CHAPTER 8

REGULATION OF FUND MANAGERS

> *Where regulation has the effect of creating barriers to entry or threatening the viability of small players or perpetuating concentration among fund managers, it is not in the interest of superannuation fund members or the community as a whole.*
> Linda Bardo Nicholls, County NatWest evidence, pp 99-100.

8.1 Fund managers play a vital role in the superannuation industry because they are charged with earning an investment return on the members' funds. During the course of the inquiry, four issues involving fund managers were highlighted:

- entry requirements for fund managers;
- concentration of fund management activities;
- the role of advisers; and
- accountability to trustees and members.

Entry Requirements

8.2 Entry requirements can take two forms:

- minimum capital or solvency requirements; and
- minimum educational qualifications.

8.3 Investment management services for superannuation funds are currently provided through one of three avenues:

- registered life insurance companies;
- companies holding a dealers licence provided by the ASC, including bank fund management activities; or
- directly by the trustees of the funds themselves.

8.4 The IAA noted in its submission that whilst the life insurance industry is closely regulated by the ISC with minimum capital adequacy standards and tests applied as to the fitness of persons to be involved in the management of life insurance companies and regular disclosure requirements, these tests did not necessarily extend to cover investment management competence.[1]

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1 Sub No. 108, p 6.

8.5 Under the ASC licensing requirements for dealers licences, greater emphasis is placed on investment management competence and the financial strength of the investment manager, and less emphasis is placed on capital requirements and regular reporting of investment management activities.[2]

8.6 Trustees of superannuation funds who directly invest the funds' assets are not required to hold a dealers licence, nor do minimum capital or solvency standards apply.

8.7 The Committee agrees with the IAA that the two questions requiring resolution are:

- whether trustees of superannuation funds who directly invest the assets of the fund should be licensed; and
- whether the ASC dealers licence requirements and the requirements for life insurance companies should be brought into line.[3]

8.8 With respect to the first issue, a dealers licence is prima facie evidence that the applicant has adequate educational qualifications and relevant experience. If the Committee's recommendations in Chapter 4 are implemented, only fit and proper persons would be able to be trustees or directors of corporate trustees. However, the Committee also considered that where the trustees are directly undertaking the investment management activities of the fund themselves, they should be subject to licensing requirements.

Recommendation 8.1:

The Committee recommends that trustees who act as investment managers of superannuation funds be required to have a dealers licence. It is intended that such licensing requirements would operate in conjunction with entry requirements for trustees as outlined in Chapter 4. Trustees whose only investments were bank deposits would be exempt from the dealers licence requirements.

8.9 Weighing the arguments for competitive neutrality between life offices and other fund managers was a difficult task for the Committee.

8.10 The IFA argued in its evidence that:

> *If you raise the quality and set proper prudential standards for those who are permitted to manage these [superannuation] funds, you will eliminate the large number of difficulties which may occur through incompetence or other things at a later date.*[4]

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2 *ibid* pp 6-7

3 *ibid*, p 7.

4 Evidence, p 2026.

8.11 To this end, the IFA supported a minimum level of capital adequacy so that managers can demonstrate that they are of substance and have sufficient capital to manage the business on a day-to-day basis. In addition, tertiary qualifications and a track record in funds management were seen as necessary.[5]

8.12 Rothschilds advised the Committee that, in the UK, regulations require fund managers to have sufficient resources to cover cashflow over some minimum period such as two months. This concept takes account of fund managers of different size and would not discriminate against small, niche fund managers who could offer specialist services but may not meet minimum capital requirements.[6] Rothschilds also suggested that fund managers should be registered and that they should have to undergo examinations.[7]

8.13 On this same question of entry requirements for fund managers, BT noted that:

> *The fact that there is no regulation does seem a bit surprising, but it is not obvious that it is having really adverse effects at the moment.*[8]

8.14 Nonetheless, BT supported entry requirements for fund managers, expressing a preference for entry controls analogous to the insurance industry.[9] (See Chapter 4 for details of prudential controls on life offices.)

