Australian Shareholders' Association

Australian Shareholders' Association Limited
Suite 301 90 Pitt Street Sydney NSW 2000
GPO Box 359 Sydney NSW 2001
t 02 9223 8811
f 02 9223 3964
e share@asa.asn.au
ABN 40 000 625 669

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Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Australian Shareholders' Association (ASA) response to Financial System Inquiry (FSI) Interim Report

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. ASA is an independent not-for-profit organisation funded by and operating in the interests of its members, primarily individual and retail investors, self-managed superannuation fund (SMSF) trustees and investors generally seeking ASA's representation and support. ASA also represents those investors and shareholders who are not members but follow ASA through various means, as our relevance extends to the broader investment community.

The Financial System Inquiry (Inquiry) is charged with examining how the financial system could be positioned best to meet Australia's evolving needs and support Australia's economic growth. This submission is generally framed as a response to the Inquiry's Interim Report (Report), and follows its structure; however, it should also be read in conjunction with our first submission on 31 March.

ASA is not qualified to make estimates of costs or savings with respect to the Report's policy options. Rather, we have responded on points of principle to several of the "Observations" made in the Report. We have also emphasised topics that are of special interest or concern to ASA.

CRUCIAL PRINCIPLES

There is fundamental need for much greater financial literacy across the whole nation, at all ages. Australia must continue, and increase, Government funding for financial counselling, ombudsman services etc, to help people who are being exploited through ignorance or desperation. The funding required is a tiny percentage of consumer losses and overcharging that should be avoidable.

This is mirrored by the urgent need for improvement in the quality of training and professionalism of financial advisors/ planners; the minimum educational standard should be a university degree or equivalent professional qualification in a related area, for example accountancy. Given the very large earnings of the planning industry and product providers, the poor standards of training and behaviour that have been so often evident in recent years are inexcusable. We support the FPA standards to become a Certified Financial Planner. ASA also supports the call for ASIC to maintain a register of all financial planners, which should be available to the public. Conflicts of interest for remuneration between sales and advice must be examined further, especially regarding the vertically integrated big four banks and AMP that together own 80% of the planner channel. The Government's partial FOFA repeal is deeply regrettable, and likely to cause (further) substantial harm to the consumer - as if the lessons of the last decade were not clear enough.

ASIC, APRA, ABS, ATO and similar bodies must be adequately funded and staffed to ensure strong and timely surveillance and enforcement. Penalties must be increased to deter wrongdoing.

The “fitness for purpose” of policy settings in general and life insurance must be tested. There must be no carve-outs from unfair contract terms legalisation. It is unfortunate that health insurance is out of the FSI scope, as its policy settings also warrant examination under finance and consumer utility, as much as under health. Policy should enable unbundling in health and general insurance; and options of higher excesses should be available if customers want them. Policy should also encourage sharing of risk data between insurance companies. The Inquiry has not yet commented on the apparently small reinsurance capacity in Australia, and whether/how this could be expanded- to reduce exposure to volatile pricing and erratic availability in overseas reinsurance markets. Work on this subject would be welcome.

Ad valorem fee models are behind many of the high cost features in finance for the retail sector, including most or all of funds management (both superannuation and general funds management), stock broking, property transactions and foreign exchange transactions (including FX credit card purchases and ATMs) and (some) financial advice. The fact that ad valorem fees have persisted, despite enormous increases in scale in asset management and improvements in technology/ processing of routine transactions, demonstrates a significant failure of genuine competition. Assertions by the financial industry that Australian funds management costs are not comparable to other jurisdictions because of our high intensity in equities, and other arguments asserting relative complexity, are fair comment in principle but we believe greatly exaggerated in degree. This is of great importance given low levels of public understanding/ engagement, and that mandated superannuation already accounts for hundreds of billions of dollars under management. Similar comments apply to the non-superannuation funds management sector, even though it doesn’t enjoy mandated contributions.

Recent reforms like MySuper are a help, but even when they have been given two or three more years to take hold we doubt whether they will cause a really material reduction in percentage fees, and certainly not in absolute fee levels. Even if they do succeed, will similar improvements be adopted in the non-superannuation funds management industry, as they should be? It is apparent that high fees are a problem mainly at the retail level; if wholesale fees were equally uncompetitive that would impede Australia’s ambitions to offer asset management services to foreign investors. The industry funds generally charge administration fees to recover overheads and fixed costs, yet these are small compared with the ad valorem fees that they charge for the investment management (IM) function. Since industry funds are supposedly non-profit, this must reflect their paying percentage fees for outsourced IM services. However, we note that some of the larger industry funds are increasing their in house IM capability, to reduce costs. We hope that these trends will continue as the funds increase in size. Whether the IM function is in-house or outsourced, it is largely a fixed cost for the provider, which ought to fall as scale increases. Several managers charge performance fees as well, which further suggests that the bulk of the IM fees ought to be fixed *dollar* costs to recoup overheads with a fair profit margin added on, but not fixed *percentage* base fees.

