Centre for International Finance and Regulation

Towards Financial System Integrity

Centre for International Finance and Regulation

Submission to the Financial System Inquiry

26 August 2014

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Foreword to CIFR's Submission to the Financial System Inquiry

The Centre for International Finance and Regulation (CIFR) was pleased to assist the Inquiry with its task by organizing two Financial System Inquiry (FSI) Workshops this year.

CIFR's mission is to promote financial sector vibrancy, resilience and integrity, supporting Australia as a regional financial centre through leading research and education on systemic risk, financial market developments, and market and regulatory performance.

Since 2012 CIFR has funded more than 50 research projects, involving over 100 researchers, with combined cash and in-kind funding from CIFR and its consortium members of around $19 million. Numerous projects relate to topics of interest to the FSI.

This submission contains research produced by CIFR's Research Director and a Research Fellow on two of the Inquiry's priority topics – superannuation, technology and financial data architecture. The submission also draws on other CIFR-funded initiatives to address numerous other topics of interest to the FSI. We trust that the FSI will find the Submission helpful.

As CIFR's Chairman, it is my great privilege to commend the submission to you.

Yours sincerely,

Peter Mason AM
Chairman

Centre for International Finance and Regulation
CIFR
Towards Financial System Integrity

26 August 2014

Dear FSI Secretariat,

Centre for International Finance and Regulation (CIFR) – Submission to Financial System Inquiry

CIFR is pleased to provide this submission to the Inquiry.

We understand that the Government and the Inquiry prefer recommendations in the Final Report to be both supported by evidence, and to be on topics that have been the subject of consultation and robust examination.

CIFR's mission is:

To promote financial sector vibrancy, resiliency and integrity, supporting Australia as a regional financial centre through leading research and education on systemic risk, financial market developments and market and regulatory performance.

CIFR is in a position to draw on its capabilities and network to provide independent and objective research and views. In this submission we address aspects of the Interim Report with observations and views supported by output from CIFR-funded research. The content of this submission reflects the output of the relevant specialists.

CIFR's submission comprises the following sections:

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Superannuation

Observations in the Interim Report on aspects of superannuation, such as fees and competition, have been supplemented by public remarks by David Murray observing that there does not appear to be a common belief about the fundamental purpose of the superannuation system.

The Inquiry is right to examine high level governance settings in the system. We suggest the Inquiry might usefully further consider the nature of fiduciary duty and the principle of stewardship in formulating its view on how the financial system might be improved.

The Interim Report addresses the state of competition in superannuation, as well as the market for post-retirement products. It is problematic to recommend policy options on specific aspects of the system in the absence of certainty of the purpose of the system and a robust case for change supported by compelling evidence. For this reason, we recommend the Inquiry exercise caution in formulating any policy options directly impacting on operational areas of superannuation. We recommend that the Inquiry commission further research to inform its deliberations, particularly in relation to any policy that might aim to place downward pressure on fees.

Technology and Financial Data Architecture

We recommend consideration be given to a suitable party carrying out an inventory or audit of current data architecture, capture, storage and accessing arrangements, right across all financial regulators, and determining what linkages (if any) and networks they share. This may be a step towards a solution that allows the safe and efficient sharing of data and intelligence right across the regulatory space. Organizations including ATO, RBA, APRA, ASIC, ACCC, and potentially the Council of Financial Regulators, might usefully be involved in such an exercise. Independent bodies, such as CIFR, could make a useful contribution to evidence-based policy making if they were able to access such data.

Contributors

This submission relied on the teamwork of a number of CIFR personnel. These included Zhe Chen, John Evans, Tim Gapes, Veronique Henrisson, Madeline Johan, Kingsley Jones, Anthony Lane, Richard Lawson, Evelyn Mike, Kala Miranda, Marisa Murray, An Thuy Nguyen, Ken Ooi, Camille Schmidt, Emily Stevenson and Geoff Warren.

Offer of further assistance

In this submission we identify areas we recommend the Inquiry give further attention to.

On the topics of Superannuation and Financial Data Architecture and Technology, we invite the Secretariat to contact us if there are any additional research tasks that we may be able to undertake to further assist the Inquiry. We also provide contact details for the relevant experts who have produced the research we refer to in Section 3, and the Secretariat is encouraged to contact any of these experts directly.

We wish the Panel and Secretariat well with the task ahead. Please contact me if you wish to accept our offer of further assistance, or if there is any other aspect of the Inquiry's work that we may be able to help with.

Yours sincerely,

Professor David R Gallagher
Chief Executive Officer
CIFR

Section 1 – CIFR FSI Commentary – Superannuation

By Dr Geoff Warren, CIFR Research Director

Disclaimer: The comments in this submission have been compiled by staff of the Centre for International Finance and Regulation (CIFR). It reflects the personal views and experience of these staff members. This submission should not be read as representing the opinions or recommendations of CIFR or any of its Consortium members.

SUMMARY OF KEY MESSAGES

Fees:

1. A deeper understanding of fee determination is required. The FSI should resist the temptation of making hasty recommendations. Rather, it should call for more research to inform policy making.
2. Focus should be squarely placed on cost versus benefit. The Australian super system offers a wide range of services which contribute to costs. The issue to address is whether members are getting value for money out of the investment services and asset exposures associated with their superannuation.
3. There is much variation in the fees that members pay, with smaller investors who enter via retail channels paying more. The retail distribution chain and the basis of price discrimination need to be better understood.
4. A research question that may yield insights is why not-for-profit super funds charge fees of around 1% p.a.
5. Care needs to be taken over pursuing policies designed to pressure fees without addressing the systemic drivers of higher costs. To do so may lead to unintended consequences.

Active vs. Passive Management:

6. The choice between active and passive management is best made by superannuation fund boards and management. The aim should be to ensure decision makers are sufficiently informed and aligned with members.

Portability:

7. The general thrust of the FSI Interim Report on portability is sensible. Portability has its costs, and should be viewed as part of a trade-off. The aim should be to accommodate more flexibility in portability rules.

Other:

8. ***Philosophy*** – The FSI might give more consideration to the role of governance, particularly the principles of fiduciary duty and stewardship. Addressing shortfalls in competition or product is just one approach.
9. Some observations are offered on: MySuper; how addressing retirement needs requires strategies and not just products; and performance fees.

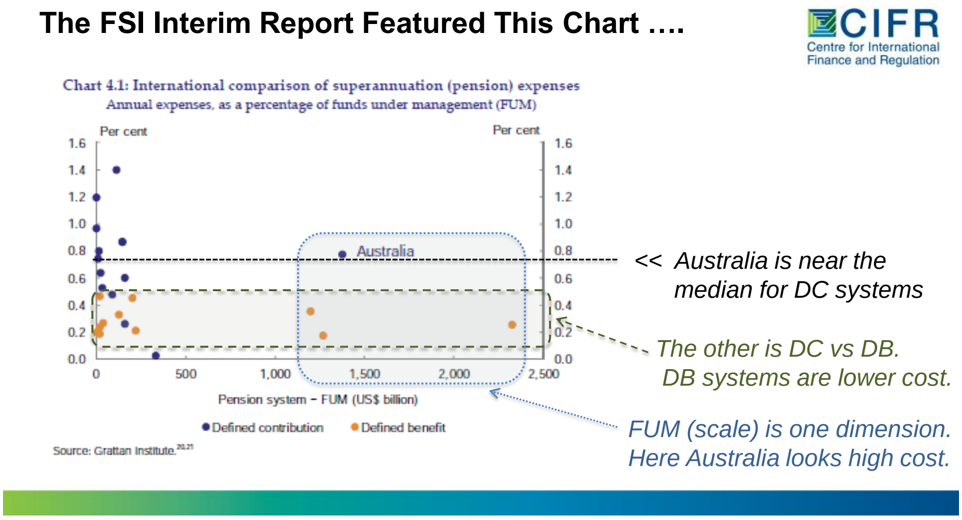
FEES

Need to Better Understand Fee Determination

- The FSI did a good job in its Interim Report at identifying the range of potential influences on fees. What is unclear is how these influences should be weighed up.
- As a structure to think about the problem, we propose three aspects that might be pushing up fees, providing a template for addressing the issue:
  - (i) Increased costs through inefficiency
  - (ii) Increased costs associated with value-added services
  - (iii) Excess profits and/or rent-seeking by providers
- The final submissions will undoubtedly have much to say on fees, given the 'heat' around the issue. It is doubtful whether much greater understanding will be forthcoming, given the state of knowledge. Further, the debate rarely seems balanced: there are too many vested interests, and commentators with preconceived ideas. Fee determination is a complex, nuanced and convoluted area that requires further in-depth analysis.
- *Implication*: Independent research is needed to support evidence-based policy making.