8.15 The TCA told the Committee that:

> *The lessons that we have learnt from the last two or three years are that there has to be a commitment by the fund managers to the work they are doing ... Many of the fund managers have been totally undercapitalised ... if your own money is at stake you tend to have a far higher commitment...*[10]

8.16 The TCA suggested that fund managers be required to have a minimum capitalisation plus additional capitalisation related to the size of funds under management.[11] The joint submission from the accounting professions also suggests minimum capital requirements for fund managers.[12]

8.17 The TPC notes in its submission that prudential supervision should not be allowed to develop into a 'barrier to entry' in the superannuation industry. In particular, the

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5 Evidence, pp 2026-2027.

6 Evidence, p 1551.

7 Evidence, p 151.

8 Evidence, p 851.

9 Evidence, p 852.

10 Evidence, p 262 -264.

11 Evidence, p 263.

12 Sub No. 119, p 11.

prudential rules should be flexible enough to encourage niche marketing.[13] In its evidence the TPC argued that:

> *Government policy does need to have regard to those outcomes sought by consumers and that regulations should interfere with those only where there is some sensible prudential reason.*[14]

8.18 The ALRC report proposes a 'fit and proper person' test for fund managers, and recommends that a corporation or individual should not have custody of the assets of a superannuation fund as investment manager unless it had a dealers licence and net assets of at least $5 million.[15] The ALRC made no recommendations with respect to other entry requirements, noting that the earlier proposal to have net assets of $5 million or be a member of a professional indemnity fund with cover of at least $5 million would not necessarily:

> ... *guarantee the performance or integrity of an investment manager yet may operate to keep out of the industry small but talented investment managers.*[16]

8.19 The ALRC recommended that capital adequacy be addressed through dealers licence requirements, noting that if a risk-weighted capital requirement for securities dealers as proposed by IOSCO is implemented in Australia, additional minimum capital and net asset requirements will be unnecessary.[17]

8.20 It is axiomatic that life offices play an important role in fund management activities. As noted by the ANZ in its evidence:

> *The people with the huge history, the long track record and the very large volume of funds already under management are the long established life companies. They have just got so much more behind them in that area.*[18]

8.21 An article on 'Managed Funds' in the ABS publication *Economic Indicators* notes that:

> *Statutory funds of life offices are the major employers of professional fund managers. They had $90.1 billion invested through fund managers at 30 June 1991, or 95.6 per cent of their total unconsolidated assets.*

8.22 The Committee concluded that the fact that life offices were not required to meet investment management competency tests had not meant that their capabilities in this

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13 Sub No. 145 p 4.

14 Evidence, p 1251.

15 ALRC Report No 59, op cit pp 75-82.

16 *ibid*, p 81.

17 *ibid.*

18 ANZ evidence, pp 472-473.

regard were inferior to those of the rest of the fund management industry. Indeed, as the following section illustrates, life offices occupy a dominant position in the industry.

Recommendation 8.2:

The Committee recommends that a 'fit and proper person' test be introduced to all investment managers similar to the conditions under the Life Insurance Act (LIA). The Committee further recommends that the need for capital adequacy be examined by the ISC and ASC. The Committee considers that a minimum level of capital adequacy expressed as some percentage of cash flow is desirable for funds managers, as are minimum educational qualifications, but is anxious that any such controls do not discourage niche marketing and that Australian practice is consistent with that overseas.

The Committee further recommends that the need for formal industry-specific educational qualifications be examined by the ISC and the ASC and investment competency measures, similar to dealers licensing requirements, be considered by the ISC in its review of the LIA.

Concentration of Fund Management Activities

8.23 The fund management industry is heavily concentrated as Table 8.1 illustrates.

Table 8.1

MAJOR MANAGERS OF AUSTRALIAN SUPERANNUATION FUNDS

Funds under Management at June 1991

	$ billion
AMP	21.9
National Mutual	12.2
BT	10.3
Westpac	7.0
MLC	6.4
Top 5 Managers	57.8
Total Superannuation Industry	132.0
Top 5 as a percentage of the Industry	43.8%

Source: Noble Lowndes *Superannuation Investment Performance Monitor*, June 1991; and ISC Submission to the House of Representatives Standing Committee Inquiry Into the Banking Industry, August 1991 (updated).