Class actions can be a useful remedy for investors, but there are unfortunate by-products. Eg shareholders can and do sue their investee companies- in effect their fellow shareholders. In principle ASA supports the ability to mount class actions generally, and specifically for shareholders, where they are based on genuine loss and directed at directors, auditors and other third parties. In many cases companies/ shareholders pay little in the settlement of damages; we understand that insurance cover often meets the bulk of any settlement. This may mean of course that premiums for all will increase. There are different types of class actions and not all are based on claims of corporate governance failure. A number relate to fees and charges, in effect challenging price/ fee setting arrangements. Lawyers’ contingency fees are being considered by the Productivity Commission; if introduced they should be capped. We note that there is contention whether some class actions are meritorious or merely a form of greenmail by litigation funders and lawyers pursuing wealthy defendants, in the hope of reaching large out of court settlements. There has been abuse of Sons of Gwalia law (in cases before the amending legislation struck it out) by predatory lawyers.

We repeat our call for an emergency liquidity backstop to be available from Government (for a suitably expensive fee to discourage moral hazard) to APRA regulated superannuation funds (not SMSFs). We discuss this further under 2-113; other related subjects are discussed under Chapter 4. The time limits for portability between funds, and switching asset classes within funds, should be relaxed. It is inefficient, contradictory and costly to demand that funds achieve good long term returns, with limited volatility, but at the same time insist on almost instant liquidity for members.

We agree that banks and superannuation funds should not be directed to finance particular classes of consumer, borrower or projects- but impediments to efficient investment choices, such as short- termism, tax and inflation effects need to be mitigated.

Information asymmetry exists between providers of financial products and services and their consumers: eg mispricing and brokers/analysts encouraging churn at the expense of long-term investor value. Fine print and legalism are used against the consumer eg in insurance and banking, even by reputable institutions, leading to loss of trust and underinsurance. Some organisations do not fully honour their own codes of practice.

Government must consider the realistic cost of regulatory failure to consumers, which is far greater than the regulatory cost to business; in any case, the latter is likely mainly passed on to consumers, rather than absorbed by business owners and shareholders.

RESPONSE TO FSI REPORT OBSERVATIONS and POLICY ISSUES

CHAPTER 1 Overview

<u>1-15 taxation</u>

Imputation: ASA disagrees with assertions that dividend imputation has distorted equity v debt investment. See below at 2-58.

IWT: ASA does not believe that IWT should be abolished; however, there may be merit in considering the removal of IWT for widely traded bonds with tenors over say 5 or 7 years (providing they are non-callable or -puttable within that period) to assist lengthening the corporate and banking sectors' liability profiles, and thereby enhancing stability.

GST: we trust that the Tax inquiry will at least consider the merit of increasing the GST rate and that all transactions should be subject to GST with no exclusions - subject to appropriate compensation mechanisms for the poor and disadvantaged. The extra tax revenue should be used to reduce corporate or income tax rates, to encourage saving versus consumption, and reduce tax evasion. The change would also reduce red tape and costs considerably.

CHAPTER 2 Competition

<u>Xviii/xix and 2-9 to 2-16 banking sector capital requirements</u>

The current variations in banks' risk-weighting methods cause significant distortion in risk- weighting, and hence ROEs of mortgage businesses between large banks and smaller ADIs. This is anti-competitive and a substantial cause of the preference for banks to fund housing loans over business finance, especially to SMEs. In consequence, this exacerbates the problems of crowding out of SME finance, booming housing prices and excessive borrowing by the household sector, and the systemic risk and economic dysfunction arising from this. Of the policy options advanced, we favour increasing minimum IRB risk weights, and also assisting smaller ADIs to attain accreditation (whilst maintaining full analytical rigour in the assessment process).

Government support should not be provided to the RMBS market; there could be merit in the second policy point, but great rigour would be needed to determine which RMBS should be allowed as HQLA eg if rated AAA or AA. There is a risk that LCR calculations could be compromised by weaker assets, and potential moral hazard.

Xix and 2-26 to 2-32 interchange fees and surcharges

Table 2.1 Percentage based charges are not justifiable for this service; the system should be directed to genuine cost recovery with perhaps a small profit per transaction. Also we note that airlines, taxis and others are notorious for charging amounts for credit card use well above the merchant rates that they incur.

CHAPTER 3 Funding

Xx and 2-47: analysis and policy must distinguish between foreign equity and debt funding. The Inquiry should examine policy (including tax policy) to enhance long-term foreign equity investment in Australia and reduce reliance on debt.

2-50-57 tax and housing distortions

The Report's point about households shifting assets into superannuation is probably valid for people within say 10 years to retirement, but the strict release conditions for superannuation would militate against that for younger investors. The Inquiry rightly notes that the CGT exempt status of the primary residence does encourage over-investment in that single asset by many households. It would clearly be politically impossible to remove the tax free status of the home; and there is also the point that imposition of CGT would be a blunt instrument of policy, as it would apply only upon sale, perhaps after many decades. Thus, unless the 50% reduction was also removed, the home might still be preferred as a tax shelter, to the detriment of other forms of investment. If the primary residence was made subject to CGT, the seller would be financially disadvantaged when buying their next primary residence and therefore required to borrow more. To mitigate that burden, the purchase price could be indexed for inflation; or, when the primary residence is sold on death, that could be the CGT trigger. The Inquiry might consider, instead, leaving the primary residence CGT exempt but propose an annual levy (prospectively) on the *land* value of the primary residence above a material threshold, and indexed for CPI. Such a levy would partly compensate for the non-taxation of imputed rent, and could be accrued to be paid from sale proceeds.

