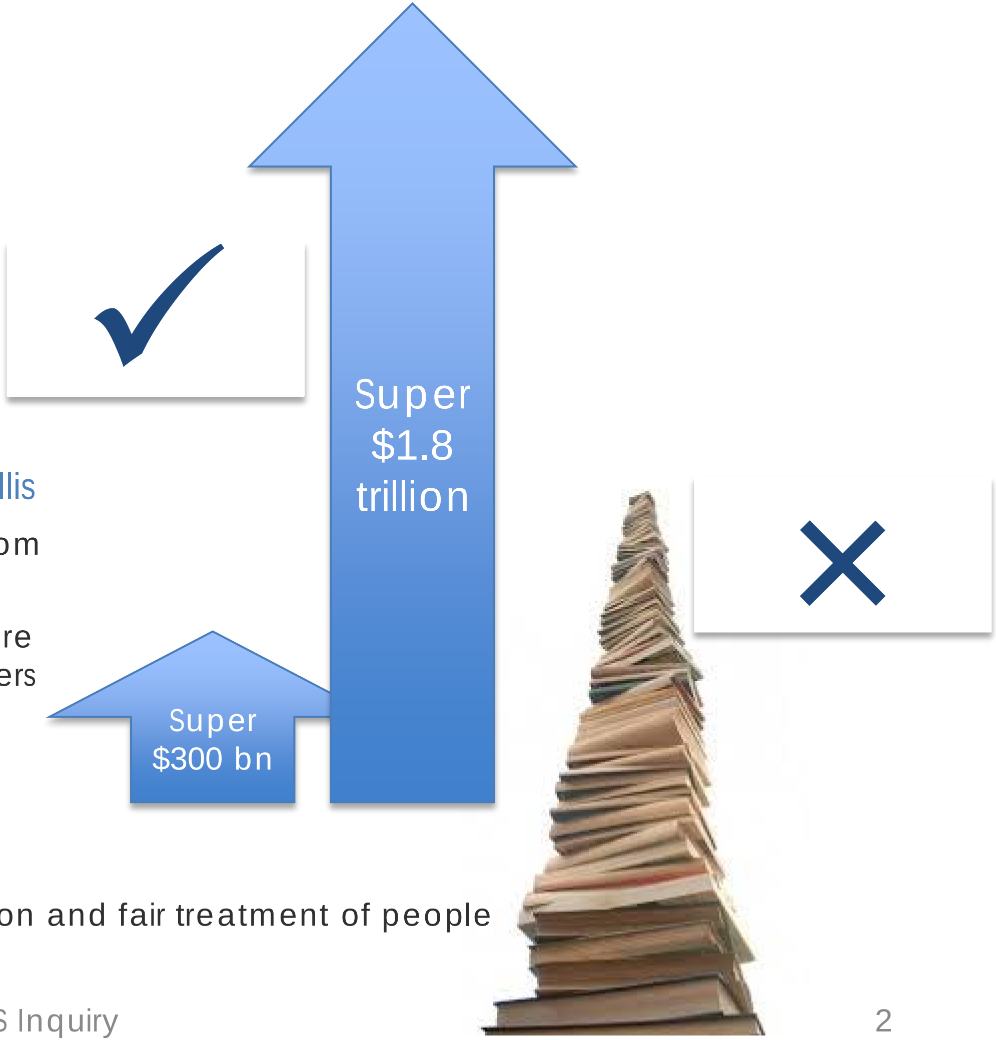
Background

- Overall Australian financial systems have performed well in meeting financial needs of Australians and facilitating productivity and growth
- What has changed in 16 years since Wallis
  - Rapid growth of superannuation assets from $300 billion to $1.8 trillion
  - Failure of (Wallis) assumption that disclosure would be sufficient to safeguard consumers
- Focus of Report is on confidence in:
  - Soundness of system
  - Retirement outcomes
  - Confidence in the exchange of information and fair treatment of people



