Keynote Speech by John Brogden

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Mr Chairman, delegates, ladies and gentlemen.

This is my fifth and final annual conference address as Chief Executive Officer of IFSA, now the Financial Services Council.

I leave this role in January next year very grateful for the opportunity and support you have given me to lead our industry.

My first week in this role was at the 2009 annual conference.

The financial crisis was still very real, the market was down, confidence was shot and the financial advice and superannuation sectors were under review.

As we meet today, the financial crisis has been replaced by a global political environment that has more in common with 1914 than 2009, markets are up and show room to go higher, confidence is tenuous and – that's right – the financial advice and superannuation sectors are under review.

In the same five year period, the superannuation system has grown from $1.1 trillion to $1.8 trillion and Australia's funds under management have grown from $1.7 trillion to $2.3 trillion – now the third largest in the world.

And we have also been through industry, market, consumer and regulatory changes resulting from two pieces of massive regulatory reform – Stronger Super and the Future of Financial Advice.

Throughout these reforms the FSC has advocated for an open, competitive, transparent and efficient industry to ensure the best possible outcomes for consumers.

The FSC has also expanded our focus to seek to influence the economy in which we invest.

As a voice of Australia's largest industry, we believe it is important to engage in policy debates <u>outside</u> our industry, but critical to our economy – national tax reform, federalism, population, trade, and labour force participation.

Ladies and gentlemen.

As we look to the future of the financial services industry in Australia, the size, role, importance and influence of superannuation looms large.

The significance of superannuation will impact consumers and their acquisition of wealth and security of, and in, retirement.

It will impact the economy as the massive and growing pool of funds provides capital, outstrips the growth of GDP and the size of banking assets, spreads significantly beyond our borders and acts as a proxy for the overall health of the Australian economy.

And it will impact government policy as the population ages and continues to put stress on the tax base as ageing and health expenditure grow – likely in an unsustainable manner – and the calls for superannuation to fund the ills of the economy grow louder and louder.

Superannuation will increasingly dominate the national economic and political debate – and the BBQ and school gate discourse – in a manner which we are neither used to and, I fear, for which we are not prepared.

As superannuation – and with it financial advice, life insurance and funds management – move from the business and personal finance pages of the newspapers to the front pages, let me list some of the arguments we will face:

- Fees are too high;
- More superannuation should be invested in infrastructure;
- Young people should be able to access their superannuation to pay their mortgage;
- There is no competition in the market;
- The Chilean system is better;
- Self managed superannuation is the saviour of the system AND self managed superannuation is a disaster waiting to happen;
- The system is misallocating capital and distorting the economy;
- There is too much emphasis on short term investing;
- Tax concessions are unfairly and unevenly distributed;
- MySuper has failed;
- Tax concessions are too high in the context of the national structural deficit;
- Asset allocation and management styles are delivering poor comparative returns;
- The rules are constantly changing; and
- The system is too complex.

At present, the one thing I can confidently predict is that these debates will continue to proliferate.

They reflect the scale of the system and its increasing importance to the economy and to more and more individuals.

In recent months, two reports – one from the think tank, the Grattan Institute and the other from the Financial System Inquiry – have weighed in with commentary, opinion and observation.

Both have based much on research and data to support and prove their arguments.

Sadly, neither have used vigorous or accurate data and in the area of international comparisons, both failed to recognise fundamental important, unique and individual features of the Australian superannuation system.

The two most common mistakes have been:

1. Comparing our fully-funded defined contribution system to unfunded defined benefit schemes in Europe.

   These schemes have totally different asset allocation and return profiles. Australia also differs due to the large amount of assets in individual accounts within the self managed sector.

   It also ignores the fact that Australia's superannuation system is full service and includes:

   - The ability to build your own investment options;
   - Life insurance;
   - Intra-fund advice;
   - Account consolidation; and
   - Automated contributions and rollovers.

   The administration cost component for the average superannuation fund is 0.40 per cent. The services offered by Australian superannuation funds are vastly different to European DB schemes which don't offer any of these services.

   Essentially the data does not compare 'like with like'.

2. Old data is widely used.

   Most of the information used in the public debate is pre-MySuper and draws on porous OECD data from 2009.

   And some of the statements on fees come from the Cooper Review in 2010, which led to the creation of MySuper.

Further, the data does not compare the same level of service and features inside pension products in other countries. In some cases additional fees are charged on different services which are not included in the reported data.