The problem of housing lending crowding out business finance, and in particular SME finance, would be mitigated by reducing the IRB advantages of the major banks, as we suggest above.

2-58/9 Dividend imputation

ASA strongly disagrees with the statement that "the case for retaining [dividend] imputation is now less clear than in the past". We contend that imputation merely removes the double incidence of tax on investment through companies, and thus places the investor and the company in a neutral position as regards debt. Not only was the pre-imputation system unfair and uneconomic, it had the adverse effects noted on 2-58 at footnotes 31 and 32 [IMF].

The last paragraph of 2-58 asserts that imputation encourages higher dividend payout ratios. That is probably true, but so is the important further comment about imposing greater discipline on boards and managements to justify major investment decisions- through using capital raisings rather than using internal funds. This is an important prudential benefit, offset by only the minor qualifications of timing and alleged inconvenience of capital raisings.

We do not, in general, support the assertion that global capital markets determine the cost of funding and hence the contention that dividend imputation is a domestic subsidy but doesn't affect cost of capital. The only exceptions to that might lie with the largest listed companies - say the top 20 or 30 by market capitalisation; below that group, cost of capital is, we believe, determined much more by local conditions and economics.

2-59 suggests that dividend imputation could contribute to a number of characteristics of the financial system, including the three examples given. Although there is some truth in that, there are more compelling reasons for the three points mentioned:
(1) the lower allocation to foreign equities holdings probably has predominant other causes such as unfamiliarity with foreign markets and companies for retail investors making direct overseas investments, and high costs for making them through managed funds/superannuation; reluctance to bear FX risk, inefficient interaction with overseas tax regimes, and cultural factors. Secondly, we doubt whether anyone would make a case that property investment, for example, has been hindered by imputation;
(2) We comment elsewhere on probable reasons for a weak corporate bond market - but we think it is more a problem of insufficient *supply* by volume and long dated tenor, than lack of demand; and retail investors' concern over inflation (whether bonds are held directly or via their managed funds and superannuation).
(3) Low take up of annuities –low long-term interest rates, which after fees make returns unattractive; inflation which reduces them to almost zero real returns; unhelpful tax treatment of deferred annuities - thereby exacerbating the valid consumer concern of longevity risk.

Even if the assertions of footnotes 30 and 33 were entirely true as a theory, we believe that a major dismantling of the principle of the dividend imputation system would have a catastrophic effect on Australian equity markets and investors, especially retail. Equity values would fall heavily, investor confidence would be profoundly shaken, not only for domestic investors, and the cost of capital would rise. Indeed one could expect a significant drying up of equity supply, especially from retail investors. Most likely, investors' capital would gravitate to the property market or foreign equities, neither of which would be desirable policy outcomes. We strongly urge the Inquiry to reject any thought of reducing the efficacy of the imputation system, which has been one of Australia's best policy developments in the last 30 years. Investors might also turn to very risky investments -eg CFDs, hedge funds, derivatives and currency trading and be exposed to aggressive and misleading sales tactics.

<u>2-77 to 2-81 credit growth and deposits</u>

As well as promoting the development of a corporate bond market, which is very worthwhile but will take some years to evolve and mature, the Inquiry should consider ways of enabling banks and other ADIs to obtain wholesale and retail funding for (much) longer than five years- which generally seems to be the limit for current funding, except for subordinated debt or hybrid issues. If the banks could gradually increase the maturity profile of their wholesale funding book, it would make the banking system more stable and less prone to external shocks; at the same time it would develop the fixed interest asset class available to fund managers and retail investors alike, and increase its share of asset allocation.

As noted in our comments on imputation, we don't accept that deposits (or fixed interest debt) are unfavourably taxed v domestic equities. Be that as it may, the Inquiry could consider the introduction of tax-advantaged investment vehicles for the public, similar to the ISA system in the UK. For example, resident individuals (only) might be allowed to invest up to $10,000 pa in separate ISAs each year, and all income would be retained until maturity, with the proceeds made entirely tax free if the ISA was held for say five or seven years. To redress the perceived systemic tax bias against income, the eligible investments might be restricted to government bonds, corporate bonds or ADI deposits.

<u>Xxi/xxii and 2-86 to 2-91 corporate bond market</u>

We agree in principle with the option of allowing already listed entities to issue vanilla bonds without a prospectus. Some safeguards would be advisable- eg the issuer must have been listed for at least three years, subject to a minimum size eg belong to the ASX 300; the bond issue should not exceed a specified percentage of its market capitalisation, balance sheet equity or gearing levels. A key fact sheet must be provided in lieu of a prospectus. Are different requirements warranted depending on whether the issue is underwritten?

Is the Report's point re $2m or $10m offering limits referring only to *unlisted* issuers? Would this be restricted to sophisticated or wholesale investors? If so, we can see merit in the limits on $ values and number of investors being (moderately) increased. The main policy concern is to ensure that unsophisticated retail investors could not be enticed into bond investments with inadequate or no information about prospective liquidity and credit risks. This concern is heightened with the expansion of the internet and social media since the current limits of ss708/9 were introduced.

