

18 January 2011

Senator David Bushby
Chair
Senate Economics References Committee
PO Box 6100
Parliament House
CANBERRA ACT 2608

BY EMAIL: economics.sen@aph.gov.au

Dear Senator

COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR

The Financial Services Council (FSC) welcomes the opportunity to make a submission to the Senate Economics References Committee to assist its inquiry into competition within the Australian banking sector (the Inquiry).

The FSC is the peak body representing the retail and wholesale funds management, superannuation, life insurance and financial advisory network industries. The FSC has over 128 members who are responsible for investing over \$1.7 trillion on behalf of more than ten million Australians.

In response to a request from the Committee Secretary, our submission focuses on superannuation investment in Australian fixed income and cash-like assets as well as the impact of the Government's deposit guarantee on bank deposit alternatives.

In relation to superannuation investment in Australian fixed income and cash-like assets, the FSC strongly opposes any suggestion or recommendation to direct the investment decisions of superannuation trustees. Any such direction will only result in a reduction in the retirement incomes of Australians.

With regards to the impact of the Government's deposit guarantee on bank deposit alternatives, the FSC calls on the Committee to recommend that the scheduled review of the deposit guarantee in October 2011 consider a full assessment of the impact of the guarantee (and any proposed amendments) on bank deposit alternatives including cash management trusts, mortgage trusts and certain bond funds.

Should you have any questions regarding this submission, please feel free to me or Martin Codina, Director of Policy, on 9299 3022.

Yours sincerely,

JOHN BROGDEN
Chief Executive Officer

Superannuation investment in Australian fixed income and cash-like assets

Compulsory superannuation was introduced in Australia in 1992 and has been one of Australia's great policy successes. Superannuation has reduced the burden on the Budget of our ageing population and improved the retirement incomes of Australians. Australia now has \$1.3 trillion of superannuation funds under management.

Under the *Superannuation Industry (Supervision) Act 1993* (the SIS Act), each trustee of a regulated superannuation fund must ensure that the fund is maintained solely for "the provision of benefits for each member of the fund on or after the member's retirement" (known as the "sole purpose test").¹ This is broadly interpreted by superannuation fund trustees as a duty to maximise the long term investment returns of members.

It is therefore a fundamental pillar of Australia's world leading superannuation system that the primary duty of a Trustee be to act in the best interests of members and select investments that maximise their returns.

Any intervention by Government to change the investment decisions superannuation fund trustees make on behalf of their members is inconsistent with Trustee duties under the SIS Act, risks reducing the rate of return and ultimately the retirement incomes of Australians.

A number of submissions to the Inquiry have suggested that the Government should take action, or investigate taking action, to increase investment in fixed income products by superannuation funds to provide a larger pool of funds for banks to draw on.

By way of example, the Australian Bankers' Association (ABA) submission makes the following recommendation:

"The Federal Government should establish a working group with banking industry experts to explore options, identify strategies and agree actions to be taken to promote investment in deposits and fixed income assets within superannuation and retirement income products".²

The FSC opposes outright any moves to direct the investment decisions of superannuation Trustees. Any such direction will result in a reduction in the retirement incomes of Australians.

Australian superannuation funds currently manage \$1.3 trillion, of which 23 per cent of funds or \$270 billion is invested in Australian fixed income and cash-like assets (fixed income assets).

To maximise returns, trustees of superannuation funds invest in a wide range of assets such as Australian and international equities, infrastructure, commercial and residential property, bonds and deposits.

The current level of investment in fixed income assets by superannuation fund trustees has been arrived at through consideration of the risk profile and demographics of fund members and the historical and expected performance of various asset classes. In this way, trustees meet their legal obligation to members under the SIS Act and ultimately maximise the retirement incomes of Australians.

¹ *Superannuation Industry (Supervision) Act 1993*, Section 62 – See Attachment A.

² Australian Bankers' Association, Submission to Senate Economics References Committee inquiry into competition in the Australian banking sector, Recommendation 5.2.4.

Changing the allocation of superannuation investments through government intervention would move funds away from the optimal allocation determined by trustees. The net result of such action would be to reduce superannuation fund returns and ultimately deliver lower retirement incomes.