8.24 The fund managers, in their evidence to the Committee, said that the industry was intensely competitive.[19]

8.25 BT argued that:

- in addition to the top five managers, there were more than 25 other managers of wholesale superannuation funds and a further 22 managers of ADFs and Rollover Funds;
- there is a very high level of real competition between fund managers and fund management in Australia and it is probably the most open and accountable business in the world; and
- there is a range of potential new entrants into the fund management business.[20]

8.26 AMP went on to suggest that tangible evidence of this competition was the net inflow and outflow of funds under management over the last two years.[21] Rothschilds also pointed to the number of new entrants into the industry – suggesting that 13 years ago there would have been eight or ten fund managers competing, whereas now there were in excess of 45.[22]

8.27 There was a divergence of views amongst the fund managers on whether concentration in fund management would continue. CFM suggested that whilst there has been a predominance of balanced fund managers in Australia to date, as trustees became more sophisticated there would be greater sector specialisation which would enhance competition in the industry.[23] Expressing a contrary view, Rothschilds suggested that if the regulatory environment continues to squeeze small company-sponsored funds there is a danger of greater concentration in the funds management industry because the larger company sponsored funds and industry funds tend to appoint the larger fund managers.

8.28 The Committee is satisfied that the funds management industry is open to new entrants and that no Government action is required to counter the dominance of a few fund managers. However, there was a suggestion by Jacques Martin that there is little price discrimination in the fees charged by the major fund managers. Jacques Martin told the Committee that:

> *... [fund management] is the only area of fees in superannuation which has not been savagely reduced by the advent of the industry scheme system.*[24]

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19 See for example AMP evidence, p 1746, BT evidence, p 853.

20 BT Sub No 105, pp 11-12.

21 Evidence, p 1746.

22 Evidence, p 150.

23 Evidence, p 1292.

24 Evidence, p 405.

8.29 However, as noted by AMP, the selection of a fund manager is not only determined by price. It suggested that the process was determined by a combination of factors, the primary ones being:

- the performance of the investment manager;
- the quality of individuals and the organisation concerned in a qualitative sense;
- the strength and depth of management; and
- the stability and risk profile attaching to the underlying performance.[25]

8.30 ACM advised the Committee that large funds are better placed to negotiate on the fees and charges by investment managers because they are offering a potential investment manager a very large sum of money.[26] ACM went on to argue that:

> *The capacity of a manager to manage a large sum spread in different avenues and produce a very competitive rate, or almost guarantee a certain rate above the average, requires a good deal of skill. It requires a great knowledge of the market place, in an increasingly complex market place, and a capacity to move very quickly. It also rests very largely on the skills of the individuals who are specifically managing that money, not necessarily the size or the credibility of an organisation with whom they might work.*[27]

8.31 If the track record and quality of the individuals and the investment strategy in the top fund managers are significantly ahead of the rest of the field, then fees charged could reflect this qualitative difference. So long as the industry remains open to new entrants who can prove their expertise in particular segments, the Committee does not believe Government action is warranted.

> ***Recommendation 8.3:***
>
> ***The Committee recommends that the TPC monitor the funds management industry to ensure that it remains open and competitive.***

Role of Advisers

8.32 The Committee has been advised that the normal procedure for the selection of a fund manager would be for trustees to seek expressions of interest. A short list would then be drawn up and the short-listed funds invited to make a presentation to trustees. Frequently, the final decision is referred to an investment committee. It would appear that almost all trustees of large funds engage a firm of consulting actuaries to advise

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25 Evidence, p 1746.

26 Evidence, p 423.

27 Evidence, p 424.

them in the shortlisting process and the ultimate selection of the fund manager.

8.33 It appeared to the Committee that the advisers sit at the apex of a triangle of power and effectively work as the 'gate-keeper' between the fund and the fund manager. They are the conduit through whom fund managers must work in reaching the trustees because the advisers undertake the quantitative modelling for trustees and help them design an asset allocation structure suitable to the particular scheme.