As the Report notes, one would expect the demand for fixed interest products to increase as the population ages, and conversely that a fixed interest market would become deeper and more sophisticated as annuity-style products are developed. There should be a positive feedback developing between the two. Is it implicit that such retirement products would be tax free- as that would clearly overcome one of the main disadvantages that the Report notes, namely the treatment of *pre*-retirement interest on bank deposits and bonds, for example?

A major challenge will be the availability of enough long-dated *supply*. The retirement income market will want access to a range of tenors, but principally ten years or longer. Beyond maturities of about five - seven years (at most), the credit quality of the corporate sector is unlikely to be strong enough to permit more than about the 20 largest blue chip Australian listed entities to be acceptable to investors; however, those issuers may find that domestic funds are not available on the same attractive terms as offered in overseas markets (eg US) until the Australian corporate bond market deepens, in particular at the long end. Likewise Australian retiree investors could be attracted to very long dated bonds issued in foreign markets. It is likely that there will need to be significant amounts of intermediation, both in Australian and overseas bonds, for several years before a greater degree of familiarity and acceptance arises between investors and issuers, which is able to support directly a domestic corporate bond market. An obvious first step would be to encourage Australian banks to issue bonds of increasing tenors to local investors. Such well known issuers ought to be attractive to SMSFs and pension funds. Infrastructure projects could also provide a demand for very long term funds (perhaps index linked), although their debt would probably need to be credit-wrapped.

Although there are major challenges, the development of a large and liquid corporate bond market is too important and necessary to be allowed to falter. It is long overdue. As well as providing an obvious match between issuers and retirement stage investors (and their fund managers), it could reduce Australia's reliance on foreign debt. The banking sector (as a major and frequent issuer) would gain greater stability by having access to longer dated funds available locally, which would reduce systemic risk.

Although the Inquiry's questions are directed to "fixed income" products, it would be valuable to obtain expert advice on the extent to which Australian fund managers are deterred by very long term FX risk (eg re holding long-term overseas bonds) or inflation risk. There would presumably be strong appetite for A$ CPI-linked securities (we understand that the current pool of these is relatively small, and mostly issued by Government) as a natural investment to back annuities—the question is how much appetite there would be from issuers of such debt? Life companies and infrastructure projects ought to be attracted to this sector.

On the question of transparency: an obvious concern for retail investors is how they could subscribe for, or trade in, bonds for amounts well under $100,000 without suffering too much leakage in buy-sell spreads or brokerage. There is considerable risk that ill-informed investors would be exploited.

2-84/5 As noted, the trend is likely to cause greater overseas investment with consequences for the balance of payments- but surely that would be beneficial? Also it would provide a safety valve to stop domestic assets becoming overpriced. Rice Warner's comments about yield and fixed income are well made: we would add deferred annuities to the desired products. Two crucial factors are inflation risk and credit quality. Retirees will be concerned about volatility of real returns, even if tax free; they will also want to know that if they buy a long-term annuity or deferred annuity, the issuer or any guarantor will be able to honour its payment obligations decades later. As Rice Warner said, this will probably need stronger capital adequacy rules- or perhaps ring-fencing of the life subsidiaries. Credit quality and inflation mitigation will be major challenges, and suggest that there is scope for very long dated indexed bonds to be issued by the life companies or the Government**.**

<u>2-92 to 2-94 Equity and access</u>

As we stated in our first submission, ASA is predominately concerned with fair treatment for retail investors, through good corporate governance, equal access to capital raisings, and engagement with their listed entities.

ASA participated in the recent work by the ASX Corporate Governance Council to develop its third edition of Corporate Governance Principles and Recommendations. Although listed entities have improved the professionalism of their engagement with institutional investors, there is often lower quality and depth of engagement with retail shareholders — even for companies with over 100,000 retail investors. Listed entities must recognise the need for regular and constructive engagement with all their capital providers, and other stakeholders. We commend the recent work of the Governance Institute to establish principles of good engagement between companies and institutional investors; we hope that a similar exercise will follow to ensure, as far as possible, that these principles will be applicable to representing the needs and interests of retail investors.

As we discussed in Section 5 of our first submission, "it is very disappointing that the requirements for annual meetings of trusts are much more limited than those for companies. We acknowledge that some listed trusts/ responsible entities (RE) do choose to hold annual information meetings anyway, but the trust sector represents a material part of the listed market and the "second class" treatment of the trust sector's investors is unacceptable (see Section 5h). We note that CAMAC is due to release its report on the future of

AGMs: we hope it will focus on the commercial benefit and substance of universal investor engagement, rather than the legal technicalities of "form" that have to date dominated debate on this subject".

We are therefore profoundly disappointed that CAMAC has been disbanded and absorbed into Treasury; it seems likely that its cost-effective, high quality and practical work will cease. We urge Government, through this Inquiry, to enable CAMAC's work on AGMs to be completed and released, to respect the enormous amount of effort that many parties contributed to it, and the interests of 7 million Australian investors.

