

ASIA-PACIFIC REGULATORS' AND INDUSTRY DIALOGUE

Session 4

Protecting the Interests of Pension Users

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SUMMARY PAPER

Protecting the interests of pensions users generally involves the regulators of pension / superannuation funds addressing or otherwise dealing with risks to consumers in three major classes;

- i) investment risk
- ii) agency risk, and
- iii) systemic risk.

Investment risk contains both diversifiable risk and market risk. Diversifiable risk is risk that can be mitigated through a sound diversification strategy – or else through restrictions on the holding of illiquid assets and very risky assets. Market risk is the exposure of members to the vagaries of the market. The long holding periods for superannuation funds have a tendency to mitigate, but not eliminate some risks in this area. In the past many funds had reserving arrangements to smooth out investment returns, but these have tended to be abolished or reduced in importance as more fund members exercise choice of fund or investment option.

In some other jurisdictions restrictions are placed on pension funds in regard to the amount of shares or like investments a fund can hold or the amount of overseas investment they can undertake. In contrast, in Australia the regulatory approach adopted is to require funds to have a documented investment strategy along with policies and practices that deal with investment risks that might arise. No particular investment or class of investments is ruled out, but trustees of funds must be able to explain why an asset is included in the investment portfolio.

Investment theory and practice suggests that relatively unconstrained investment choices lead to better investment outcomes, both in regard to risk and return. Indeed ASFA had its genesis in corporate superannuation funds objecting to the introduction of a requirement by the then Australian government for funds to hold specified percentages of assets in different types of government securities.

Australia is also unlike many jurisdictions in that the vast bulk of members are in accumulation funds and accordingly carry much of the investment risk associated with their retirement savings. This gives rise for a need for adequate disclosure to fund members of the nature and characteristics of the investments backing investment options available. It also gives rise to the obligation placed on financial advisers to consider the risk tolerance and circumstances of a customer and devise a recommended strategy for retirement savings accordingly. ASIC is active in enforcing these obligations.

Agency risk is where the interests of the persons operating the fund diverge from the interest of fund members. The legal and financial complexity of superannuation, combined with a lack of member knowledge of these complexities, generate an imbalance of information that can disadvantage members and create opportunities for incompetence, misuse or outright fraud and theft by plan providers and/or their service providers. Agency risk can also include operational risk, where administrative or computer systems may prove inadequate or fail.

The system of trustee and fund licensing that is applied by the Australian Prudential Regulation Authority to superannuation funds provides considerable protection for fund members in regard to agency risk. Superannuation fund trustees are required to go through a rigorous and demanding licensing process which is designed to weed out those who are not fit or proper.

Systemic risk is where the possible failure of a financial institution threatens confidence in the sector or the economy as a whole. Traditionally, this has been of greatest concern in the banking sector, where a failure of a major bank can have a ripple effect throughout the economy that threatens economic stability.

Requirements in the legislation governing the superannuation sector guide trustees towards a diverse and liquid investment strategy. The licensing requirements further formalise investment decision-making processes, primarily through the risk management documentation, but have not had a dramatic impact on how trustee actually invest.

With some hundreds of superannuation funds and with the largest superannuation funds having no more than a few percentage points of the overall funds in superannuation, systemic risks do not loom large in the array of risks faced by superannuation fund members. Superannuation funds are also generally prohibited from borrowing, so leverage issues and margin calls are not usually issues for funds and fund members. Counterparty risks are also generally not relevant to superannuation funds, or the exposures are very modest and well dealt with. However, in the Self Managed Superannuation Fund sector there have been issues emerging in regard to the use of Instalment Warrants.

The implications of these approaches to dealing with risk

In the terms of the questions asked in the program for this session, the Australian supervisory framework provides quality and relevant supervision which protects fund member (pensioner) interests.

More specifically, the regulatory framework requires the trustees of a superannuation fund to be fit and proper, and to have in place policies and practices to deal with a range of risks. Such risks can include those associated with outsourcing certain services, such as administration or investment management, to third party providers. There are also regulatory requirements dealing with the avoidance or management of conflicts of interest. These arrangements protect the interests of fund members in regard to the direct actions of trustees, and also in regard to the activities of fund managers and asset managers.

Since the introduction of trustee licensing with effect from July 2006 there have been no recorded cases where agency risk could be said to have incurred. If any future cases of fraud or theft occur, there are compensation procedures in place which allow for the payment of the bulk of any losses that are incurred by a fund member. These compensation payments are funded by way of levy on all regulated superannuation funds.

However, investment losses can occur which do involve fraud or theft. While not every investment made by a superannuation fund will necessarily be a success, the process of selection used for investments and the extent of diversification within funds addresses a considerable part of the investment risk.

Australia's regulatory system prevents the kind of losses that have occurred in other countries when an employer associated with a fund has experienced financial difficulties. Employer contributions are required to be in cash, not in kind. The Australian system has what are known as "in-house asset rules". This restricts the fund from holding more than 5 per cent of its assets in employer stock. Australia's superannuation system also provides further levels of protection, including in many cases equal representation of employers and fund members at the fund board level.

For the majority of fund members who do not exercise an investment choice, the existence of balanced default investment options and/or aged based investment options provides a reasonable response to dealing with the investment risk faced by fund members. For those who exercise investment choice, regulation of disclosure and of advisers is crucial in fund members understanding and accepting the risk/return profile they are taking on.

In short, fund members in accumulation funds have the legal certainty that their fund balance after contributions and applicable investment earnings less contributions and earnings tax will be available for them when they retire. For the remaining defined benefit schemes, the regulator requires a high level of employer funding with regular actuarial reviews. Levels of member satisfaction with their fund are high, with opinion polling indicating that in September 2007 around 90% of respondents were happy with their current superannuation fund.

In regard to the quality of information available to fund members, the Corporations Act requires comprehensive and regular reporting to fund members. Before joining a fund a Product Disclosure Statement is required to be provided. Fees and expenses are disclosed in a standard format, utilising an example based on a specified account balance and contributions. On an ongoing basis an annual report and member statement are required, with many funds reporting more regularly. Funds are also required to report any significant events that occur in regard to the fund. Many funds maintain websites with comprehensive information on the fund and its performance and access to individual account information on a password protected basis.

The over-riding principle for disclosure in Product Disclosure Statements is that they be clear, concise and effective. However, in practice many PDSs would be better described as comprehensive. The Australian Government has established a Financial Services Working Group drawn from government agencies which has as one of its first

tasks the development of more effective disclosure arrangements. ASFA will be participating in this process. Our initial suggestions have included better use of incorporation by reference, where the base document contains details of how to obtain more detailed or specialised information.

Increasing financial literacy is a challenge in all countries. While making disclosure more effective in practice will assist consumers in understanding the financial product they have and the risks they face, more than effective disclosure is required. Funds and financial advisers devote considerable resources to the financial education of consumers. However, opinion polling conducted for ASFA in September last year indicates that investment risks associated with economic and investment cycles are still not well understood by a significant proportion of the population. Around 70% of those surveyed indicated that they expected that investment returns in 2007-08 would stay as high as the double digit returns in the previous year or even be higher.

The Australian Government established a Financial Literacy Foundation which has prepared a range of resources for consumers and conducted various campaigns designed to lift the level of financial knowledge of consumers. The regulator ASIC also has prepared several publications specifically aimed at consumers and has a consumer website (www.fido.gov.au) with extensive materials and calculators dealing with superannuation.