System Design Entails a Wide Range of Costly Services

- A characteristic of the Australian superannuation system is the large range of costly services that are available to members. These are listed below; most of which are acknowledged in the FSI's Interim Report:
  - Asset allocation: meaningful exposures to growth assets and alternatives
  - Extent that active management is used
  - Choice, and its associated architecture (many products, portability, advice, marketing, etc)
  - Member servicing and administration
  - Insurance embedded within superannuation
  - Regulation (the cost of guaranteeing integrity)
- More services result in additional cost and hence higher fees. Much of this proliferation of services and hence increased cost is a consequence of building a 'full service' system founded on choice and competition.
- Australia is a defined contribution (DC) system, which tends to be higher cost than defined benefit (DB). Costs can be lower under DB system because there is often a single fund being 'offered' and member servicing is less onerous. Asset allocation can also differ, to the extent that DB funds use fixed income assets to hedge liabilities.
- Australian fees sit just above the median for DC systems (see slide copy below).This dimension needs to be considered, as well as funds under management or 'scale'.



- The observation that fees have failed to come down commensurately with the growth in system assets requires closer scrutiny. The FSI Interim Report seems to intimate that this is due to lack of effective competition, but this is only one possibility. Another explanation is that system costs have risen, perhaps through the provision of additional services or the cost of meeting regulatory requirements. More evidence is needed.
- *Implication:* The issue is not so much cost; but whether members are getting value for money. A question that needs addressing is the extent to which fees reflect the wide range of services provided to members, and whether members are paying for costly services of limited value.

Price Discrimination

- Price discrimination is rife throughout the superannuation system and the investment industry more generally. What fee is paid by a member – both on their superannuation fund and for investment management – depends on how they enter the system. Focusing only on the average level of fees misses a key point.
- The main divide is that retail investors typically pay more than institutional investors. Discounts also exist for volume. The tables below give a sense for the fees paid for Australian equities products. The numbers are indicative only, but are representative of how the pricing of managed products operates including in parts of superannuation. An investor entering an active equity fund directly as a retail investor might pay as much as 2%. If they utilize an adviser and a platform, they pay a wholesale rate to the manager but will incur adviser and platform fees. These components may effectively sum up to over 2% (see Kingston and Weng, 2014); although given there is an element of fixed dollar value fee (e.g. the adviser's fee) it is hard to be precise. If the investor has enough volume to go direct as a 'wholesale' investor, the average fee paid according to Mercer is 0.9%. Meanwhile, institutional investors pay much less for access to the same underlying manager, perhaps as little as 0.13% for a $1billion mandate according to Mercer. Similar price discrimination is even observed for passive funds: refer table right on what Vanguard charges for its Australian Share Fund.

Fees Paid For Active Australian Equities

Retail:	
Direct - Retail	~1%-2%
Direct - Wholesale	Average: 0.9%
Via Adviser and Platform	Wholesale + fees (2%-plus?)
Institutional:	
Pooled Trust, $10m	0.70%
Pooled Trust, $100m	0.62%
Segregated Mandate, $100m	0.49%
Pooled Trust, $1bn	0.18%
Segregated Mandate, $1bn	0.13%

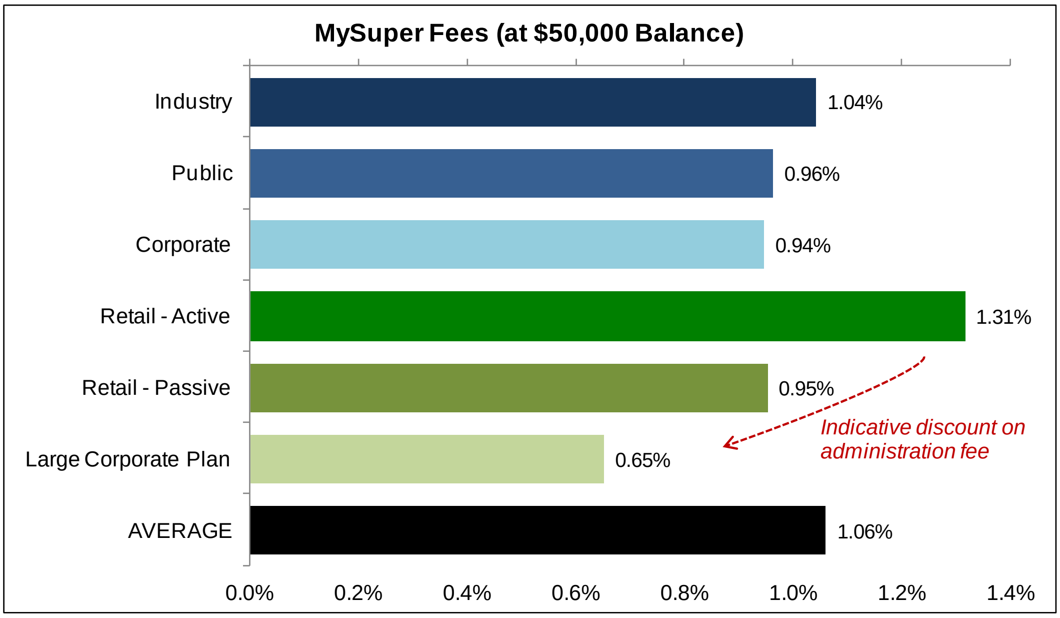
Source: Mercer Fee report; industry contacts and examples

Vanguard Australian Shares Fund

Retail:	
First $50,000	0.75%
Next $50,000	0.50%
Balance over $100,000	0.35%
Institutional:	
$500,000-plus	0.18% (Negotiable)

Source: Vanguard website

- Price discrimination is also observed for MySuper funds, notwithstanding the general requirement that all members are charged a common fee. A notable exception to the common fee rule is that discounts on administration fees can be negotiated by corporate plans on behalf of their employees. Retail providers use this latitude to offer volume discounts to corporate plans of as much as 0.70% for a $1billion-plus plan (see Chant et al., 2014). The chart below gives a sense for the impact. A member entering an actively managed MySuper fund of a retail provider via (say) an adviser may pay an average of 1.3%. If they happen to enter a similar fund via a large corporate plan, they could pay as little as 0.6%-0.7%, considerably less than most industry funds.



- A key issue is the extent to which price discrimination is justified by differing services, or whether it reflects rent-seeking in parts of the distribution chain. The higher fees paid by retail investors might be justified as an implicit payment for services such as administration, access to advice, or because smaller investors are more costly to service. On the other hand, the distributor may be exploiting behavioural shortcomings, lack of bargaining power or an absence of effective competition in the retail arena.
- *Implication*: The reasons for price discrimination in fees needs to be better understood. Research is required.

Competition and Returns to Providers

- The FSI Interim Report alludes to an absence of price-based competition in superannuation. Lack of price competition could contribute to higher fees through all three avenues mentioned earlier:
  (i) System costs are increased if a lack of competitive discipline helps to perpetuate inefficiencies;
  (ii) System costs are increased if the basis of competition shifts to proliferating products and services;
  (iii) Lack of competition could manifest in excess returns for providers.

  Some related observations are offered below. Again, a complex situation emerges requiring further research.
- A unique aspect of the Australian superannuation system is a substantial cohort of not-for-profit providers, including industry, public sector and corporate funds. These funds charge around 1% on their MySuper products (see Chant et al., 2014), thus indicating where fees have settled in the absence of a profit motive and hence greater likelihood of alignment with members. The question arises: '*why aren't not-for-profit fees lower?*'
- Competition through product proliferation is an unlikely explanation for fees sitting around 1%. This is evidenced by the median of seven options are offered by not-for-profit funds, according to APRA Fund-Level data at June 2013. For retail funds, the median number of options is 21; with some of the larger providers offer more than 100 products on their superannuation platforms.
- The fact that the ~1% not-for-profit fund fee sits roughly in line with the overall industry average hints that any excess returns may not attach to superannuation funds themselves. Two areas where excess returns could reside include investment management, and the retail distribution chain.
- Investment managers have traditionally been able to make large profits, at least where funds under management exceed levels where fixed costs are covered. Evidence of high profitability, although largely circumstantial, is compelling. Signs include wealthy fund managers (see BRW Rich list); the profitability of fund management companies (e.g. see report by Sally Patten, AFR, 21 July 2014); and proliferation in the number of Australian managers. For instance, the Mercer data base of Australian equity managers contained around 150 products as at mid-2014 (peak of 161 in February 2011), compared with 95 in 2004 and only 30 in 1994. The system is supporting what seems a lot of managers for a small regional market.
- In the case of the investment management, discussions with industry players provide anecdotal evidence that competition is starting to bite. Institutional investors such as superannuation funds are reportedly becoming tougher negotiators. The capacity of institutions to secure fee reductions is being assisted by internalization of fund management, and shifting the portfolio mix towards cheaper products such as passive and 'smart beta'.
- The other area where rent-seeking *might* exist is retail distribution: see earlier discussion on price discrimination. This issue aligns with the FSI's call for more information on vertical integration in financial services.

- *Implication*: The role being played by the purported absence of fee-based competition is opaque and unproven. Again, further evidence is needed. Two issues worthy of scrutiny include: (a) understanding why not-for-profit fees sit around 1%; and, (b) the retail distribution chain.