8.34 Whilst the Committee was not presented with any firm evidence that the relationship between advisers and fund managers on the one hand, and advisers and funds administrators on the other hand, materially affected the appointments made by trustees, it is clear to the Committee that the advisers occupy extremely influential positions and are not subject to any regulatory oversight.

8.35 CFM suggested to the Committee that:

> *The Australian experience at the moment is probably similar to that in the United States where there is a very powerful advisory function to trustees of new schemes and I think that relates to the newness of some of the trustees to their tasks ... From our experience, there is a considerable desire on the part of trustees to do the best by the contributors to their scheme and there is a feeling that they want to be fully briefed by advisers in relation to investment matters. But I am not aware of, nor to my knowledge have we seen a situation where there might be too great an influence by advisers.*[28]

8.36 The MMBW Employees Superannuation Fund had a more sanguine view, suggesting that there was complementarity between the actuary and the investment manager. It advised the Committee that:

> *... the actuary provides the 'number crunching' ... the investment adviser ... reviews the efficiency of our investment structure, examines alternative scenarios as to whether they will improve the return we are likely to get and the risk profile of the investments. You put the two together and see whether they fit.*[29]

8.37 Given the lack of financial expertise of many trustees, the Committee was of the view that the actuary would not only provide the number crunching but would also evaluate the investment strategy proposed by the fund manager. In addition, the Committee is aware that advisers employed by trustees are normally employees of the major actuarial consulting firms and these firms are also embarking on funds management and funds administration activities.

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28 Evidence, p 1289.

29 Evidence, p 255.

Recommendation 8.4:

The Committee considers that the 'bundling' of services by the actuarial firms warrants further examination by the ISC and TPC, particularly as actuarial advisers to superannuation funds are not subject to any regulatory oversight.

Accountability to Trustees and Members

8.38 The Attorney-General's Department told the Committee that one area of regulation of collective investments that needed upgrading was:

> *... the superintendence by contributors of the investment strategies being followed by their trustees and fund managers.*[30]

8.39 This was a view put strongly by AFCO which told the Committee that the surveys of pooled investment managers and rollover vehicles which were undertaken by various firms were inaccessible to consumers because of the fees charged. AFCO advised the Committee that:

> *From our perspective as community advocates, that sort of elitism in information gathering of information distribution is completelyunacceptable and is indicative of the elitism in terms of the management of the funds.*
>
> *We believe that the Government needs to blow that open by actually enabling consumers on the ground and particularly their statutory bodies, which are representing their interests, to access information that is relevant on these investment strategies. We are not going to change the fact that people with a particularly limited range of backgrounds and beliefs are managing our money. That is going to continue for a considerable period of time. However, we do need to actually get information about what they are doing out in the community so at least we have the opportunity to criticise it.*[31]

8.40 It appeared to the Committee that some funds were already taking positive steps to communicate the investment strategy of the funds to members. For example, ARF told the Committee that members should be advised of:

> *[the fund's] investment strategies and performance, the basis on which fund managers are chosen, and the asset allocation, crediting rates, fund earning rates, if we create reserves, and a reasonable outline of administration charges and fees.*[32]

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30 Evidence, p 1205.

31 Evidence, p 1949.

32 Evidence, p 319.

8.41 MTIA pointed to the STA which endeavoured:

> *... in a fairly positive way to communicate with members fairly regularly on the investment policy and performance of the fund. Quite apart from individual member statements and annual reports, special investment reports have been prepared and forwarded to all members of the fund. Those reports have gone into some detail as to what the investment strategy is, the asset class structure, and the investment managers who are used.*[33]

8.42 AMP cited in its evidence to the Committee that trustees are now taking much more formally their obligations with respect to investment strategies and goals[34] and are being more precise in specifying what they want the investment manager to do.[35] The Committee welcomes this development and notes that the new information disclosure requirements to operate from 1 July 1992 will require trustees to advise members of the fund's investment philosophy strategies and the strategies undertaken to achieve stated goals.