Interim Report

AI Initial submission

- Objectives of report
  - ✓ Sets priorities for committee
  - ✓ Seeks input on policy options not recommendations
  - ✓ Seeking evidence based responses on costs, benefits and trade-offs

- Out of scope
  - ✗ Tax (as subject of white paper 2014)
  - ✗ Competition review (2014)
  - ✗ Preservation age, Age Pension & Adequacy
  - ✗ Life insurance - Industry already addressing issues with TPD claims and under-insurance

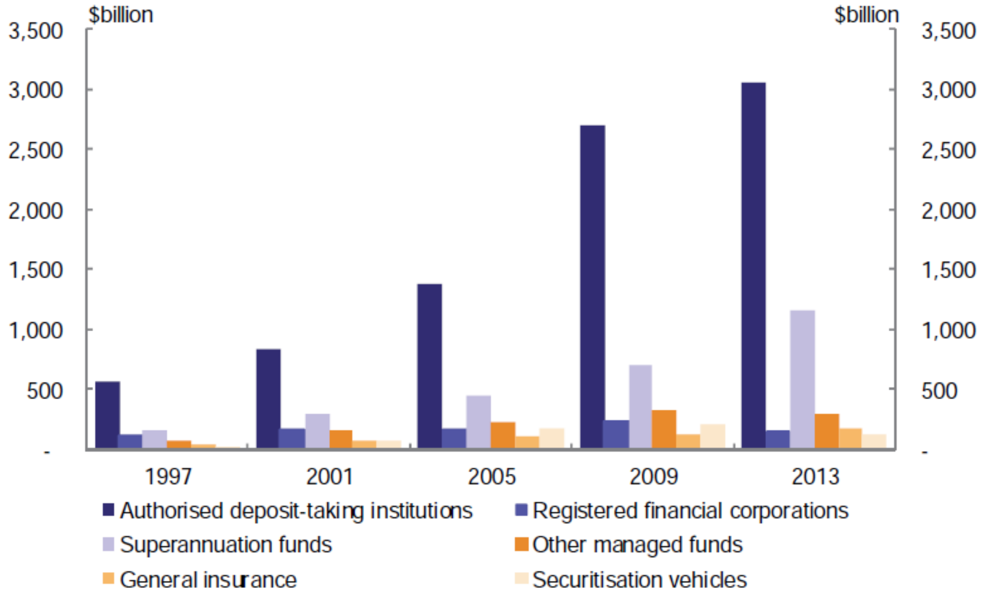
Today's focus:

- Superannuation key issues
  - ✓ Impact on capital markets
  - ✓ Efficiency
  - ✓ Regulation
  - ✓ Disclosure
  - ✓ Advice
  - ✓ Retirement incomes
  - ✓ Leverage
  - ✓ Lack of policy settings
- Briefly cover:
  - ✓ Life insurance
  - ✓ Banking sector
  - ✓ Governance – role of boards/trustees

Why superannuation is so important..

- Major source of funding for our economy!
  - The largest component of wealth management
  - $1.8 trillion March 2014 vs. $1.6 trillion ASX market cap
  - $9-$13trn by 2040
  - Exceed bank assets by 2030
- Structure
  - #300 APRA regulated funds
  - > 500,000 SMSFs (largest by FUM)