Beware the Unintended Consequences of Addressing Fees in Isolation

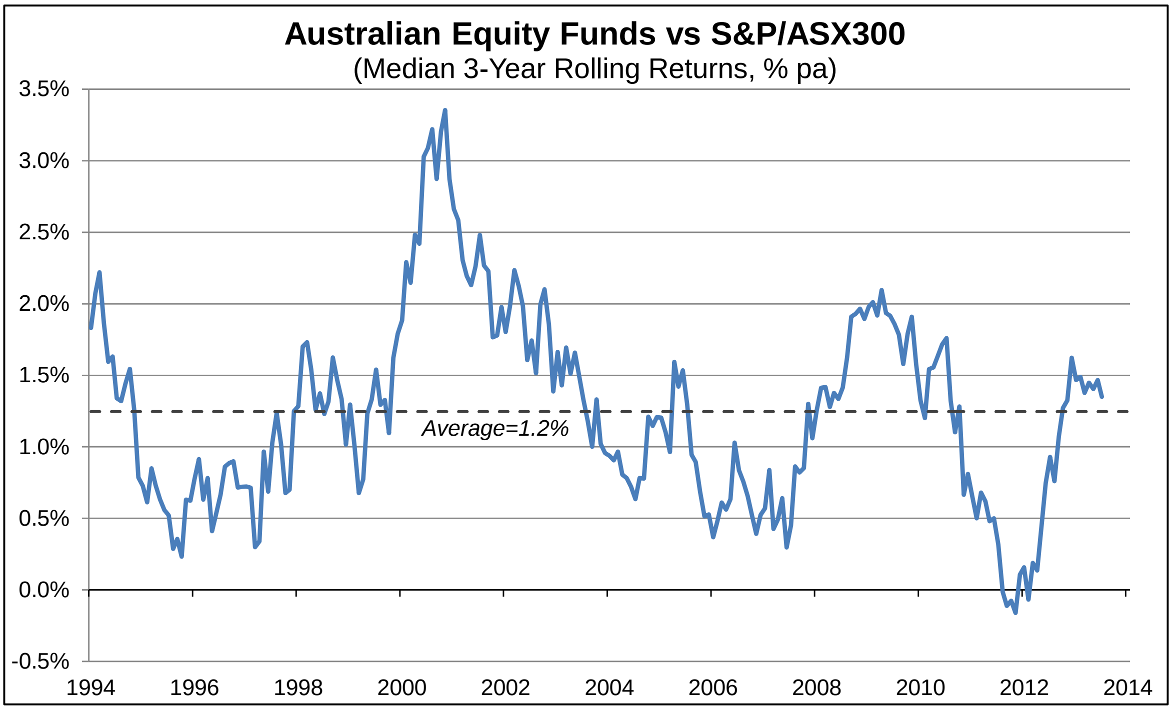
- The discussion above strongly hints that system design may be an important determinant of the level of fees. The level of costs and thus fees probably has a lot to do with Australia's substantially DC system that aims to provide members with a wide range of services and choice. In this context, adopting policies that are explicitly aimed at reducing fees without first addressing issues of system design may have unintended consequences. Lower fees are likely to result in reduced services. Whether reducing services is of net benefit to members depends on the value they add. It is net benefit that matters, not cost.
- The introduction of MySuper provides an insight into the type of response that might occur if the focus is thrust upon fees, say for instance through putting default funds up for tender based largely on price. Chant et al. (2014) document how retail providers responded to MySuper by reducing fees but moving towards lower-cost product designs (plus probably also reducing profit margin). Product design shifts included greater use of passive and reduced use of alternative assets. Effectively they cut out services that might be seen as more costly but could potentially be value-adding, depending on one's viewpoint. Whether retail members are better off is a moot point.
- A related issue is that fee disclosure is flexible and may be gamed. The basic problem is that costs incurred in managing assets are sometimes charged as a scheduled fee, and at other times charged against assets and hence gross returns. Compare a superannuation fund that takes property exposure directly via a listed REIT, with another fund that takes similar exposure via an externally managed unlisted property manager. The fund that directly invests in the REIT records no 'fee' and indeed no marginal management expense. Meanwhile, the cost of managing the properties relates to internal REIT management and is embedded in returns. For the fund that uses the unlisted vehicle, all the cost of managing the properties is recorded as a fee. The net result for the members could be the same. The FSI should be aware that focusing too heavily on fees in isolation may have the consequence that fee disclosure considerations can drive behaviour, rather than net benefit to members. It could also encourage manipulation of reported fees, by charging costs against assets rather than as fees where possible. For a comment by industry participants on this issue, see Butt et al. (2014, pp11-12).

ACTIVE MANAGEMENT

- The FSI has requested further input on active management, largely on the premise that it is a 'value-added' service that does not justify the cost. The FSI Interim Report refers to the Squam Lake Group and US evidence that active managers have added value; as well as the 'zero sum game' constraint of Sharpe (1991).

- In fact, the evidence on active management from the US is actually mixed. Recent studies conclude that US active managers demonstrate some capability to generate alpha (see Jones and Wermers, 2011). Estimates of gross alpha prior fees are in the order of 0.40%-0.50% (see Barras et al., 2010; Fama and French, 2010). This is consistent with the argument of Grossman and Stiglitz (1980) that those who invest in becoming informed should achieve higher gross returns than those investors who do not in equilibrium. The issue is whether active management covers its fees. In part this depends on what fee an investor pays, with a similar distinction between retail and institutional occurring in the US to that described further above.
- The choice between active and passive investing is not absolute, but should be viewed as a choice that depends on the circumstances under which it is made. Policy should not be attempting to favour either active or passive management, but should aim to ensure the choice is made by informed and aligned decision makers, cognisant of the greater costs of active investing due to higher fees and tax impacts due to turnover.
- As an illustration of the nature of the decision, Ezra and Warren (2014) identify the five situations listed below that may justify an investor using an alternative to passively replicating a capitalization-weighted index. The first three items relate to the efficacy of the passive alternative, and have nothing to do with manager skill.
  - (i) *No readily replicable index is available* – This applies in many alternatives assets, as well as illiquid as markets such as small caps and high yield debt.
  - (ii) *The passive index is at odds with the investor's objectives* – This can occur for example in fixed income, or where ESG concerns are important.
  - (iii) *The standard passive index is inefficiently constructed* – In some instances the index may be inefficient due to incomplete coverage or construction, e.g. fixed income. This may even be the case in equities. Evidence arises from the outperformance of a range of 'smart beta' products, such as weighting by fundamental measures or minimum variance (see Amenc et al., 2013). These products often embed rebalancing strategies that capture mis-pricing or anomalies such that related to 'low beta'. They may accordingly be considered as hybrids between active and passive.
  - (iv) *The environment favours active managers* – In some markets and at some times, the environment is conducive to active managers outperforming. That is, active managers may have an advantage over other investors in the market, thus circumventing the zero sum game of Sharpe (1991). See next dot point.
  - (v) *Skilled managers can be identified* – Some investors may be able to justify active management through an ability to pick skilled managers and blend them into a portfolio.
- It is dangerous to generalize from evidence arising from the US, which is the largest (49% of MSCI ACWI) and probably the most efficient market in the world. In particular, there are signs that the average Australian equity manager has been able to add net value, at least at fees typically paid by institutional investors such as superannuation funds. The outperformance versus the S&P/ASX300 based on the Mercer universe (excluding indexed and long/short products) has averaged around 1.2% over the last 20 years or so – see chart. Small cap managers have done

even better. These findings are confirmed by more rigorous academic studies, e.g. see Pinnuck (2003), Gallagher and Looi (2006), Chen et al. (2010), Bennett et al. (2014). In other markets – including global equities and fixed income – the performance of active management has been less inspiring. The point is that the results vary across markets.



- *Implication*: There is no absolute answer to the issue of whether active management creates value: it depends on the circumstances. Given this, the choice between active and passive is best left to informed decision makers. In the context of default (MySuper) superannuation funds, this would be trustee boards and internal management. However, there is a caveat – decision makers need to be sufficiently informed and aligned. Hence policy should remain neutral with respect to active versus passive; but aim to ensure that those making the choice are driven by what is best for members. The latter is an issue of governance and alignment.

PORTABILITY AND SWITCHING

- The FSI Interim Report correctly portrays portability as a trade-off between fostering greater competition and long-term investing, in accord with discussions in Warren (2014). It also mentions difficulties in liquidity management, including the return impact of holding additional cash to facilitate portability. It is possible to add further to the costs associated with portability:
  - By discouraging the use of illiquid assets, portability may hamper diversification, including dilution of the dominance of listed equity exposure over portfolio risk;
  - Redemption activity has been shown to have a significantly negative impact on fund returns as a consequence of the market impact costs (for instance, see Edelen, 1999; Johnson, 2004);

- There can be member equity issues with respect to the use of appraisal-based assets in pooled vehicles, to the extent that members may enter or leave the pool at stale valuations.

  There is a sense in which portability imposes externalities on other investors in the pool, i.e. those who exercise portability can impose costs on other investors who retain their holding for the long-term.