> *Recommendation 8.5:*
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> *The Committee supports legislation requiring trustees to establish investment targets and for investment managers to report against those targets. The Committee recommends that trustees be able to seek compensation from fund managers where the latter have failed to fulfil the conditions of the management contract.*

8.43 Whilst there is no shortage of public information on returns achieved on funds under management, it was clear to the Committee that publication of such data on a monthly and quarterly basis focused attention on short-term returns rather than strategies which would assist in the long term growth of the fund. Whilst some funds publish investment returns against accepted industry benchmarks and measure the performance of the funds' manager, it is of concern to the Committee that the industry has failed to develop strategies which would enable trustees and members to evaluate the appropriate long-term investment strategies to meet the funds' liabilities.

8.44 The IR&D Board, in its evidence to the Committee, suggested that fund managers be required to report on long term performance. Speaking specifically about income streams, Mr Hanley, a former Chairman of the Board, said that:

> *... I really want to know how much my fund manager made in terms of long term income flow, because that is eventually wealth creation. I would also want to know how much he made from share trading, which I see as a zero sum game ... Lastly, I want to see what the inflation issue is and what the impact of inflation is on his performance. The guy I want to put my money*

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33 Evidence, p 981.

34 Evidence, p 1747.

35 *ibid.*

> *with is the fellow who can develop that long term, wealth creating, income flow ...*[36]

8.45 The Institute of Actuaries noted in its submission that:

> *... a significant problem exists in that superannuation fund assets for many funds are invested for stability of investment returns rather than for achievement of high long-term returns.*[37]

8.46 Satisfactory real investment returns are critical to funded defined benefit schemes since there is a clear relationship between the level of real investment returns and the level of contributions required to provide the benefits. In accumulation schemes, although the assets and liabilities are both dependent on investment earnings, the relationship between the earnings rate of the fund and a member's salary determines (other things being equal) the relationship between his/her benefit and the standard of living at retirement.

8.47 The IAA argued that the risk averse nature of superannuation trustees would become more of a problem in the future due to the introduction of the new accounting standard AAS25 relating to the valuation of assets in superannuation funds.[38] The IAA advised the Committee that in conjunction with other industry professions, it was developing a set of standards to focus trustees more towards a longer-term perspective.[39] The IAA felt that the education program currently under way will take a long time to show results.[40]

8.48 As many submissions to the Committee noted, focus on short-term investment returns has become more prevalent with the trend towards accumulation schemes. SBC Dominguez Barry outlined the problem to the Committee in the following terms:

> *Fund Managers have an obligation to maximise the return on funds within safe limits. The constraints are:*
>
> - *the three-monthly investment return mentality;*
> - *the requirement to report against benchmarks on particular asset classes;*
> - *the need to minimise the transmission effects to the Australian market from a major shakeout offshore through the use of options and future's contracts; and*

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36 Evidence, p 1969.

37 Sub No. 108, p 16.

38 *ibid*, p 12

39 *ibid*, p 14.

40 *ibid*.

- *liquidity – the need to get in and out of stock quickly.*[41]

8.49 With respect to developing longer term investment prospectives, the Alexander Consulting Group advised the Committee that:

> *funds investment and advice will be a growth area (over the next decade) and communicating to members whether the policy has been successful or not. Introducing virtually compulsory preservation on all benefits would tend to encourage funds to invest more in the equities market than in fixed interest because members would then be looking through until age 65 years at least, and then even beyond 65, if the cash-back pension-type arrangements come into place. In that case, they can afford to invest a large amount in equities, because if there is a negative return in any particular year, it is not really relevant in the long scheme of things, provided the long term trend is accomplished.*[42]

Recommendation 8.6:

The Committee recommends that the ISC, the Institute of Actuaries, the Australian Institute of Trustees Inc and other professional bodies devote resources to improving public awareness of long term returns, as well as improving the ability of funds managers to focus on those long term returns.

The Committee further recommends that trustees be required to explain to members the strategies being employed to achieve a real rate of return over a given period, preferably at least five years.

41 Evidence, pp 1929-1930.

42 Evidence, p 869.