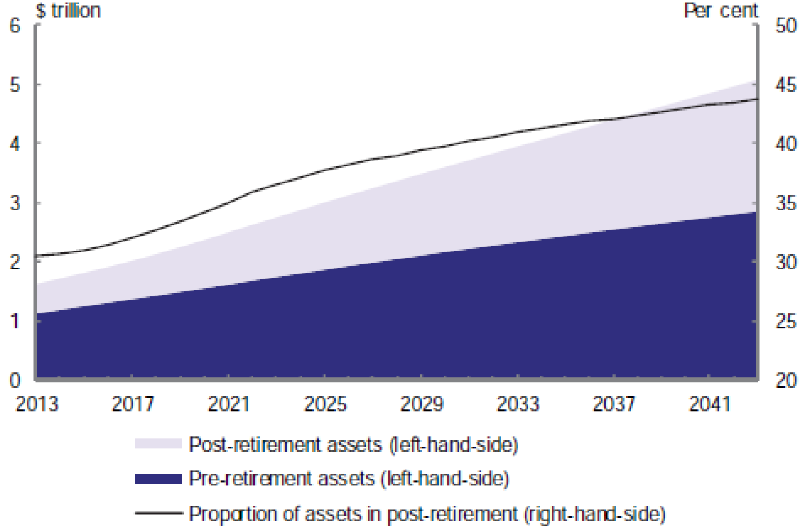
Chart 1.1: Assets of financial institutions



Note: Refers only to domestic operations and does not include assets of banks' overseas subsidiaries and branches. Registered financial corporations include money market corporations (for example, merchant banks) and finance companies (for example, debenture issuers).
Source: Reserve Bank of Australia.[9]

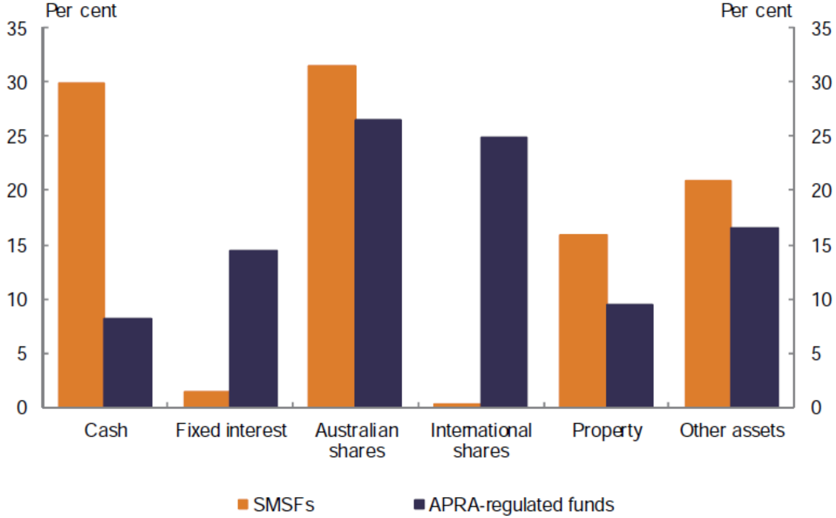
Capital markets-Super

Chart 8.2: Superannuation assets in the retirement phase
2013 dollars



Source: Rice Warner.[6]

Chart 3.9: Asset allocation of superannuation funds, 2013



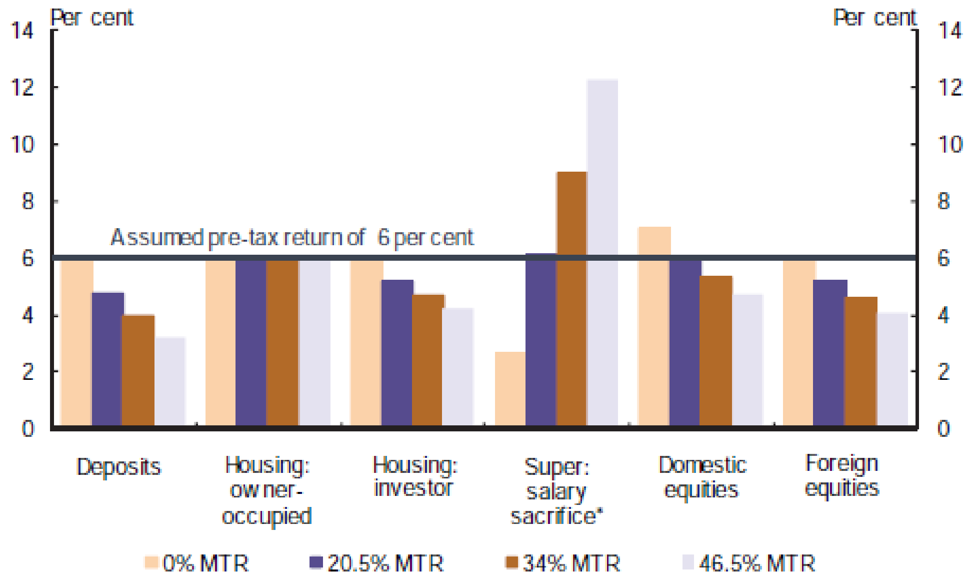
Sources: APRA and ATO.[92]