We noted with the concern the developments regarding the proposed Roc/Horizon merger. Although that appears unlikely to proceed, it raised an important principle for shareholders involved in scrip bids. Shareholders in the target company were rightly allowed a vote on the proposal, under the Corporations Act; yet the Act has no corresponding requirement for the shareholders of the bidder. Although the topic is covered in the Listing Rules, the ASX can excuse the bidding company from holding a vote of its own shareholders if the bid satisfies some simple tests. A literal reading of the exemptions suggests that a small company could mount a reverse takeover, by scrip, for a much larger company in the same industry, and ASX could excuse it from holding a shareholder vote, even if the terms were materially unfair to the bidders' shareholders. We believe that it is wrong for the Act not to have a requirement to hold a bidder's vote (as this case in leading jurisdictions overseas or failing that, there should be no discretion for exemption under the Listing Rules. Shareholders' rights on such an important matter –for example they could be heavily diluted- should not be asymmetric or left to the discretion of ASX.

CHAPTER 4 Superannuation

The Report appears to use the terms 'fees' and 'costs' and sometimes ' expenses' interchangeably: this is understandable from the viewpoint of members. In our comments below we include <u>all</u> such annual costs in the term "fees"—other than ad hoc costs like switching fees that apply only to individual members. Many of our comments in this section are also generally applicable to the non-superannuation managed funds sector.

<u>2-95</u> ASA strongly agrees with the Report's 3 observations.

<u>2-99/100 High fees in super</u>

ASA applauds the Inquiry for its intention to look further into fees. The Report notes that many submissions (presumably from industry participants rather than investors and fund members) purported to justify why superannuation funds costs in Australia are high. ASA urges the Inquiry to test these assertions very stringently, in dollar values rather than words. Expert advice from truly independent finance professionals (eg chartered accountants or actuaries) is needed to have a much better informed analysis and debate. For example, a common justification put forward is that Australia's system is much more expensive than overseas comparisons because of our higher equity intensity. In view of the huge sums involved, it is vital to test this contention by comparing Australian fees with overseas examples for each distinct asset category. (i.e. Chart 4.1 is interesting, but since it appears to show results averaged across all asset classes, it is of limited use.). The same applies to the cost of group life cover and income protection paid through super, and how much that need to be allowed for in making overseas comparisons. It would also be valuable to have rigorous comparisons with overseas funds to test whether long term real returns in Australia from Private Equity, infrastructure and other alternative asset classes *are* actually superior, as claimed, once (retail) fees have been deducted.

We recommend that the Inquiry also examine volatility of historical returns in these comparisons, not merely the compound average long-term returns, since high volatility is arguably at least as important a concern to fund members as high fees. This is particularly pertinent to sequencing risk and retirement income strategy. Eg, hedge funds and absolute return funds may assert that their after-fee returns have been good, but they are likely to be highly volatile; risk adjusted returns need to be assessed to determine the true value added against fees charged.

Chart 4.2: the Inquiry should also compare fees for large funds (with FUM over say $5B) against both overseas comparatives and the same Australian funds over the previous five years. One expects that, despite huge growth, individual funds have demonstrated only very small reductions in percentage fees—much less than the scale benefits would predict.

<u>2-101/2 Economies of scale</u>

Chart 4.2 rightly excludes the fees of (all?) the 530K small funds: many SMSFs would by definition have little or no IM costs. However, there is a separate question to consider whether there is adequate competition in provision of administration, accounting and trustee services to the SMSF sector.

We dispute the assertion that having more than one member account makes much difference to effective costs, other than for small balances. Apart from the modest administration fees that industry funds charge, (nearly) all funds charge ad valorem fees for IM - is the Inquiry aware of any exceptions to this, which are open to the public? The IM fees usually account for the vast majority of total costs to members. With rare exceptions, most funds charge the same percentage ad valorem fees, irrespective of the member's balance, unless (in some cases) it is over a very high threshold like $500K. Apart from convenience, there is little incentive for members to amalgamate funds, unless they have very low balances. It's not the costs of administration, governance and reporting that are the problem, although we concede that technology investment is significant. The largest component is IM costs and far too many "me too" products available from dozens of fund managers that multiply their overheads, marketing and distribution costs, which are then passed on to members. The Inquiry would do fund members a great service by seeking ways of creating more powerful price competition between funds, and product innovation, especially for IM. Eg. auctions or tendering of the IM functions for some funds, not necessarily only default funds. The Chilean example is impressive, albeit at the extreme.

<u>2-103 notes 34 & 35</u>

Why can there be confidence that fees will reduce from future competition and consolidation, as this has provided little evidence to date? All the statements in Box 4.1 are plausible reasons, and remain of concern for the future. Is the reference to "administration fees" for note 35 intended to mean all costs, in particular including those for IM?

Overall, price competition appears to be weak and, perhaps surprisingly, even competition based on returns may be limited. We suggest that the main reasons for this are a large degree of member inertia and/or lack of financial literacy, 'client capture' by the funds, and sophisticated and selective marketing that emphasises only the attractive attributes of a given fund. No fund would draw attention to its earning below median returns, even if it had other very good features. Marketing material tends to be selective when showing historical returns against benchmarks, by choosing only the more favourable comparison periods eg whether one, three, five, seven, or ten years -and being inconsistent on this usage from year to year. Even though most funds describe their objectives for a given fund segment in their PDSs, they often fail to compare the subsequent actual performance with those targets. Likewise, industry benchmarks may be referred to only selectively, when a given fund's comparison against a relevant benchmark is favourable.