- The above notions suggest there is benefit in providing more scope for funds to limit portability. What is needed is provision to alter portability arrangements in certain situations, rather than a general change to the portability requirements. For instance, restricting portability is most likely to be valuable where funds wish to pursue a long-term approach or invest in illiquid assets. Extending the regulator's power to make determinations using a principles-based approach seems sensible, as it provides this flexibility.
- In terms of specific ideas, the FSI refers to permitting longer maximum time periods or conducting staged transfers. These ideas are worthy of consideration. Two additional but somewhat radical ideas for managing redemptions are put forward in the box below.
- Consideration may also be given to providing scope to charge switching costs that better reflect the full cost of providing portability. One mechanism might be to impose a switching fee within pooled vehicles that comprises two components: a cost-recovery charge related to the expense incurred by the fund provider to undertake the transaction, plus an excess that is paid into the pool to be shared amongst other investors. The effect is that those redeeming units would not only incur the direct costs imposed on the fund as a consequence of the transaction, but they would be effectively selling at a discount to other investors in the pool. The latter may a mechanism by which those who withdraw funding more fully bear the costs of the externalities they create.
- *Conclusion*: The focus of the FSI on portability is welcomed. Providing near-immediate portability entails costs which are arguably greater than the benefits in many situations. A re-thinking of the trade-off involved is well worthwhile.

Two (Radical) Ideas for Deferring Redemption

Idea 1: Permit delayed portability for a hold-out slice of illiquid assets

This idea is intended for open-ended pooled funds that contain an illiquid asset component. It may be particularly relevant for diversified funds comprising liquid asset and illiquid alternatives, such as balanced pension funds for instance. The basic notion involves immediately satisfying a substantial portion of any redemptions, but retaining a 'hold-out slice' for a period long enough to permit the illiquid asset component of the portfolio to be valued and liquidated if required. This is how we envisage it might operate:

- Funds would be divided into two pools: liquid and illiquid. The illiquid pool would probably comprise of a single diversified portfolio of illiquid assets; but might be structured as a series of asset pools.
- The amount redeemed immediately would equate to all funds in the liquid pool, plus a portion of the illiquid asset pool. This portion would be set with an eye on valuation risk for the illiquid assets. For

example, say a fund is 20% weighted in illiquid assets, of which 75% is paid out immediately upon redemption. The result is that 95% of funds are paid out immediately (0.95 = 0.80 + 0.20*0.75). Hence 5% is retained as a hold-out slice.

- The hold-out slice would be held in trust, and would act as a valuation and illiquidity buffer. The residual after valuation adjustments would be released once two conditions are satisfied. First, a valuation event occurs (say, every quarter). Second, redemption can be met from existing cash resources within the illiquid pool. The second condition may be satisfied in a number of ways: the pool could have cash on hand; assets may be liquidated in the normal course of business; or cash becomes available through other investors entering the fund. The latter would effectively amount to a transfer of units within the illiquid pool.
- Release of funds held in trust may take some time where there is no cash on hand, the fund is unable to liquidate assets, and there are no inflows. Given the relatively small size of the hold-out slice, any hardship should be limited. Note that investors would remain fully exposed to the unlisted pool until settlement.
- The prime benefit of this mechanism is that the fund will never be placed in the position of being forced to sell illiquid assets quickly to satisfy redemptions. Illiquidity risk is diminished, and becomes effectively fully borne by investors. Another benefit is that member equity is enhanced with respect to valuations and unit pricing.
- A complementary arrangement might be established for new funds flows, so that the funds are held in trust and invested in the illiquid asset pool only after a valuation event. Indeed, all transfer activity might be coordinated.
- Requirements may need to be imposed to ensure that the manager attempts to satisfy redemption with efficacy, given that there may be incentives to defer liquidation to retain funds under management.

Idea 2: 'One-in-one-out' facility

The intuition behind this idea is that investors cannot switch out of the fund unless new cash enters. The aim is to ensure that funds invested cannot decline through switching activity, thus providing the manager with security of funding. The mechanism effectively creates a fund that is open-end on the buy-side, but becomes closed-end on the sell side under conditions of net outflows. While the basic idea is straightforward, we envisage two variations:

- A sponsored market might be created in parallel to accommodate switching activity in cases where the fund is facing net switching outflows. The assumption is that there will always be a buyer at some price, although the seller may suffer a discount to asset backing in order to attract a buyer. This would amount to a secondary market similar to what is available for many closed-end funds. Setting up arbitrage facilities may be helpful, including perhaps permitting the fund to use any excess cash reserves to purchase back units.
- Redemption requests might be categorized into switching activity and drawdown for genuine needs such as retirement or hardship, with drawdown for genuine need satisfied immediately. The latter

can be managed to the extent that retirement withdrawals are relatively predictable, and hardship withdrawals are minor.

This idea might be viewed as a watering down of total commitment. Nevertheless, the mechanism still involves a high element of commitment; plus investors face the risk they may no liquidity whatsoever if events turn sour.

OTHER COMMENTS

Below are additional observations on matters that may be of interest to the FSI, many of which stem from research that CIFR staff have published or are currently undertaking

Philosophy

The underlying philosophy behind the policy framework surrounding superannuation has been somewhat schizophrenic (see Donald, 2011). In some areas, members are treated as consumers of financial products, coupled with the presumption that fund providers should be disciplined by the market through competition and disclosure. In other situations, members are considered as beneficiaries that are being looked after by fiduciaries, i.e. trustee boards. The Wallis Inquiry and the Cooper Review both adopted clear stances on these matters. This does not seem to be the case with the FSI, at least as far as revealed by the Interim Report.

The FSI might give closer consideration to the philosophy underpinning any recommendations. In certain circumstances it may ask be worth asking if it is more appropriate to strengthen fund governance, particularly the principles of fiduciary duty and stewardship, rather than seek a market-based or rules-based solution. A case in point is the idea of putting default funds up for tender, which is essentially a market-based solution that aims to minimize the price of a particular product. A better approach may be to ask whether the governance settings ensure that disengaged, default members are being looked after; and what might be done if this is not the case. The debate over trustee independence is relevant here, as is the issue of trustee expertise and capability. Also relevant is the discussion below, which highlights some encouraging signs that the industry is taking its fiduciary duty seriously. To the extent that this is the case, there may be limited call for substantial policy action around MySuper.

MySuper Research

The FSI has requested further information on a number of aspects around MySuper that are being addressed by CIFR researchers. For instance, Chant et al. (2014) provide a comprehensive overview of the landscape of MySuper products, including aspects such as product structures, investment strategies, fees, and the competitive response to MySuper. The report also addresses tailoring of asset allocations to an extent, by providing detail on the MySuper lifecycle products.

Another highly relevant research project is SUP002, which involves interviews of superannuation fund executives. One paper has been published from this project on views about the industry and its regulation (Butt et al., 2014). A second paper on MySuper is planned for later in 2014. A precursor of insights from the interviews appears below:

- *Objectives: signs of a shift* – Encouraging signs were detected of a shift in focus away from funds primarily aiming to maximise their short-term returns and relative performance, towards viewing their prime purpose as helping members prepare for retirement. Most fund executives (including those in the retail sector) appear to be taking their role as fiduciaries seriously, especially with regard to default members.
- *Disclosure* – Consistent with the above, complaints were encountered about a disclosure regime that focuses on returns as the basis of accountability and of how risk is defined. Many funds are considering a shift towards reporting outcomes and engaging with members in terms progression towards adequate income in retirement.
- *Tailoring and advice* – Also consistent with the shift in focus within the industry, many funds are grappling with how they may better tailor to individual members. A lack of member data was seen as one constraint. Increased use of advice was seen by some as a mechanism for better tailoring and member engagement.
- *Cheaper not necessarily better* – A number of fund executives reacted negatively to a singular focus on fees. The point that cheaper is not necessarily better was raised.
- *Retirement phase* – This is clearly a major area of focus amongst the funds. Some called for the ability to default members into retirement products.

Addressing retirement needs – general comment

Both the discussions with fund executives and a reading of the literature point towards the insight that addressing the retirement needs of members requires *strategies rather than just products*. Strategies can handle the heterogeneity of member circumstances, and capture the benefit of being able to dynamically respond to developments along the path. Advice and tailored solutions are likely to play a role. While products like annuities may be part of the solution, they will not be suitable for all members plus sacrifice valuable flexibility.

Performance fees

Consideration should be given the merits (and potential pitfalls) of shifting the balance from asset-based fees, towards performance fees that are suitably structured and measured on a risk-adjusted basis. Kingston and Weng (2014) argue for fulcrum performance fees, where the manager shares in the downside as well as the upside. They observe how fulcrum fees are rarely used in Australia; but have become the only legal form of performance fees in the US outside hedge funds. Properly structured performance fees may help to enhance the alignment between investors and managers.

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Section 2 – CIFR FSI Commentary – Technology & Financial Data Architecture

By Dr Kingsley Jones, CIFR Research Fellow

Disclaimer: The comments in this submission have been compiled by staff of the Centre for International Finance and Regulation (CIFR). It reflects the personal views and experience of these staff members. This submission should not be read as representing the opinions or recommendations of CIFR or any of its Consortium members.