- Will there be a increasing shift to more defensive assets due to:
  - Conservatism of retirees as they age
  - Older superannuants preferring yield
  - Defensive overlays against significant asset falls
  - Increased demand for longevity products

Capital markets – other issues

- Dividend imputation
  - Is there still the need in a more global economy?
  - Does it distort exposure to equities at expense of domestic bond market?
  - Erosion of a large company tax revenue source given # of retirees with refundable ICs
- Housing and household leverage
  - Crowding out other investments
  - Risk to bank balance sheets

Chart 3.2: Stylised example — after-tax return on savings vehicles[8, 9, 10]
For individuals on different marginal tax rates, no leverage

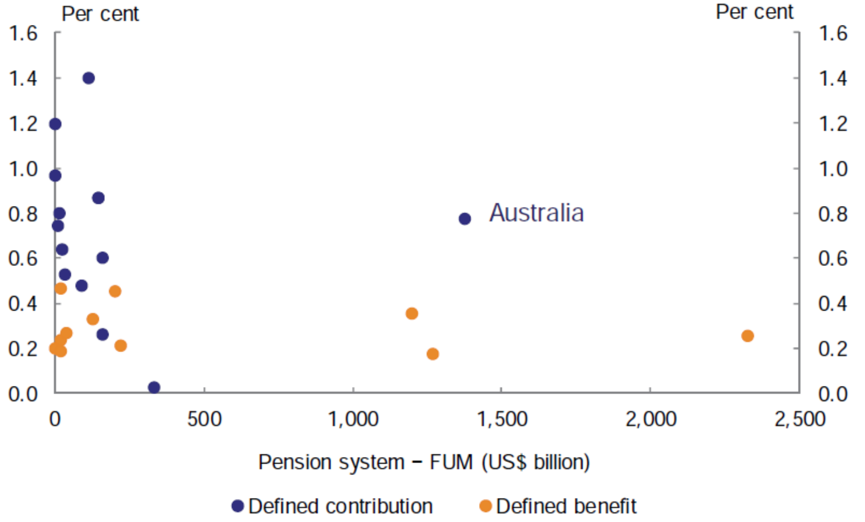


Efficiency of Super

AI No 1 recommendation

- Observation
  - Competition has led to feature rich, costly super
  - Australia 1.2% fees, 0.8% costs vs 0.4% OECD costs
  - Possible factors when comparing costs
    - Higher allocation to equities & alternatives
    - Lack of economies of scale
    - Shift towards modern admin platforms
    - Increase in member engagement
    - Lack of competition due to disengagement & complexity
  - After tax returns are paramount
    - Do not want a focus on fees to create low cost, low return environment
  - Next steps
    - Inquiry investigating reasons for fee differentials

Chart 4.1: International comparison of superannuation (pension) expenses
Annual expenses, as a percentage of funds under management (FUM)



Source: Grattan Institute.[20,21]

Lack of stable policy settings is increasing costs and reducing confidence and trust

Efficiency policy options and questions

Efficiency policy options

- No change
  - Review MySuper fees later
- Change MySuper
  - Default fund auction?
  - Other options?
- Replace 3 day portability rule
  - Longer time frame
  - Staged transfer
  - Other options?
  - Principles vs prescription for portability

