IFSA Members Lunch – John Brogden, IFSA CEO

24 November 2009 - Melbourne

1. Introduction

Today Australia stands at the edge of an evolution or a revolution in financial services.

Much of the reform recommended in the widening public debate is not only necessary, however overdue.

However other changes will destroy Australia's competitive edge and with it any opportunity to become a global financial hub and – despite all stated intentions – make financial advice so expensive, it will be unaffordable to working Australians.

2. Spotlight on the industry

In the past 12 months there have been three major inquiries underway that affect our industry:

- Australia's Future Tax System Review (the Henry review);
- The Super System Review (Chaired by Jeremy Cooper); and
- The Parliamentary Joint Committee Inquiry into Corporate Collapses and financial services and Products (Chaired by Bernie Ripoll).

Getting the right outcomes from these reviews is crucial, not just for our industry, but for the retirement incomes and lifestyles of all Australians – and indeed for the Australian economy.

I think it is important to remind everyone what is on-the-line for Australia, through the recommendations these reviews make.

- Since compulsory superannuation was introduced in 1992, funds under management have grown from $250 billion to over $1.3 trillion – greater than the size of the Australian economy;
- Of this, approximately half can be attributed to compulsory superannuation, with the balance divided between voluntary contributions and managed investments;
- Australia now has the fourth largest pool of managed funds in the world and the largest in the region;
- Collective investment vehicles hold around one third of the Australian equities exchange;
- During the financial crisis, Australian superannuation funds played a crucial role in financing through equity purchases, a large scale de-leveraging of corporate Australia;
- In 2008-09 the finance and insurance industries combined, accounted for 8.1% of the total economy;
- The financial services and insurance industry directly employs close to 400,000 people in Australia - many in high skill and high wage occupations; and
- Indirectly through the businesses we invest in, we employ millions more.

All this at stake, Australia cannot afford to get the regulatory settings for this industry wrong.

The first of the three reviews impacting on our industry reported to the Government last night, when Bernie Ripoll tabled the Parliamentary Joint Committee Report into Corporate Collapses, financial services and Products.

The Committee makes 11 recommendations – most of which we agree with:

- The Committee's recommendation seeking a fiduciary duty for financial advisers is a win for consumers and a win for the professional standing of the advice industry. The debate over conflicts of interest should now be put aside, enabling the industry to move forward on a solid professional foundation;
- Fiduciary duty is the highest professional standard available and is superior in all ways to any payments between product manufacturers and financial advisors. This view was echoed in ASIC's oral submission to the inquiry:

  " *. . . once you are in a fiduciary relationship, if you are going to take commissions or some other benefit, that belongs to your client . . . unless your client through disclosure, but more importantly through informed consent, allows you to keep it."*

- However, if a fiduciary duty for financial advisers is adopted, we do not believe that ceasing remuneration paid to financial advisers from product manufacturers is required;
- However, if the Government adopts this recommendation, we will work with them to ensure that the outcome is in the best interests of consumers;
- We are pleased that the Committee recognises the need for Australians to be able to claim for payments for financial advice as a tax deduction, irrespective of the method of payment. This will, if adopted, put financial advice within the reach of many more Australians;
- We also welcome the Committee's adoption of IFSA's recommendation for a risk-weighted approach to the supervision of licensees. This will enable ASIC to more effectively monitor and assess licensees and the quality of advice; and
- Further, we support the establishment of an independent, industry-based Professional Standards Board for financial advisers.

Having digested the report from the Ripoll inquiry in less than 24 hours, we now turn our minds to the Cooper Review - with submissions to Phase two of Cooper due in on 14 December 2009.

3. Cooper Review

The Cooper Review has not reported to the Government yet, however some of the comments from the Chair of the Review raise grave concerns for the industry.

Jeremy Cooper gave an indication of his views in a speech in Melbourne on 12 November 2009.

One of his key themes is the scale of the individual funds in the industry and the benefits of larger scale.

He has suggested that a possible future structure for the industry consists of 27 funds each, with funds under management of between $50 billion to $200 billion.

It is worth pausing here to reflect on recent history. There has already been significant consolidation in the industry.

Prior to the introduction of the RSE licensing regime in 2004, approximately 1200 Trustees operated 9000 funds. At the completion of the licensing program in June 2006, these figures had decreased dramatically to 307 licensed Trustees operating approximately 6900 funds.

We do not disagree that there are benefits to economies of scale.

However, we need to be clear that it is the market that should decide the optimal size of a fund – not prescriptive Legislation.

The optimal size of a fund should not be mandated by Government or forced on an industry.

The fundamentals of economics still apply.

In superannuation, as in all financial services, competition is the driver of efficiency, effectiveness and innovation.

The weight of money in super, ever improving transparency regarding the options available to Australians and the fact that Australians are exercising choice, has supported competition within the industry.