The Government commissioned a comprehensive review of Australia's superannuation system through the Super System Review in May 2009. Supported by a secretariat drawn from Treasury, the Review panel was requested to ". . . *comprehensively examine and analyse the governance, efficiency, structure and operation of Australia's superannuation system.*"³ The Review was conducted over twelve months and handed its final report to the Government on 29 April 2010.

The FSC is pleased that the Government's recent response to the Super System Review expressly recognises that "*government should not mandate that superannuation fund trustees participate in any particular investment class or vehicle*".⁴

The FSC recommends that the Committee uphold this position.

Expected growth in fixed income assets

There are a number of factors that will lead to an increase in superannuation fund investment in fixed income assets over the next twenty years.

Firstly, total funds under management are projected to grow to \$3 trillion by 2020 and \$5 trillion by 2030. If the proportion of funds in superannuation allocated to fixed income assets stays constant, then \$620 billion and \$1.03 trillion will be invested in such assets by 2020 and 2030 respectively.

Additionally, it is expected that the risk appetite of superannuation fund members will also change over this time. As Australia's population ages, and the proportion of retirees in the population increases, more trustees and superannuation fund members will make investment choices which include a greater share of fixed income assets. This is because of the relatively low risk nature of fixed income assets and their fixed rate of return – especially attractive those to close to, or in, retirement.

As a result, the proportion of funds directed to fixed income assets in future is likely to be greater than that projected above.

Impact of the deposit guarantee on alternative funding sources

As has been well documented, the introduction of the bank deposit guarantee contributed to a significant increase in redemptions and a cessation of new investment monies/applications flowing into Bank Deposit Alternatives (BDA) – including Cash Management Trusts, Mortgage Trusts and certain Bond Funds.

BDAs play an important role as a savings and investment vehicle for many retail and institutional investors – including superannuation funds. They also serve as a fundamental source of financing for our capital markets and financial institutions.

While we acknowledge that the deposit guarantee was an important market intervention to shore up confidence at the time, it created a significant dislocation in investment

³ Super System review Terms of Reference 29 May 2009.

⁴ Super System Review Final Report Recommendation 6.18.

markets which remains despite relatively recent amendments to the terms of the deposit guarantee.⁵

The failure to include of BDAs from the deposit guarantee served to significantly widen the gap with regards to the perception of the underlying risk between bank deposits and BDA's. As a consequence, for as long as the deposit guarantee remains at its current level, it effectively discourages investors from investing in BDAs.

It is important to note that BDAs have historically been heavily utilised by retail/institutional investors for the same purposes as bank deposits, predominantly because they offer a low risk, safe and secure yield-based return in an investor's portfolio.

Mortgage funds

Conservatively managed retail mortgage funds serve a very similar function to term bank deposits for long term investors looking for a regular income stream.

Mortgage funds primarily lend on small to medium sized commercial property as well as residential, rural and other sectors. Mortgage Funds have played a vital role in providing competition to the banking sector in these parts of the market. In addition, they provide a similar, competitive investment outcome for retail investors, paying a stable income yield, usually monthly.

During the financial crisis, some mortgage funds were forced to freeze redemptions in order to protect the interests of all investors in such funds – thereby avoiding the distressed selling of assets which would have been to the detriment of investors wishing to remain in the fund. Even those mortgage funds that did not freeze redemptions were affected by the negative sentiment in the market. As a result of the almost non-existent inflows and redemption pressures on the sector, it became extremely difficult for many borrowers to refinance.

While the Government has acted on several occasions to provide support to the RMBS market to ensure competition continues for residential lending, the action taken in respect of the deposit guarantee has adversely impacted competition in the commercial and general mortgage market.

Figures from Morningstar (September 2010) show that since September 2006, funds managed by mortgage trusts have declined from \$19.4 billion to \$11.5 billion – a decline of 41%. Critically, unlike equities over the same period, the decline in value is principally due to redemptions and the closure of funds – not a fall in the value of the underlying assets.

Cash management trusts

Cash Management Trusts (CMTs), while legally different to bank deposits, are almost indistinguishable by investors from traditional bank accounts. CMTs are highly diversified and regulated under a Managed Investment Scheme structure by ASIC.

⁵ The Government amended the terms of guarantee in 2010 so that Australian depositors continue to be protected by the Government's Financial Claims Scheme, providing free coverage for all deposits up to \$1 million. The Government has indicated that the \$1 million cap will continue until at least October 2011, when it will be reviewed.