SUMMARY OF KEY MESSAGES

Technology & Financial Services Innovation:

1. The **Regulatory Philosophy** of Investment Management and Advice is likely to be profoundly impacted by the natural evolution in digital service models and the related phenomenon of *unbundled fund services*. The future of financial services may well be viewed as a "Services Stack" comprising different specialized functions that were formerly vertically integrated into one service provider. Understanding this current of change is likely an important factor in foreseeing those areas where existing regulation may conflict with emerging trends.
2. **Digital Technologies** significantly lower the costs of distributing *informational*, *educational* and *advisory* product on a *direct basis* to the customer. However, while the new technology stack is *global*, the regulatory and taxation stack is *local*. This means that cross-border financial services trade patterns are only *limited by regulation*.
3. **Legal Innovations** and **Business Model Innovations** are likely to be as important as the digital technology in shaping the growth of investment services and regulatory pressures. This is because entrepreneurial activity will typically adapt new technologies within a re-thought business process to deliver new value to customers.
4. The concept of **Technology Neutrality** may be insufficient to fully capture the interaction between technology and regulation as it impacts the evolution of new business models. It is here that the future regulatory philosophy is most likely to both contact and be impacted by demographic and market changes.
5. The capture of global and regional opportunities in **Trade of Financial Services** depends on the ability of the trading parties to transact across borders. This already happens in global electronic execution for securities. Without careful attention to the regulatory philosophy, services in the area of capital management, trading, information and advice may well migrate offshore, via digital distribution channels towards the lowest cost players with global reach. This has happened already in the global markets for UCITS funds and US listed and traded Exchange Traded Funds (ETFs). Future regulatory settings need to be mindful of the balance between protecting local markets and harmonising regulation to grow the global reach of Australian service providers.

Customer Information Protections:

6. The analysis of **Customer Information** is increasingly a competitive tool for businesses engaged in digital services delivery. There are existing privacy protections, but the regulatory philosophy is likely to centre on principles such as anonymisation of data, security of identity and breaches of data custody responsibility.
7. Public data can be viewed as a **National Asset**, in which case sound policy would dictate widespread release. However, the principles of *aggregation* to preserve privacy, *embargo* of time-sensitive data, and *authorisation* for sensitive data will likely figure prominently in discussion of regulatory principles.
8. The **Mosaic Principle** refers to the hidden value of data when it is linked and combined to reveal identity or commercial profile. The development of regulatory philosophy will be important in this area to provide for remedies in the event of personal and/or public harm. This may come under the Trade Practices Act.

Cyber-Security Risks and Opportunities:

9. The role of **Trusted Digital Identity** is important for the future security of digital commerce. However, an undue emphasis on a *single* trusted identity may elevate the value in misuse by *identity theft*. Regulatory models that encourage distributed trust via multiple possible corroborating sources may prove more secure long term.
10. **Behavioural Hacking and Phishing** are modern confidence tricks which undermine trust. Policy development in this area likely needs to recognize the problem as an *opportunity for public-private cooperation*.
11. Specific government activity in **Cyber-Security** is probably best focused on Cyber-Crime enforcement and the tracking of State-Sponsored activity. The private sector recognizes the commercial risk of the problem but can benefit from high-level government activity in protecting and monitoring core network assets.
12. The major policy opportunity in this area is likely the encouragement of a thriving **Digital Security Innovation** sector. 'Black Hat' Cyber-Criminals reinvest some portion of the proceeds of crime in new means of attack. The obvious response is to encourage growth in 'White Hat' activity to close these risks down as they arise.

Data Architecture and Regulatory Analytics:

13. Improved Analytics and Data Science may alter the balance between **Regulation and Enforcement** through enhancing the ability of regulatory agencies to monitor and act on suspect activity. However, this is likely to require some attention to the organisational process separately from the regulatory architecture.
14. **Data Quality and Availability** have a profound effect on the ability of policy makers and regulators to answer important questions as and when they arrive. Through the growth of Superannuation, it seems probable that a growing need will arise for high quality and timely data on *life expectancy*; *cost of living by cohort*; the *costs of financial services* and the *income patterns*

and asset allocations of different investor classes. This challenge transcends the activity of government statistical agencies due to the rapid growth of private data collection. Policy is likely to be very challenging in this area, since *data linkage* is a key area of value-add which will increasingly occur across the legal boundaries of public or private data ownership.

15. **Data Science and Analytics** have become the lifeblood of many decision-making activities. One of the greater areas of challenge is to develop policies which foster knowledge, skills development and culture. Regulatory policy can help set the boundaries of acceptable behaviour, but the regulatory architecture itself will likely change as a result of these forces. Government and Regulatory agencies represent information-rich areas of economic activity which will benefit from these trends and so they must be active participants in the changes.

We recommend consideration be given to a suitable party carrying out an inventory or audit of current data architecture, capture, storage and accessing arrangements, right across the financial regulators, and determining what linkages (if any) and networks they share. This may be a step towards a solution that allows the safe and efficient sharing of data and intelligence right across the regulatory space. Organizations including ATO, RBA, APRA, ASIC, ACCC, and potentially the Council of Financial Regulators (CFR), might usefully be involved in such an exercise. Independent bodies such as CIFR could play a useful role if they were able to access such data, even on anonymised/confidential terms, as an extra layer of independent contribution to "evidence-based policy making".

UNBUNDLING OF THE INVESTMENT SERVICES STACK

Unbundling of Investment Services

In order to research this phenomenon, we conceived of a simple unbundled services stack. The ingredients that go to make up a traditional managed fund can be unbundled into component specialized services.

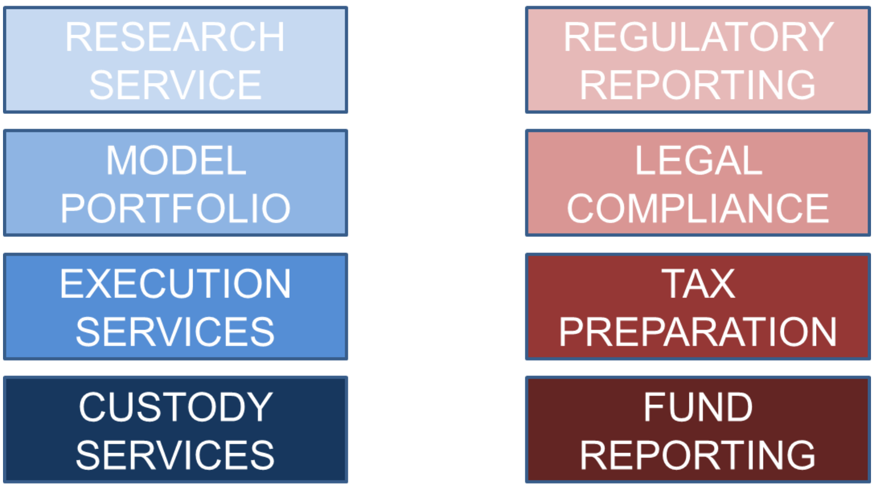


Figure 1 Illustrative Investment Services Stack

On the left, we list four key services which contribute to an implemented investment. On the right, we list four complementary services that address the administrative and compliance functions.
In a traditional *Pooled Managed Investment Scheme* each of these functions may be the responsibility of one single entity on a fully integrated basis, or at the very least on a tightly integrated basis.

For obvious reasons, pooled investment funds represented the initial means to bring professional investment management services to the mass market. In earlier times, there were clear benefits to aggregating investor capital within a single management vehicle and then defraying the costs of operating the fund across large numbers of investors. However, computer technology has since eroded the costs of:

1. Fund accounting and custody;
2. Execution and transactional services;
3. Information gathering and strategy research; and
4. Preparation of fund holding registry and tax statements

In the world of global electronic securities transactions, the *high-cost components* of the service delivery model are increasingly those which are the most *difficult to automate*. These activities centre on tax, legal, and regulatory compliance and those aspects of the distribution and sale of investment services which are people intensive.

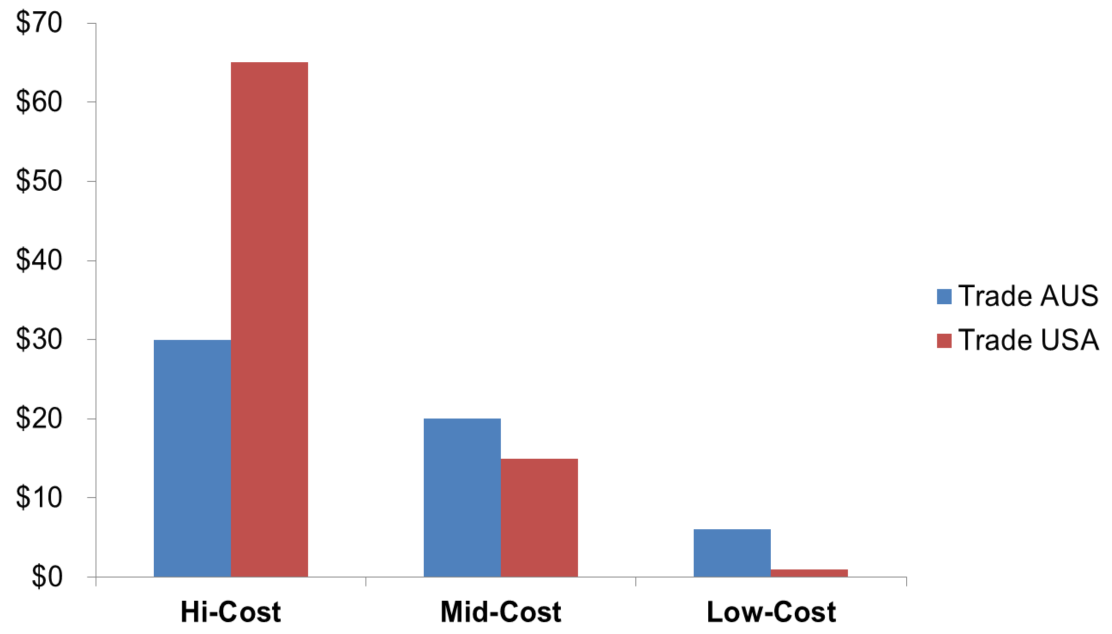
In this regard, it is notable that *pooled managed investment funds* have a high intrinsic regulatory cost since they must meet the more stringent requirements of such collective managed investment vehicles.