Further information on

- Vertical integration
  - Is this helping or hindering fee reductions
- Asset allocations
  - Should they be tailored?
  - Is there short termism?
  - Active vs passive?
  - How should switching be priced taking into account liquidity?
- Trust Structure
  - Does this meet member needs in cost-effective manner

Regulation

- Conduct regulation applies to most financial products and services REs and MIS
  - To ensure financial markets are sound, orderly, transparent; users are treated fairly; and markets are free from misleading, manipulative or abusive conduct
- Prudential regulation applies to Superannuation, ADIs, Insurers
  - Targeted to where intensity of promise is highest
  - Superannuation is prudentially regulated because mandatory, preserved, tax concessional & essential for retirement

Figure 7.1: The Australian financial system regulatory framework

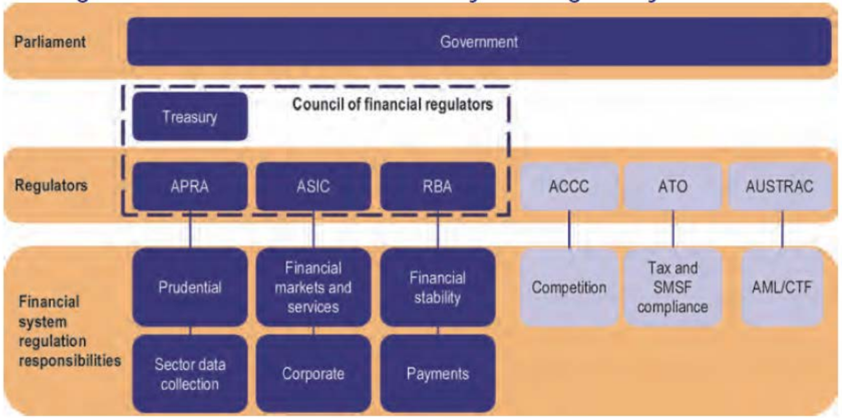
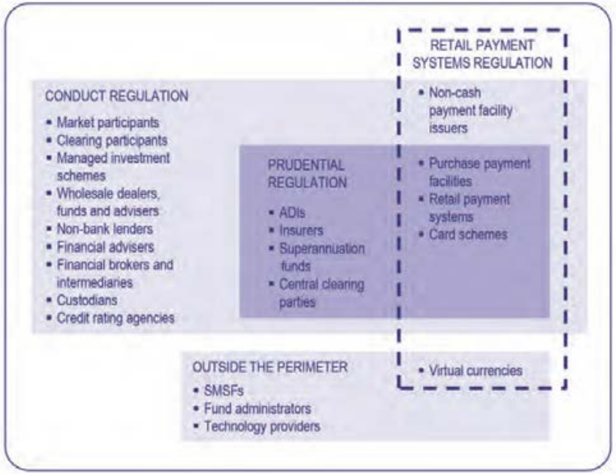


Figure 7.2: Current regulatory perimeters – illustrative summary by institution/activity type



Regulation

- Observation
  - No case for significant change to current regulatory “two peaks” (ASIC, APRA) framework
  - Concerns about cost of increasing regulation
- Costs benefits of regulation
  - Inquiry commissioning further work on burden of regulation both domestic and international reform
- Blurring of roles between prudential and non-prudential and overlap of ASIC and APRA

Regulation

How should entities be regulated?

- No change
- Conduct regulation:
  - Align Super funds with RE / MISs
  - Include financial administrators and technology service providers
- Apply market integrity rules to security dealers
- Are there instances where costs outweigh benefits
- Should a more tailored approach be considered eg for small ADIs?

Data requirements

- Could data collection be streamlined?
- Should new data requirements be offset by reducing existing data?
- Could more be made of existing data, including making it publicly available?