According to Mercer research, unlike Australia, many countries also do not report on administration, investment or insurance costs. This dramatically lowers their reported fees.

And of course taxation also varies greatly, which can have a large impact on costs.

Unhelpfully this data has been complemented with a series of incorrect assertions on:

1. Active management;
2. Asset allocation;
3. Our competitive cost position on superannuation and funds management; and
4. The impact of MySuper.

The interim Murray report quoted only negative views of academics and regulators on the value of active management. For example, it quotes one study which says:

> "the average actively managed dollar [will] underperform the average passively managed dollar, net of costs."

There is an important place for both active and passive management in a balanced portfolio for a 40 year investor. Passive management controls costs and has performed strongly in recent years. Passive superannuation FUM has reached $340 billion, growing by 28 per cent in the past financial year.[1]

We strongly caution a structural review of the financial system to take a particular view on whether active or passive management is superior. There is a place for both styles in the system.

Good trustees, acting in a strict regulatory environment with a sole purpose test, a fiduciary duty and transparency obligations, should be permitted to select an asset allocation and management style befitting their membership.

As acknowledged in the FSI interim report, individual active fund managers can and do beat the market and therefore justify the cost when they do so. That means superannuation fund members should not be shut out of investing money with fund managers that beat the market. To do so would only reduce returns.

The management style and asset allocation of the Australian superannuation system has been a unique factor of its long term success.

We have been pioneers in investing in infrastructure and alternatives. Active management of these assets has delivered performance that would not have been possible elsewhere.

The Murray Inquiry and the Government want to find ways to increase the level of superannuation investment in infrastructure. There is already $45 billion of superannuation funds invested in direct and indirect infrastructure. This is projected to rise to $100 billion in the near term as state governments' commitments to privatisation and new infrastructure increase.

Investment in infrastructure could jump to $225 billion if policy settings between the Commonwealth and states:

1. Encourage asset recycling;
2. Establish a pipeline of brownfield projects; and
3. Maintain policy stability.

However, as infrastructure investments are typically active in nature, this asset allocation may not be desirable if seen through the Inquiry's looking glass.

The Inquiry has rightly asked how cheap or expensive the Australian superannuation system is when compared globally.

[1] Rainmaker

To answer this question, we need to look at the cost and value of the superannuation system and the funds management industry.

The returns that members receive from their superannuation funds over the long term are the most important factor.

Focusing on cost alone is both dangerous and lazy.

Accordingly, the FSC commissioned Deloitte Access Economics to benchmark fees and returns to Australian superannuation funds against comparable OECD countries.

There are a variety of factors that drive differences in both gross returns and in the volatility of returns between retirement income systems in different countries:

- The larger the retirement income system, the higher gross real rates of return tend to be;
- Retirement income systems with greater competition also tend to experience lower volatility of returns; and
- Higher returns are associated with occupational (as opposed to personal) retirement income systems, closed systems and retirement income systems with multiple funds.

Australia ticks all of these boxes so it might be expected to have relatively higher returns and lower volatility than the average.

New data from Chant West in the report I am releasing today shows the median return since the start of compulsory superannuation 22 years ago to June 2014 was 8 per cent per annum which is 5.4 per cent above inflation. This is net of investment fees and tax and well above the typical return objective of CPI +3.5 per cent.

On any measure this is definitive evidence that Australia’s superannuation system is working.

The Deloitte Access Economics report also compared Australia’s superannuation system against 11 other systems internationally.

The report states:

> “Of the twelve jurisdictions included in the review, Australia has the third highest returns. “

The debate on fees is less definitive. Whilst MySuper is only eight months old, it has already seen a real reduction in fees. However we, like Chris Bowen, believe fees can go lower.
The FSI interim report observed that there is a lack of competition and sensitivity to fees in the superannuation sector, and that operating costs appear above international standards.

It did, however, also observe that it is too early to assess the effect of MySuper on fees in superannuation.

In contrast the Grattan Institute came to the remarkable conclusion that MySuper has already failed.

Research conducted by Rice Warner Actuaries for the FSC shows that MySuper has had an immediate and significant impact on fees in default superannuation.

Superannuation fees have shown a steady decline over the past decade driven by greater competition.

The commencement of MySuper has had a dramatic impact on fees.

Whereas total fees declined from 1.37 per cent to 1.2 per cent between 2002 and 2011, a significant decline in its own right, the decline has accelerated in the past two years.