Whereas this may have made sense in an age when high quality accounting, execution and custody services were expensive, that is no longer the case in the world today. Arguably, the pooling benefits of scale that formerly argued in favour of the managed investment scheme no longer apply but the regulatory philosophy has yet to adjust fully to the new economics dictated by digital investment services. The benefits of scale seem to favour disaggregation.

Rise of the Self-Managed Superannuation Fund (SMSF)

The rise of the Self-Managed Superannuation Fund (SMSF) is a clear example of the process of unbundling in action for consumer benefit. While there has not been one single identifiable trigger for the rapid growth of the SMSF in Australia, we may point to some very favourable *economic tailwinds* due to electronic execution.

Firstly, the global growth of electronic execution has significantly lowered the costs of direct to market access for retail investors. Whereas brokerage rates in excess of 1% were not uncommon in earlier times, retail rates of commission have fallen substantially. A shadow shopping exercise will serve to illustrate the key dynamic.



$ per trade

Figure 2 Simple shadow-shopping exercise across three tiers of electronic brokerage commission

In the above chart, we display sampled rates of retail brokerage commission, such as might be used to implement an SMSF strategy across three identifiable tiers of cost for *two scenarios*: trade in Australian (ASX) listed equities; and trade in USA (Nasdaq and NYSE) listed equities. There is a large dispersion in costs for what are all discount brokers with no advice. However, they all involve the *Australian registered office of an AFSL licensed broker*.

Arguably, each of these cost structures across the broad market is inexpensive since the flat rates involved are generally applicable for trade parcels of up to $10,000 or more. Indeed, among the lower cost brokers the rate is generally capped at around 0.08% to 0.25% on trades of any size. In the context of an SMSF of average size, around $1M AUD and turnover of 50% p.a. that is a very reasonable $800 to $2500 for implementation.

Indeed, the costs of execution for such strategies become substantially *less* when the investor chooses to build their portfolio using vehicles such as Exchange Traded Funds (ETF) listed and traded in the USA. Commission rates of as low as $1 per trade can be accessed by SMSF investors in today's marketplace.

While the above survey is of a limited nature, and could be enhanced by more comprehensive assessment of the nature of the service bundle across each of the three tiers, we think it noteworthy to remark:

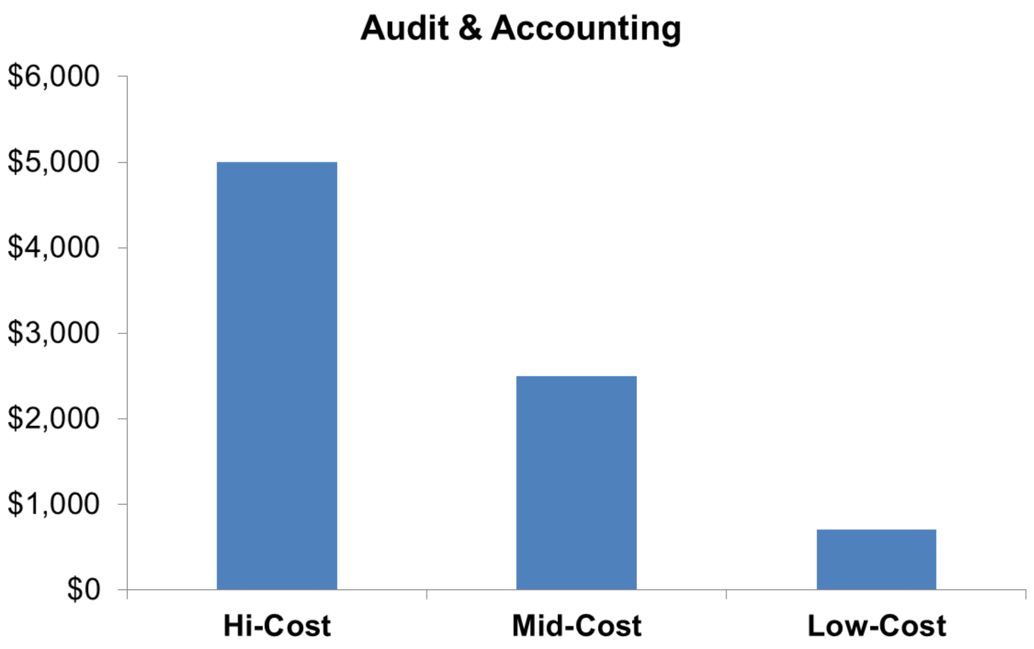
1. The largest Australian retail brokerage by market share is in the highest cost tier
2. The cheapest brokerage listed is the Australian registered office of a USA market leader

3. The greatest investor protections (SIPC and FDIC Insured status) attach to the accounts at USA firms

In this regard, it should be clear where the battle lines lie in the growth of self-directed implementation services.

Patterns of Value in Audit and Accounting Services

As we saw above, electronic execution can significantly lower the costs of implementation for self-directed investors and make such strategies competitive with pooled managed funds. As the SMSF market has now grown to more than 500,000 individual funds, the market for *unbundled fund administration* has grown rapidly. Here we can see the effect of digital commerce reflected in fee structures and market share.



$ cost per service

Figure 3 Shadow shopping for Fund Audit and Accounting across three tiers

Again we estimated total costs of SMSF fund audit and accounting services across three tiers. Unlike in the case of electronic execution the above service tiers are more clearly differentiated. The high cost tier generally impounded some component of portfolio construction advice while the low cost tier was an online pure administration product.

What is noteworthy about this exercise is:

1. The high-cost tier is often structured as full-service flat rate or may be a percentage of assets
2. The mid-cost tier typically reflects no-advice accountancy practice fund administration services
3. The low-cost tier is typically *direct-to-customer* online service delivery integrated with an online broker

When reflecting on the above cost structures several points appear to stand out. Firstly, there does seem to be a strong differentiation of *service level* which is reflected to some degree in costs. Secondly, the downward driver on costs is clearly the degree of direct-to-customer internet delivery. Thirdly, there is no necessary requirement, nor any evident need, for *financial advice*, but there is a clear regulatory requirement for *auditors* to be registered.

In short, the present regulatory architecture has created a large, circa 500,000 unit market, for individually audited SMSF fund accounts. At present rates, that market is estimated at around $250M per annum and growing. The interesting feature of this situation is that we appear to have regulated audit in a manner which makes it *more manual* than is fund accounting. Perversely, this makes the activity *worth more* in the marketplace.

One might anticipate that the downward pressure on fund accounting due to technology will increase the revenue share going to mandated regulatory activities like *audit* and *fund tax advice*. One should set this observation in the context of our early remarks on technology. Regulatory bottlenecks become the areas with strong pricing support.

The Disruptive Impact of Exchange Traded Funds (ETFs)

To continue with the above program, we need to incorporate the cost of implementation for strategies resembling a typical balanced fund, but implemented using instruments available to the typical SMSF. The obvious low-cost strategy is to implement the portfolio using ETF instruments via an online broker linked to an online direct to customer fund accounting and tax reporting service. This could be done using ASX listed instruments, or via investment on the USA exchanges using an available Australian registered online broker.