Even when members know what to look for, it can be very difficult to obtain this objective information from the funds' managers. As the text with note 36 states, many funds are (unnecessarily) feature –rich; innovation has been blunted and many managers offer largely identical product ranges. This causes high marketing and distribution costs with little compensating benefit for consumers, as stated at note 45.

2-106 notes 46/7/8

Although these and the comments re MySuper and Fair Work are reasonable, we urge the Inquiry to seek evidence of how much those "extra" costs are in $ or percentage terms, as we suspect that the arguments could be overstated. Switching costs should not be cross subsidised; it would be interesting to know the degree of switching based turnover within funds, and how much this contributes to the funds' costs and liquidity disruption. Some restrictions on the immediacy of switching would be desirable for liquidity management and cost saving.

The comments at notes 49 to 53 are important warnings that are still resisted by the industry, although passive management and ETFs are slowly gaining market share to compete against these inefficiencies.

2-110 to 2-113 Liquidity management

We agree with much of the commentary in this section, and the good sense in a modest lengthening of portability and switch times. However, we respectfully suggest that 2-113 is too literal a response on possible RBA facilitation of liquidity. From the aspect of systemic risk, we agree that it could be better to exclude funds from the liquidity facility available to banks, as well as for the reason given. Yet there are other possible solutions for a liquidity facility: the Government or the RBA could provide a facility for APRA-regulated superannuation funds separate from the banks' facility, or the funds management industry could establish one itself- with emergency funding lines from Government until it had built up adequate capital. In all cases, we suggest that a very small standby fee be charged annually, as well as significantly larger fees if the facility is called upon. We ask the Inquiry to reconsider this subject, as well as the sensible suggestion of lengthening portability time limits. The APRA-regulated superannuation system must be of unquestioned strength, in aggregate, even if individual funds get into difficulties.

2-114/5

We believe that worthwhile changes should be introduced promptly; if they are delayed for two or three years until MySuper has evolved, it may give the industry a signal that it can afford to defer any material improvements and efficiencies. Auctions for default funds status are an excellent idea. We favour a longer time period for portability (with regulatory power to extend it in emergencies), rather than the vagueness of a principles-based approach. Projecting future member benefits is fraught with risk of unrealistic forecasts and mis-selling, compounded by investors' ignorance. This was a major problem about 20 years ago, and it would be unhelpful to reintroduce it. Treasury consulted on "*Better regulation and governance, enhanced transparency and improved competition in superannuation"* and received nearly 100 submissions by the February 2014 closing date. These suggested improvements to reporting and governance are badly needed and long overdue. We urge Treasury to discuss its findings with Government so they can be implemented quickly. They would be of great benefit to members and would address and enlighten several of the policy problems raised in this section of the report.

2-115 to 117 Leverage in superannuation

In our first submission we stated the following: *"There may also be a need for surveillance (rather than legislation) by ATO and ASIC to determine whether SMSF owners have unsuitable asset concentrations or levels of borrowing. It is concerning that some superannuants are being beguiled into investing their superannuation funds into geared real estate — such superannuants are generally SMSF trustees regulated by the ATO, hence our inclusion of this topic under this heading in the TR. The concerns we have are those of putting too many eggs into a single basket, the illiquid nature of such investments, inappropriate marketing and/or overpriced properties, and the greater risk assumed through gearing investments. We recommend that the Government should look at introducing more restrictions on the ability of superannuation funds to incur borrowings (for example, by imposing percentage gearing limits, subject to annual audit) to mitigate investors' risks of such losses. We also note that real estate agents need no training or qualifications in financial advisory skills to propose purchases to SMSF trustees (unlike financial advisers) and that this situation adds further risk (and conflict of interest) for SMSFs."*

We believe that it would be too severe to prohibit direct leverage outright, but some percentage limits should be imposed prospectively. As a guide 30% might be an appropriate limit, but this needs expert analysis, as the appropriateness of the gearing strategy would depend on the asset mix and liquidity needs of the specific SMSF, limits of the recourse etc. How would indirect leverage (eg through warrants) be accounted for in any such calculation and restrictions? Although one could argue that SMSFs should bear the consequences of their own decisions, as each is established for only a few individuals who determine their own investment strategies, there is a policy implication that if large numbers of SMSFs fail it would place a burden on the Government pension system. Thus it is not unreasonable for Government to consider some limits. This subject needs more analysis; until a well-considered response can be legislated, we repeat our suggestion of greater vigilance and intervention by ASIC and ATO.

2-118 to 224 and note 79: stability and tax concessions

As mentioned earlier, we strongly reject any dismantling of the imputation system. If Government believes that a small number of very wealthy individuals are getting excessive benefit from imputation through the superannuation system in pension phase, this should be approached as a different problem. One could suggest that income paid *from* a superannuation fund be made fully taxable at marginal tax rates after the first $200K pa (but retain the tax free status of income *inside* the fund, when in pension phase.)