As a result of the deposit guarantee announcement, many funds were effectively forced to migrate underlying investments into either guaranteed deposits, or eligible non-deposit debt obligations issued under the guarantee. Others have since decided to close their CMTs due to a decline in market demand for CMTs.

Morningstar data shows that CMT assets peaked in September 2007 at \$50.2 billion. As at September 2010, CMT assets were \$40.5 billion. The decline in the value of the sector is principally due to outflows during the financial crisis, lower inflows since the financial crisis and the conversion of some CMTs from investment trusts into guaranteed accounts – therefore no longer being classified as a CMT.

Recommendations

1. The Committee reject any suggestion or recommendation to direct the investment decisions of superannuation trustees. Any such direction will result in a reduction in the retirement incomes of Australians.
2. The Committee recommend that the scheduled review of the deposit guarantee in October 2011 consider a full assessment of the impact of the deposit guarantee (and any proposed amendments) on Bank Deposit Alternatives (BDAs) including cash management trusts, mortgage trusts and certain bond funds.

The FSC would be pleased to discuss these recommendations with the Committee.

Attachment A

SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993 - SECT 62

Sole purpose test

(1) Each trustee of a regulated superannuation fund must ensure that the fund is maintained solely:

(a) for one or more of the following purposes (the *core purposes*):

(i) the provision of benefits for each member of the fund on or after the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged (whether the member's retirement occurred before, or occurred after, the member joined the fund);

(ii) the provision of benefits for each member of the fund on or after the member's attainment of an age not less than the age specified in the regulations;

(iii) the provision of benefits for each member of the fund on or after whichever is the earlier of:

(A) the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged; or

(B) the member's attainment of an age not less than the age prescribed for the purposes of subparagraph (ii);

(iv) the provision of benefits in respect of each member of the fund on or after the member's death, if:

(A) the death occurred before the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged; and

(B) the benefits are provided to the member's legal personal representative, to any or all of the member's dependants, or to both;

(v) the provision of benefits in respect of each member of the fund on or after the member's death, if:

(A) the death occurred before the member attained the age prescribed for the purposes of subparagraph (ii); and

(B) the benefits are provided to the member's legal personal representative, to any or all of the member's dependants, or to both; or

(b) for one or more of the core purposes and for one or more of the following purposes (the *ancillary purposes*):

(i) the provision of benefits for each [member](#) of the [fund](#) on or after the termination of the [member](#)'s employment with an employer who had, or any of whose [associates](#) had, at any time, contributed to the [fund](#) in relation to the [member](#);

(ii) the provision of benefits for each [member](#) of the [fund](#) on or after the [member](#)'s cessation of work, if the work was for gain or reward in any business, trade, profession, vocation, calling, occupation or employment in which the [member](#) was engaged and the cessation is on account of ill-health (whether physical or mental);

(iii) the provision of benefits in respect of each [member](#) of the [fund](#) on or after the [member](#)'s death, if:

(A) the death occurred after the [member](#)'s retirement from any business, trade, profession, vocation, calling, occupation or employment in which the [member](#) was engaged (whether the [member](#)'s retirement occurred before, or occurred after, the [member](#) joined the [fund](#)); and

(B) the benefits are provided to the [member](#)'s [legal personal representative](#), to any or all of the [member](#)'s [dependants](#), or to both;

(iv) the provision of benefits in respect of each [member](#) of the [fund](#) on or after the [member](#)'s death, if:

(A) the death occurred after the [member](#) attained the age prescribed for the purposes of subparagraph (a)(ii); and

(B) the benefits are provided to the [member](#)'s [legal personal representative](#), to any or all of the [member](#)'s [dependants](#), or to both;

(v) the provision of such other benefits as the [Regulator](#) approves in writing.

(1A) Subsection (1) does not imply that a [trustee](#) of a [regulated superannuation fund](#) is required to maintain the [fund](#) so that the same kind of benefits will be provided:

(a) to each [member](#) of the [fund](#); or

(b) in respect of each [member](#) of the [fund](#).

(2) Subsection (1) is a [civil penalty provision](#) as defined by section 193, and Part 21 therefore provides for civil and criminal consequences of contravening, or of being [involved](#) in a contravention of, that subsection.

(3) An approval given by the [Regulator](#) for the purposes of subsection (1) may be expressed to relate to:

(a) a specified [fund](#); or

(b) a specified [class](#) of [funds](#).