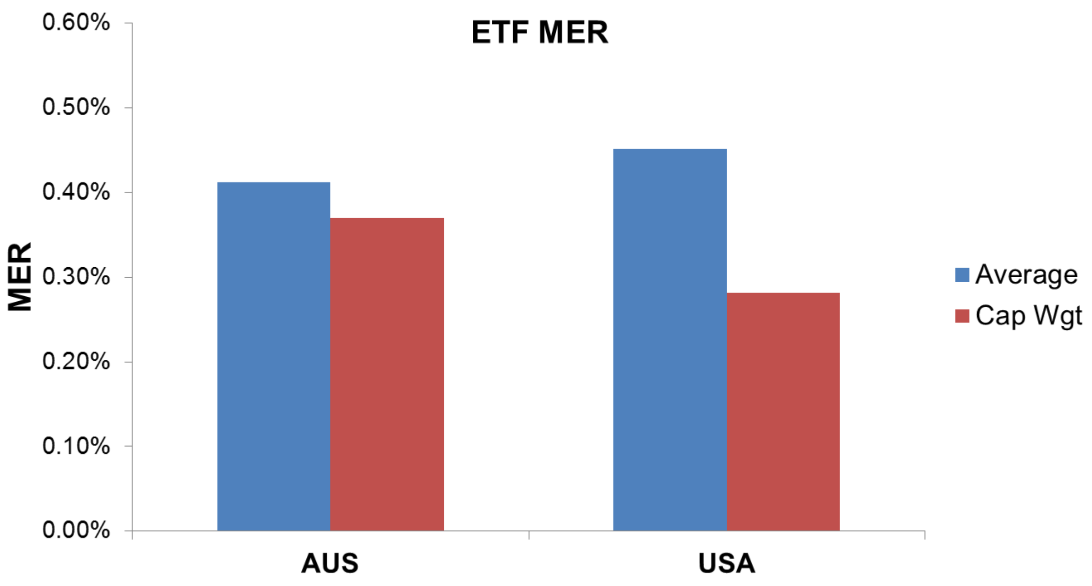


Figure 4 Comparative Management Expense Ratios for ETF Instruments

To compare these approaches we looked at the roughly 70 co-listed ETF instruments offering *similar exposures* between the USA exchanges and the ASX. In making this comparison, it is important to note that we found no evidence of fee differentiation between markets for a common product provider.

To state this clearly, if an ETF was offered at one fee rate in the USA market then the *same provider* offering the *same product* in the ASX marketplace *charged the same MER*. In simple terms, there is no advantage in going offshore to trade the ETF, *on an MER basis*. However, as we noted earlier, the brokerage commission rates are typically lower when trading the USA listed ETF through an Australian registered office of a USA broker.

In this respect, there are the expected economies of scale available by going to the larger market.

The other major difference is in the range of securities on offer. The Australian market offers around 70 listed ETF instruments while the USA market offers around 2,000 listed ETF instruments. This broader product range is responsible for the dispersion in average MER between markets as well as capitalization weighted MER.

On the face of it, there would seem to be little incentive, other than product variety, for the Australian SMSF to execute offshore in preference to onshore. However, there are a number of other factors to consider: some negative, such as time-zone; and some positive such as a wider array of investor information services.

However, the overarching factor in market growth is likely to *market spreads* and *depth of liquidity*.

The Importance of Depth and Spreads to Implemented Strategies

Our earlier considerations highlight the avenues for a self-directed SMSF to achieve low costs of operation through the use of ETF vehicles, online execution and direct-to-customer online fund administration. Using such service options, the execution and administration costs can plausibly be contained at around 0.5% to 1% p.a. This level seems consistent with full-service "all-in" flat rate market offerings of $5,000 to $10,000, which is around 1% of an *average* sized $1M SMSF portfolio. Even allowing for the natural skew in fund size, it seems that containing costs below $5,000 per annum is perfectly reasonable, given available market offerings in Australia.

With this fee level in mind, we must recognize that typical pooled fund MERs of upwards of 0.8% to 1.2% or more, without regard to additional platform-driven advisory fees, are under some clear competitive pressure.

As per the accompanying research by Geoff Warren, it would seem premature to judge *where fees should be* if we are unclear as to where they are now, or indeed what pressures exist on fees according to the chosen model. The SMSF model is not for everybody, but the lessons learned

above beg obvious questions on the future of managed investment funds. Could not an institutional manager drive costs even lower by employing a similar strategy to that of SMSFs?
To investigate this, we examined the depth of liquidity and spreads on offer using either: the USA market; or the ASX market to implement a balanced portfolio. This research could be tightened considerably, but the top level conclusion is readily apparent by looking at the typical market spreads in each location.

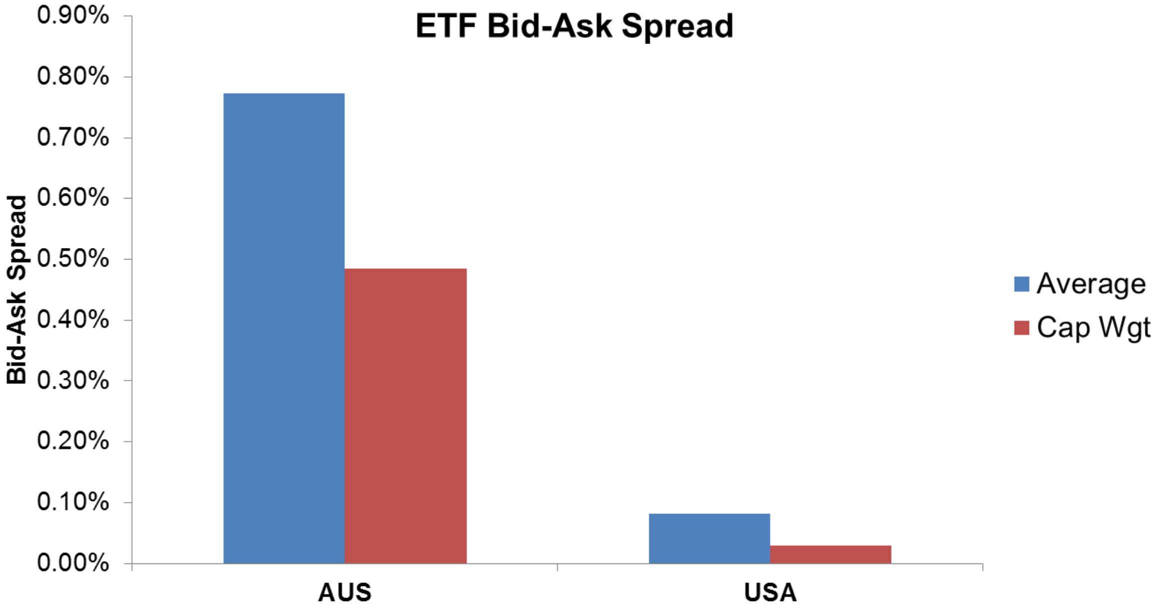


Figure 5 Estimated Market Spreads for trade in Common ETFs in two locations

In compiling the graph shown at Figure 5, we have estimated closing market bid-offer spreads in securities that are co-listed in both the ASX and USA markets. The sample is limited to around 50 ETF securities. In view of the large difference in spreads (typically less than 5bps in USA markets), we think the topic is worthy of more research.

Implementation, at scale, of global strategies based on ETFs appears more favourable when conducted using a USA-based market infrastructure.

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Dr. Kingsley Jones, *Costs and Opportunities of Smart Beta in Global Markets* (CIFR Research in Progress).

Section 3 - Overviews of topics and CIFR-funded research

A. Funding Australia's economic activity

Topic

Under the theme Growth and Consolidation, Chapter 3 of the IR states correctly that ongoing access to foreign funding has enabled Australia to sustain higher growth than would otherwise have been the case.[1] The IR also recognises that the risks associated with foreign funding can be mitigated through a prudent supervisory and regulatory regime. The Inquiry has requested views on the implications of not making changes to current arrangements.

Submission

Australia has an undeniable need for continuing inward foreign investment, and competition for investment capital from many other countries is likely to increase.[2] Considering the changing global landscape, a key question is how regulation might affect foreign direct investment in general and investment by Chinese State Owned Enterprises (SOEs) in particular.[3]

The legal and policy framework under which foreign companies can acquire Australian businesses and invest in Australian property is constituted by: the Foreign Acquisitions and Takeover Act 1975 (Cth) ('FATA'); the Foreign Acquisitions and Takeovers Regulations 1989 and Australia's Foreign Investment Policy (AFIP), which is the key policy document that guides interpretation and application of the legal framework. The FATA is now over 40 years old and has been substantively amended only three times since its commencement. It is worth considering if, in the changing global landscape, the FATA and supporting policy on the 'national interest' is still adequate to assist current consideration of foreign investment applications.[4]

While FATA may remain unchanged, the policy surrounding the implementation of FATA needs reform. Recommendations in the research cited below address three areas: the national interest test and public opinion; enhancing transparency and consistency; and non-discrimination.[5]

Supporting Work Available:

- Working Papers (refer to Appendix A for the link to access the paper)
    - Megan Bowman, George Gilligan and Justin O'Brien, *Foreign Investment Law and Policy in Australia: A Critical Analysis*, CIFR

[1] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 2-43.
[2] Megan Bowman, George Gilligan and Justin O'Brien, *Foreign Investment Law and Policy in Australia: A Critical Analysis*, CIFR, 18.
[3] Ibid.
[4] Ibid.
[5] Ibid.

- CIFR Financial System Inquiry Workshop II 21 August 2014 (refer separate document submitted by CIFR)
    - Geoff Weir, *Opportunities in the Asian Century*
    - Justin O'Brien, *International Perspectives*

Issues

Domestic policy and legal restrictions are put in place to provide public assurance that the economic, political and social risks of foreign investment are minimised. Equally as important, certain and transparent legal and policy frameworks are required to enhance investor confidence in Australia, particularly from growing economies such as China that now have choice about where they invest.

CIFR recommends the policy surrounding FATA and its implementation be considered by the Inquiry with a view to mitigating risks that may jeopardise the coherence and legitimacy of the Australian foreign investment regime.[6]

[6] Ibid.