2-123 to 126 SMSFs and costs

We agree with much of the commentary in this section. However, we note that ASIC conducted extensive consultation on these matters (in its CP216) in the last quarter of 2013, and received many useful responses. We understand that ASIC intend to report on this subject relatively soon. It is difficult to draw definitive conclusions from Rice Warner's work, because there are wide and overlapping cost ranges depending on assumptions used. Below about $100K an SMSF is very unlikely to be cost-effective and above $500K it would be cost effective—setting aside trustee obligations and time required. Yet between these two figures, there is too much variety of data to be prescriptive.

Also, the analysis appears to take a snapshot at one time i.e. it assumes that fund balances are static- if they are later increased substantially, whether through concessional or non-concessional contributions, that could quickly change the analysis efficacy for specific members. There does not appear (yet) to be sufficiently clear evidence of widespread mis-selling of SMSFs (other than property and leverage promotion discussed above) to warrant concern from the Inquiry. A better approach at this stage is for strong surveillance by ASIC and providing alerts to prospective users though its Money Smart website and other channels. Note 94 is fundamental- providing that good quality, non-conflicted advice is given- or at least available- this oversight and regulation should be left to ASIC surveillance. ASIC's report on its CP 216 consultation should be published as soon as possible to inform the debate. A further formal review of cost levels and quality of advice for SMSFs should be conducted in 12-18 months before radical changes to policy are considered.

CHAPTER 5 Stability

3-6/7 and 3-55 shadow banking- debentures

In 2013 ASIC consulted in relation to debentures in its paper CP199 (as did APRA). A number of failed property finance and development companies issued debentures, and the public- which had misunderstood their risks- suffered large losses when they collapsed. We understand that ASIC and APRA made recommendations to Treasury early in 2014 on law reform to prevent or reduce the risk of recurrence of such failures; Treasury should urgently proceed to present these proposals to Government for implementation.

3-16 to 3-18 Financial Claims Scheme

We understand that this has been abused by some wealthy individuals to obtain protection for over $5m through holdings at multiple ADIs. This is evident in the statistic that "the scheme fully covers over 99% of eligible depositors but [only] over half of deposits by value". This must be investigated, and enforced, so that an eligible individual is able to claim protection for only $250K in aggregate, irrespective of the number of ADIs he uses. We believe that an ex-ante fee system is preferable. This is not necessarily to build up a substantial "bail-out" fund, but to provide a suitable pricing signal against moral hazard and arbitrage. There is no justification for creating a free arbitrage against the Government's AAA credit rating—which is probably worth 20 to 40 bp, depending on the ADI and the tenor. It is unclear how this benefit is being split between the ADIs and their depositors. Even if the Government is subsidising the ADIs by only 15 bp per annum on average the subsidy is likely to be worth at least $1billion pa.

3-20

In principle we agree with ring-fencing banks' retail activities, along the lines of the Vickers proposals in the UK. The outright prohibition that appears implicit under the Volcker Rule is arguably too harsh- perhaps risk taking investment banking activities should be permitted up to a modest percentage of the banks' capital bases (subject to strict policing by APRA) We would support more stress testing [3-31] despite its burden, especially if banks argue against an ex. ante fee for the FCS, which is of great benefit to them.

CHAPTER 6 Consumer Outcomes

3-49 to 3-62 Context

We endorse the Report's three observations and five outcomes on 3-49 and 50; however, we note that the first four outcomes do not refer to the products and services etc being available *at a fair price*. They should also be available on explicitly fair terms, as well as the 'fair treatment' mentioned in item three.

3-62 disclosure regime

All of the options for change are commendable. ASIC should be given the additional powers suggested. ASIC's Money Smart website is valuable and its coverage should be expanded. Any online comparators should be independently audited for fairness and veracity. We applaud ASIC's recent work on Complex Products (REP 384 and REP 400) and hope that their suggestions for a considerable tightening of consumer protection in these products be implemented promptly and vigorously.

3-63 to 3-69 financial advice

We have grave concern about the recent rollback of some of the FOFA reforms, especially as the new position appears to do little to rectify the conflicts of interest that are embedded in the intense vertical integration of the advice sector and the "Big five". It is hard to see how an incentive payment cannot be a commission—what is the practical difference? These problems are considerable and can be (only partly) mitigated by requiring stronger educational or professional qualifications, more intrusive ASIC surveillance and banning powers. We fully support all three policy options for change made on 3-69. These should be implemented urgently; although the current investigations into inappropriate advice at Macquarie and Commonwealth should provide many useful insights, regulators should not delay making policy improvements until those investigations have been completed.

3-69 to 3-74 accessibility, independence and sales

Clearly, improved financial literacy and professional qualifications in the planning industry will help prevent repeats of some of the worst problems that have emerged in the last decade. High standards need to be developed to ensure that the word "independent" is allowed to have only limited and strict usage. We agree that 'general advice' should be renamed as 'sales' or 'product information', and that 'advice' be permitted only in relation to personal advice.

3-74 to 3-80 under-insurance

Removal of state based taxes would help, as would better data sharing between insurers, so that there is less cross-subsidisation between policy holders.