Overall fees declined a further 0.08 percentage points to 1.12 per cent in June 2013.

While all sectors have experienced a reduction in fees, MySuper default products have driven the majority of the decline.

Between 2011 and 2013 fees in MySuper default-like products declined from 0.92 per cent to 0.73 per cent.

Given that 80 per cent of Australians default, this means the vast majority of Australians are receiving the benefit of MySuper immediately.

At 73 basis points, MySuper products compare favourably to the other jurisdictions considered by Deloitte. MySuper compares strongly to both national funds and systems including:

- CalPERS (US) – at 77 basis points and a return of 3.5 per cent;
- The Canada Pension Plan at 92 basis points and a return 5 per cent;
- Government Pension Fund of Norway at 74 basis points and a return 4 per cent; and
- MPF system in Hong Kong at 130 basis points and a return 4.1 per cent.

MySuper must be given time to deliver what the Cooper Review intended it to do - that is, lower costs through competition.

And superannuation fees needs to be given the opportunity to go further through reform in the way default superannuation funds are selected by the introduction of an open, competitive and transparent market.

The superannuation selection process by the Fair Work Commission has been utterly discredited. The only way default superannuation will be truly competitive – the only way the 80% of Australians who default will ever get the best price, product and returns available – will be when superannuation is removed from the industrial system.

MySuper has been a path breaking change for millions of Australians who default in their superannuation.

At an average fee rate of 73 basis points, MySuper products compare well on a global basis. And the good news is that there is room for improvement.

As a significant proportion of the expenses incurred by superannuation funds, it is also important to consider the funds management industry's competitive position relative to other markets.

Despite views to the contrary, the primary reason that funds management fees are competitive in Australia is that superannuation trustees use their scale and experience to achieve lower costs.

This is a fiercely competitive marketplace. This MySuper data is supported by the global research house Morningstar which says in its 2013 Global Fund Investor Experience Report:

> "Australia fares very well with respect to fees and expenses. Australian equity, allocation and fixed income funds are some of the least expensive globally, with only the much larger United States charging consistently lower total expense ratios."

In order to determine whether or not Australian superannuation funds are being paying high fees to fund managers, we decided to undertake research into investment fees. The initial results from the survey reinforce Morningstar's point that Australian investment management fees are comparatively low.

The research is a comparative survey of global fund mangers with operations in Australia who offer the same product offshore.

The interim results of the survey shows that, on average, when compared to Europe and Asia, wholesale investment fees in Australia are:

- Five basis points lower for equity products;
- 10 basis points lower for bonds; and
- 10 basis points lower for property.

This means that our superannuation funds are driving down fees charged by multinational fund managers. It demonstrates fees for funds management in Australia are lower than comparative markets.

It shows that the 200 plus fund managers operating in this country are competing strongly for business by driving down fees in this market.

Ladies and gentlemen, we would be naive to think that the debate on fees will go away.

I said earlier that superannuation is moving to the front pages.

This month APRA will publish the first of its quarterly reports on the performance, fees and other features of the 120 MySuper products in the market.

With the weight of prudential regulation behind them, these numbers will be widely reported.

My fear is that we will see reports focused on fees, not performance.

Fees are and will always be important.

But performance is the most important measure to the consumer.

At the point of retirement no-one is going to thank their fund for the lowest fees and the worst performance.

Member companies of the FSC have superannuation products in the market that will compete strongly.

But increased reporting and comparison will drive changed consumer behaviour.

Commentators and critics should be careful of what they wished for.

Regular comparisons will drive greater sensitivity to fees and greater competition.

It may – <u>may</u> – also see increased engagement.

However, it is likely to see more switching – and with that a need for greater liquidity – and from that less capacity for illiquid investments in assets such as infrastructure.

It may also drive greater concentration on short term returns and costs and with them short term investment decisions.

Despite widespread agreement that it is both foolish and dangerous to make decisions on a 40 year investment based on monthly or quarterly investment returns, the greater frequency of comparisons increases the risk of this outcome.

We are not arguing against comparisons and transparency. I make these points to highlight that behavioural responses will have systemic outcomes that in many cases conflict with what advocates wish for. I'm not sure the people who have called for greater comparison and transparency understand it may drive increased short term investment and lower investment in infrastructure.