The regulators – ASIC, APRA and CFR

Regulators

- Options re budgets, reviewing and assessing performance of, and oversight of regulators
- Options to clarify mandates and review penalty regimes

Council of Financial regulators

- Series of policy options for increasing the role, transparency and external accountability mechanisms for CFR

Resourcing

- Options to attract and retain skilled and experience staff especially given FS sector high salaries

Disclosure

- Observation
  - Current disclosure regime produces complex, legalistic, lengthy documents that do not help/safeguard consumers and are costly
- Factors inhibiting informed consumer decision making
  - Disengagement
  - Complexity
  - Conflicts between providers and consumers
  - Poor financial literacy
- Changes to date
  - Short form PDS's have not helped
  - Government has intervened in some cases eg MySuper

Disclosure and product policy options

Disclosure	Product options
• No change • Improve using layered disclosure, risk profile disclosure and online comparators • Remove ineffective disclosures and facilitate new ways including use of technology and electronic delivery	• Targeted regulation of product features and distribution • Provide ASIC with product intervention powers to prescribe marketing terminology for complex or more risky products and temporarily ban products • Consider more default products with simple features and fee structures

Advice

Table 6.1: How consumers prefer to receive advice

Preferred method of advice (when cost is recognised as a factor)	Cost	Percentage of consumers who prefer this
Willing to pay for advice		
Scaled advice – phone and online	Low	19%
Scaled advice – face to face	Medium	14%
Comprehensive advice – phone	Medium	11%
Comprehensive advice – face to face	High	7%
Not willing to pay for advice		
Can't afford advice	-	21%
Do it myself	-	27%

Source: Investment Trends September 2013 Advice Report, based on a survey of 5,412 Australian adults.[38]

- Observation
  - Need affordable, quality advice
  - Comprehensive advice is costly
  - Less than 42% adult population had ever used a financial advisor
  - ASIC shadow shopping showed 3% good, 39% poor, rest "adequate"
  - Consumer demand for lower-cost scaled advice
- Factors potentially inhibiting provision of quality advice
  - Low minimum competency requirements
  - Influence of conflicted remuneration arrangements
  - Vertically integrated structures may also impact

Advice options

Quality of advisers

- No change
- Raise minimum education and competency standards and national examination for providers of personal advice
- Enhanced public register of financial advisers
- Enhance ASIC's banning powers

General advice

- No change
- Rename as 'sales' or 'product information'
- Mandate that the term 'advice' can only be used in relation to personal advice

Access to low cost advice

- Opportunities for enhancing access to low-cost, effective advice?
- Opportunities for using technology to deliver advice services and what are the regulatory impediments?
- Potential costs or risks and mitigations

Independence

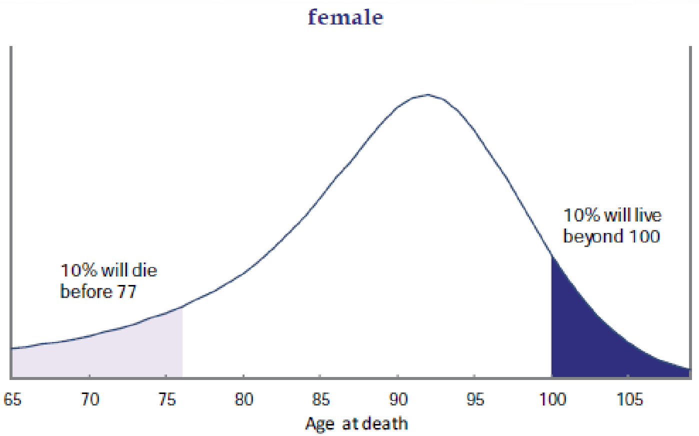
- Should we more clearly distinguish between independent and aligned advisers, and how?
- Would consumers understand the difference and, if so, would this factor into decision to take advice?
- Would consumers be sensitive to price differences of independent or aligned advice?