3-82 microfinance and fringe lending

We have heard anecdotal reports that the payday lending sector is considerably bigger than the $380m mentioned, perhaps of the order of $3B. We suggest that the Inquiry investigate how much funding the mainstream banking sector provides to the fringe lending sector (including payday lending). This must create conflicts of interest (as well as ethical concern) and discrimination between consumers, if banks then encourage potential customers to use fringe lenders (at much higher direct and indirect cost) instead of their own direct lending. In consultation with expertise from the NFP sector, banks should be encouraged to develop proposals for microfinance at reasonable rates.

3-85 MIS & losses

The RE regime has in a number of cases been a signal failure for investors, who have lost billions of dollars – especially in forestry schemes (see Section 5b of our first submission); despite CAMAC's report two years ago, it would be timely for the Inquiry to reconsider whether REs should be abolished. See also 3-102/3 below.

3-86 PI & loss

We agree that consumer losses from adviser malpractice or poor advice should be reduced by requiring both stronger PI cover and more extensive surveillance (and shadow shopping) by ASIC. Advisers should be required to have a minimum level of PI cover, audited annually.

3-87 legacy products and other

Government should renew consideration of the 2009 proposals on product rationalisation. As much of the impediment is likely to be tax driven, this should be a theme for the Tax inquiry. We are doubtful about the strength and quality of self-regulation. At the least, financial entities and institutions should show that they fully comply with their own respective codes of practice.

CHAPTER 7 Regulatory Architecture

3-97 regulatory burden and cost

ASA is very sceptical of assertions that the regulatory burden on the financial sector, and its cost, is high in absolute or relative terms. Consumers and investors have suffered very large losses - sometimes personally catastrophic- from financial failures (HIH, highly geared property trusts, debentures, poor financial advice, MIS failures, weakness of the RE regime to name only a few). Government must understand that there is a much greater burden (and not only financial) on the personal sector (i.e. voters) from having inadequate regulation, surveillance or enforcement, and poor or heavily conflicted advice.

3-102/3

We do not accept the claims that regulation of the superannuation system is (unreasonably) burdensome, expensive and intrusive. Because of the problems that the Report raises (including moral hazard, public ignorance and systemic risk) it is vital that at least the APRA regulated funds are subject to very high standards of governance, reporting and scrutiny. The cost is a price worth paying- as with personal safety in industry and mining. Despite some submissions to CAMAC reports on REs and MISs, we believe that they are in general an unsatisfactory regime and have often afforded no protection to investors. Regulation of REs and MISs should be raised to the strength and effectiveness of APRA regulation of superannuation funds, not the reverse. Even this would not stop all problems: although we accept that APRA is not responsible for market risk, one wonders how, for example, the MTAA superannuation fund was able to be so heavily exposed to overvalued and illiquid assets going into the GFC, causing major losses for its members.

3-113

APRA and ASIC must be able to rely on an adequate level of long-term funding, to enable them to plan and discharge their responsibilities thoroughly and promptly. Depriving major regulators of funding and certainly is very short-sighted and counterproductive. The Australian financial system is enormous in its value, scope and importance: the cost to users of major failure could be thousands of times the cost of maintaining strong regulators. We do not object to a more autonomous and user pays funding basis, providing it was strictly policed to avoid conflicts of interest.

3-117

Regular reviews of regulators' performance and capabilities would be welcome, providing they are independent of Government and not subject to political interference, lobbying or other distractions. The so-called efficiency dividend is a crude and unsatisfactory tool, and is often wielded at significant detriment to the consumer sector. It should be replaced by tailored accountability mechanisms: these should take into account realistic and comprehensive SOEs and SOIs.

3-122 to 3-129

ASIC's mandate is indeed broad, but it needs to be. We would be concerned if "refine the scope and breadth of its mandate" connoted any weakening of objectives or resources. Its mandate, and its capability, must be strong and comprehensive, and command respect from its regulated public. Transferring the insolvency function to AFSA is worth investigating, in principle, subject to cost/ benefit analysis. Removing the registry function would be logical, providing ASIC received adequate compensating revenues to sustain its work, and providing the new 'owner' of the registry had no material conflicts of interest. We don't see any merit in transferring ASIC's consumer protection functions to the ACCC. The penalties regime should be strengthened considerably - see for example ASIC's REP 387. ASIC should have greater stop and intervention powers. Its budget needs to be adequate to maintain intensive and timely surveillance. There would be merit in removing APRA and ASIC from the public sector wage bargaining framework, and ASIC from the Public Service Act.

CHAPTER 8 Retirement income

4-3 to 4-25 retirement income system

Any or all of the first three policy options are worthwhile. This would include the need to remove tax impediments from DLAs. In principle, we don't believe that mandating particular products is desirable, although we concede that this might need to be considered to some extent in the context of age pensions and tax policies.

4-25 to 4-31 products

All three of the options for change have merit, especially the last point about longer dated and indexed bonds.

4-32/3 home equity release

We cannot comment on the impediments that may exist. However, we urge caution to ensure that retirees are not exploited through unscrupulous sales and advisory practices, or put under pressure by relatives. Especially with older retirees, regulators must be mindful of the risk of impaired understanding. Residual negative equity schemes must not be permitted.

CHAPTERS 9 and 10

ASA has no observations on these chapters**.**

ASA commends the work of the Inquiry, and would be happy to discuss any of the matters in our submission. We look forward to the publication of the final report.

Yours faithfully,

Ian Curry
Chairman