Ladies and gentlemen

When reflecting on the Australian superannuation system, I often think of Winston Churchill's opinion that, "It has been said that democracy is the worst form of government except for all the others we have tried."

We have the worst private pension system in the world – except for all the others!

When evaluating our superannuation system it is critical to remember that it is only 22 years old.

It might be $1.8 trillion, growing to $3 trillion by 2020 and $5 trillion by 2030, but at present it only provides a total retirement income for around 10 per cent of retirees.

On one view, the system will not reach maturity until the first worker retires having paid 12 per cent contributions for their entire working life.

Lets assume a working life of 45 to 50 years, and a 12 per cent superannuation guarantee rate by 2021 – so we will be looking at a 10 year old today retiring in 60 years.

Our hope would be that a majority of workers retiring at that time will be fully self-sufficient.

So now is not the time to tinker with the system.

We are pleased that the government and the opposition went to the last election committed – with some differences – to a three and five year moratorium on changes to superannuation.

The government is to be praised for maintaining their commitment in this year's Budget.

I view this as a short-term reprieve.

We must now embrace the opportunity and lead the debate on taking superannuation from a world class accumulation scheme to the world's best retirement system.

We must see superannuation and retirement income policy in the overall context of short, medium and long-term national budget sustainability.

The system must not only provide a majority of Australians with an appropriate retirement – it must also take intergenerational pressure off the budget.

Failure to do this will mean our superannuation system and policy has failed.

So the FSC will lead the debate from the current focus on inputs to a debate on outputs and outcomes.

Australia does not have a national retirement income policy. Let me be clear about this – we have a comprehensive superannuation policy, but not a retirement incomes policy.

In the 1980s we adopted a comprehensive national competition policy which drove the reforms that have underpinned much of the economic success over 25 years – deregulation, privatisation, lower tariffs and more flexible labour markets.

In coming months we will work with our members, business leaders, community organisations and others to develop a “National Retirement Outcomes Policy”.

We have chosen our words carefully. We want to move beyond simple policy on how much money people get from their superannuation fund when they retire – an incomes policy - to a comprehensive policy on how all the public and private elements of post retirement work together – outcomes policy – in a sustainable manner.

This policy will form views on critical issues that will determine whether superannuation succeeds or fails as the savings vehicle for Australia’s future.

The stakes are that high.

The alternative is rolling, piecemeal and constant changes to the system that undermine confidence and stability.

The “National Retirement Outcomes Policy” will integrate the design of the superannuation system with government policy on ageing, welfare, health and tax.

Our policy will consider the following:

- The efficiency of tax concessions at the contribution, earnings and drawdown phases. Over the past 10 years we have moved from a universal approach to taxation to progressive tax rates on contributions and zero tax on drawdown;
- Whether tax concessions cease at a certain accumulation point (lifetime caps)?
- Should we continue to allow access to lump sums or opt for compulsory or incentivised pensions?
- Are the age pension and preservation ages right? Should they be aligned? Should they be actuarially linked to life expectancy?
- Is the assets test set at the right level? Is access to the age pension too easy? Should the family home be in the mix?
- What is the increased role of life insurance attached to superannuation? How can life insurance reduce the burden of welfare payments, aged and health care costs? Should life insurance be incentivised as health insurance is? and
- Is 12 per cent the right contribution level? Can 12 per cent ever provide for life expectancies moving into the 90s and beyond 100? Does it meet our demographic profile? Do we move to 15 per cent? If so, does the additional 3 per cent pre-fund our health and ageing costs?

We know the government is working on a major tax white paper. Superannuation is in scope. We must front foot the consideration of tax concessions for superannuation with a comprehensive retirement outcomes policy.

We look to the Financial System Inquiry to recommend beyond its observation on the need for more work on the retirement phase. We will submit that their final report recommend to the government a comprehensive retirement policy.

Ladies and gentlemen

I am an optimist about the benefits of the superannuation to Australia and Australians.

As the overall system grows, as individual balances grow, as awareness of the importance of superannuation increases and as people come to realise they will need to rely more on their superannuation alone to fund their retirement, superannuation needs strong leadership and clear communication.

For years we have told ourselves that superannuation is too complex, people don't understand it and aren't engaged. That ground is shifting under us.

The industry must lead, advocate and defend the superannuation system. The failure to do so will leave the future of superannuation to the critics and threaten the opportunity for Australia and Australians to enjoy the benefits of the best retirement outcomes policy in the world.

[ENDS]