Retirement incomes

- Observations
  - Retirement phase underdeveloped
  - Does not meet retirees risk needs
- Issues
  - Largely account based pensions, some life & term annuities
    - Annuity market 0.3% GDP Aus vs 15% US, >=30% UK/Japan
    - Age pension crowds out demand for annuities
  - Some stats
    - 50% of benefits taken as lump sum (may confuse rollovers?)
    - 1/3rd of assets withdrawn before Age Pension age
    - 1/4th of people have depleted super by age 70

Table 8.1: Features of retirement income products

	Account–based pension	Lifetime annuity
Income	✓ Difficult for retirees to decide how much to withdraw Payments cease when balance is exhausted	✓ Payments continue for life Purchase price includes margins, some of which are for servicing capital
Flexibility	✓✓ Complete flexibility of withdrawals (subject to statutory minimum) Residual balance at death available for bequests	✗ Non-commutable Generally no residual balance at death
Risk management	✗ Individual exposed to longevity, inflation and investment risks	✓✓ Provides complete longevity risk protection Indexed annuities also provide inflation risk protection



Source: Australian Government Actuary.[18]

Retirement policy options

No change

- Improve financial advice
- Remove barriers to product development

Policy incentives

- Discourage lump sums
- Encourage annuities through significant tax and Age pension benefits but offset costs elsewhere

Defaults

- Retirement defaults with or without policy incentives
- Defaults could depend on range of factors such as size of account

Compulsion

- Mandate all or part of account balance to purchase specific "retirement products" possibly at later ages

Range of products

- Observations
  - Regulatory and policy impedes retirement product development
- Issues
  - A portfolio of products may be answer including DLAs & group self annuitisation products and others that may emerge
  - Impediments include
    - SIS regulations
    - Age pension means test
    - Multiple approvals required
    - Lack of long dated bonds
    - High capital requirements for annuities in Australia
    - Insurance cover for credit risk on deposits but not annuities
  - Government intervention and provision of products – last resort only!
- RI group (reporting to FS secretariat) established to do further work

Range of products

Policy options

- No change
- Principles based approach for tax and Age Pension concessions
- Streamline approvals
- Issue longer dated bonds

Other options

- DLA and group self annuitisation?
- Other suitable products?
- What would be appropriate defaults?
- How can private sector manage longevity risk if large increase in coverage?
- Should Government increase its longevity insurance and how would it control political risks?
- How to assess and compare retirement income products?
- Is ‘income efficiency’ a useful measure?

Home equity

- What impedes product development for home equity?

Other policy options

- SMSFs
  - Restore prohibition of leverage in super (on prospective basis), 11% growth in SMSFs with leverage (to 38,000)
  - Are the high operating costs a concern?
  - Should their be limits on starting SMSF's
- Too big to fail?
  - Impose losses, increase regulators resolution powers, increase capital, ring fence critical functions
- Corporate Governance
  - Review prudential requirements of boards to ensure not drawn into operational/compliance matters
  - Regulators clarify expectations on the role of boards
  - Should duties of directors of banks, insurers & trustees of super funds be the same & who should primary duty be to?
- Insurance
  - Is there a problem with under-insurance
  - Technological developments increase risk based pricing which may make insurance unaffordable for some but encourage risk minimisation
  - Aggregator access to insurance information
  - Potential opening up of state based schemes to competition
  - Legacy products remain an issue

Other policy options

- Banking
  - Competitive but concentrated (78% of ADI assets in major banks)
  - IRB Banks capital/cost advantage over non IRB (smaller) banks
  - Regulation of credit card and debit card payment schemes is required
  - Access to foreign funding has sustained higher growth. Risks can be mitigated by prudent supervisory/regulatory regimes and sound public sector finances.
- Options
  - For smaller banks to better compete
  - Increase comprehensive credit reporting
  - Should critical bank functions be ring-fenced?
  - Greater use of stress testing by regulators with appropriate resourcing

What next?

- Submissions due Tuesday 26th August 2014
  - Note navigation tool on web site