To date, this competition has been effective in putting downward pressure on superannuation fees.

Since 2002 Rice Warner Actuaries have published the superannuation Fees Report.

Their June 2008 report showed that superannuation fees averaged 1.21% as a percentage of assets under management, compared to 1.26% in 2006 and 1.37% in 2002.

The results of competition are also apparent, with the average fee charged by large corporate retail master trusts falling by 36% since 2002 – from 124 basis points to 79 basis points – making this the lowest cost segment of the industry.

It is clear that fees have reduced and that this trend will continue as the pool of funds grows and competition increases with it.

If there is to be consolidation in the funds management industry, let it take place the way it takes place in any industry – through competition and a competitive market for corporate control.

The role of Regulation in improving competition, should be to remove the barriers, to further consolidation by assisting in product rationalisation.

Artificially driving consolidation in the industry, also risks reducing competition.

Cooper also argues that larger funds allow for direct investment in infrastructure.

In the words of Cooper this would allow funds to:

> "*. . . predominately own major assets directly, either alone or in partnership, cutting* ***out expensive intermediaries, agency costs*** *and ownership structures*."

However, one of the central concepts in economics is efficiency through division of labour and specialisation. Intermediaries and specialists in any market <u>reduce</u> cost and risk – they do not increase costs.

By specialising in a particular skill, a service provider in any market can become very efficient at delivering this particular service, driving down the cost of that service.

This then allows organisations to focus on doing what they do best.

There are numerous examples of organisations using external intermediaries and specialists.

Any large organisation will procure external specialists for:

- legal advice;
- tax advice;
- human resources; and
- dare I say it - even lobbying the Government.

We use these specialist providers because this is the only thing they do and they are the best at what they do.

As a result they are cheaper than keeping all of these services in-house.

Additionally, by using these providers, it gives us the flexibility to adapt our strategy and respond quickly to changing circumstances.

The same holds true for funds managers and investment advisors.

Trustees seek the advice of fund managers and investment advisors because they are specialists in this field, making them cheaper and better at this job.

Rather than being "expensive intermediaries" - funds managers and investment advisors are necessary and skilled specialists in a highly competitive and efficient market.

Cooper also argues that larger funds are necessary to allow them to invest directly in assets in the same way that the Canadian superannuation fund does <u>and</u> that this would be a good outcome for Australian superannuation funds.

Australian superannuation funds already invest in large infrastructure projects.

However, they often, but not exclusively, do this through intermediaries who invest in a wide range of different assets around the world.

As you all know, some of these investments will consist of shares in companies that manage large scale diversified infrastructure assets.

The strength of this approach is that the investment portfolio is diversified and so is the risk.

Another strength of this system, is that it provides more liquidity than is possible through the direct ownership of assets.

The shares in a company that owns a large infrastructure project, can be sold at any time.

Selling a controlling interest in a company or an asset in its entirety, is clearly another matter.

Do we really want superannuation funds building, owning and operating large pieces of infrastructure?

The skill of trustees is in investing in businesses, not managing them.

Let me be very clear about this point – we are not opposed to direct investment by Australian superannuation funds.

What we are opposed to is the suggestion that it is unquestionably the best investment approach in all cases and that the Government should design a system to force consolidation to create funds of a large enough size to make this happen.

4. Conclusion

Jeremy Cooper’s views have one other dangers outcome.

Putting a sword to the funds management industry in Australia, will end any chance of the Government fulfilling its vision of Australia becoming a global financial centre.

The results of the 2009 World Economic Forum Financial Development Report in October 2009, demonstrated the resilience of the Australian economy and financial system.

Australia was ranked the number two financial centre in the world – up from eighth last year. Significantly, Australia was ranked first for financial market access.

The Melbourne Mercer Global Pension Index, ranked Australia second in a comparison of 11 retirement income systems from around the world.

The comparison included the Netherlands, Sweden, the UK, the US, Chile, Singapore, Germany, China, Japan and Cooper’s favourite, Canada.

The report also found that the Australian retirement income system ranked second to the Netherlands for integrity and second against Sweden for sustainability.

We have come out of the Global Financial Crisis well and we are well placed to take advantage of a growing market.

Global funds management represents a significant potential export growth market for Australia.

There are a number of factors which are expected to drive growth in investment globally:

- Ageing populations in mature and developing economies coupled with pension system reforms and liberalisation;
- Growing wealth in developed and developing countries;
- Pressure to fund commitments to defined benefit and corporate pension schemes;
- The shift away from banking deposit products to wealth management products which are drivers of productive capital; and
- The growth and diversification of sovereign wealth funds.

Australia has an extraordinary opportunity to become a major exporter of financial services.

Before Cooper recommends radical changes to Australia’s funds management and superannuation systems, he needs to consider the impact of any changes on the prospects for Australia as a financial services Hub.