B. Consumer outcomes

Topic

Under the theme Post-GFC Regulatory Response, Chapter 6 of the Interim Report defines the purpose of the regulatory framework as to protect consumers through prudential regulation, generic consumer regulation and licensing and conduct regulation.

The Inquiry has observed that improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. The Inquiry has requested views on several policy options relating to cost, disclosure requirements, financial product design, fee structures and ASIC powers.[7]

Submission

Improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. We note recent efforts of some large organizations to respond to concerns by electing to reform their own practices in these areas.

CIFR-funded research provides a number of areas for consideration:

- In considering the extent to which consumers' interests ought to be served via regulatory requirements to protect their interests when considering investing in financial products, the Inquiry should consider risks associated with types of fee bases. For example, performance fees charged by advisers to unsophisticated investors should be confined to fulcrum fees, whereby benefits and costs to advisers are symmetrical around a passive benchmark.[8]
- It would be in the interest of consumers if financial advisers were required to disclose their service as offering either restricted or independent advice (following the practice adopted in the UK).[9]
- Investors seeking advice on modest sums can be uneconomic to service. Subject to caps on the amount of funds under advice, clear written warnings whenever advice is from a restricted adviser, and caps on the remuneration of advisers via commissions,[10] an exemption for conflicted general advice may satisfy the need for lower-cost scaled advice raised in the Report observations.[11]
- Reviews of financial plans should not take place on a fixed two-year schedule but on a contingent, 'trigger' basis. For example, when a client's life circumstances change.[12]

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[7] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 3-62.
[8] Hazel Bateman and Geoffrey Kingston, *Regulating Financial Advice: Lessons from the United States, the United Kingdom and Canada*, CIFR, 2.
[9] Ibid.
[10] Ibid.
[11] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 3-63.
[12] Hazel Bateman and Geoffrey Kingston, *Regulating Financial Advice: Lessons from the United States, the United Kingdom and Canada*, CIFR, 2.

Supporting Work Available:

- Working Papers (refer to Appendix for the link to access these papers)
    - Hazel Bateman and Geoffrey Kingston, *Regulating Financial Advice: Lessons from the United States, the United Kingdom and Canada*, CIFR
    - Geoffrey Kingston and Haijie Weng, *Agency Theory and Financial Planning Practice*, CIFR

- CIFR Financial System Inquiry Workshop II 21 August 2014 (refer separate document submitted by CIFR)
    - Gail Pearson, *Consumer Outcomes*

Issues

The Inquiry is seeking further information in relation to opportunities that exist for enhancing consumer access to low-cost, effective advice.[13] The research referred to above includes several suggestions that directly address this through alternative fee structures, disclosure, restricted advice in certain circumstances and change in timeframes to the review of financial plans.

The Inquiry could further consider the following issues:

- The practice of product issuers paying commissions to planners (there is a case for them to be banned)[14]
- Challenges associated with asset allocations for clients on the cusp of retirement[15]
- The challenges associated with providing quality advice to consumers unable or unwilling to pay for sufficiently tailored advice (e.g. financial plans tending to be ‘cookie cutter’ ones rather than customised to the particular circumstances of clients)[16]
- There is evidence of inadequate disclosure of dollar (rather than percentage) amounts charged in fees[17]

[13] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 3-72.
[14] Geoffrey Kingston and Haijie Weng, *Agency Theory and Financial Planning Practice*, CIFR, 4.
[15] Ibid.
[16] Ibid.
[17] Ibid.

C. Stability and the prudential framework

Topic

Under the theme Post-GFC Regulatory Response, Chapter 5 recognises the importance of maintaining stability through prudent management by financial institutions, sound macroeconomic policy and a strong regulatory and supervisory framework. The Inquiry has stated that international and domestic policy reforms have and will continue to be implemented in response to lessons from the GFC.[18]

The observations from the inquiry provide a good overview of the issues most relevant to stability. Three of these will be addressed below: too-big-to-fail and moral hazard; systemic risk; and the implementation of international prudential frameworks.

Submission

Too-big-to-fail and moral hazard

The Financial Claims Scheme is currently post-funded.[19] CIFR research supports the IMF recommendations that a pre-funded scheme is preferable.[20] A pre-funded scheme provides a counter-cyclical approach, charging an *ex-ante* fee at a stage when Authorised Deposit-taking Institutions can actually afford to pay rather than creating unnecessary burden during or shortly after a downturn.[21]

Systemic Risk

The Interim Report recognises that although regulation for systemic risk is mostly focused on the banking and insurance sectors, instability can come from many sources.[22] It is necessary to have a method or tools to monitor the degree of interconnectedness risk in the economy and CIFR research provides a possible framework for understanding this.[23] Additionally, the superannuation system and APRA's approach to systemic risk also warrant attention.[24]

Implementation of international prudential frameworks

The Interim Report states that the weight of evidence indicates having a more conservative approach to prudential requirements has not placed banks at a significant competitive disadvantage.[25] CIFR research also supports the view that in many cases going above the global median and lifting the bar can be a positive move. One example is Basel Pillar 3 reporting requirements. The increased

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[18] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 3-3.
[19] Ibid 3-17.
[20] International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF Country Report No. 12/308, IMF, Washington DC, November.
[21] For a discussion of a 'counter-cyclical buffer', See James Cummings and Kassim Durrani, *Effect of the Basel Accord capital requirements on the loan-loss provisioning practices of Australian banks*, CIFR, 3.
[22] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 3-4.
[23] Mardi Dungey, Matteo Luciani, David Veredas, *Googling SIFIs*, CIFR.
[24] Scott Donald, Bruce Arnold, Hazel Bateman, Ross Buckley and Kevin Liu, *The implications of complexity for systemic risk in the superannuation system*, CIFR.
[25] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 3-40.

frequency of reporting requirements in Australia as compared to Europe has been found to be a more effective tool for imposing market discipline on banks.[26]

In relation to implementation of international prudential frameworks, Australia has taken a stronger approach to financial stability than required under global standards and Australia should maintain this position in the global financial stability spectrum. This will allow Australia to remain an influential member of international standard setting bodies and continue to drive changes appropriate for the domestic environment.

Supporting Work Available:

- Working Papers (refer to Appendix for the link to access these papers)
    - James Cummings and Kassim Durrani, *Effect of the Basel Accord capital requirements on the loan-loss provisioning practices of Australian banks*, CIFR
    - Scott Donald, Bruce Arnold, Hazel Bateman, Ross Buckley and Kevin Liu, *The implications of complexity for systemic risk in the superannuation system*, CIFR
    - Jerry Parwada, Stefan Ruenzi and Sidharth Sahgal, *Market discipline and Basel Pillar 3 reporting*, CIFR
    - Mardi Dungey, Matteo Luciani, David Veredas, *Googling SIFIs*, CIFR.

- CIFR Financial System Inquiry Workshop II 21 August 2014 (refer separate document submitted by CIFR)
    - Professor Mardi Dungey (Systemic Risk)

Issues

Ahead of finalising policy recommendations in the area of stability, the Inquiry should consider other areas of potential systemic risk, including superannuation.[27] The degree of interconnectedness risk in the economy and global interconnectivity should also be considered.[28]

The Inquiry might consider the merit of moving to a pre-funded Financial Claims Scheme. The advantages of a counter-cyclical approach outweigh costs to industry, which can be absorbed during a stable economic period.

[26] Jerry Parwada, Stefan Ruenzi and Sidharth Sahgal, *Market discipline and Basel Pillar 3 reporting*, CIFR, 1.
[27] Scott Donald, Bruce Arnold, Hazel Bateman, Ross Buckley and Kevin Liu, The implications of complexity for systemic risk in the superannuation system, CIFR.
[28] Mardi Dungey, Matteo Luciani, David Veredas, *Googling SIFIs*, CIFR.

D. International Integration

Topic

Under the theme Emerging Trends, Chapter 10 of the IR highlights that Australia has benefitted substantially from international financial integration. We support the statement that continuing engagement is necessary to facilitate integration into Asia.[29] The Inquiry is seeking further information on potential impediments to integration, and the benefits to the broader Australian economy.[30]

Submission

Australia has strong trade ties with Asia and in particular with China which is now our largest source of imports and largest destination for exports. In contrast, our financial ties with Asia are underdeveloped and this is in part a reflection of China's strict capital controls and immature financial markets. However, with China's commitment to develop its financial markets and to internationalise the Renminbi, Australia has the opportunity to be more closely integrated with China.

This integration, however, will not happen as a matter of course. It will require the right policy settings and these are clearly outlined in the CIFR RMB report. Much of the financial architecture is already in place (e.g. Swap agreement, direct trading of AUD/CNY) with others in the pipeline (e.g an Australian RQFII quota and an official settlement bank in Australia). However the CIFR RMB reports also outlines significant impediments to international integration.

The biggest hurdle is the tax uncertainty with respect to cross-border transactions. As China continues to remove capital controls and deregulate its financial markets, capital flows both into and out of China are likely to be extremely large. This is in part due to the very large and growing pools of savings in China that are expected to be invested offshore as capital controls are removed. While the Australian funds management sector has the skills, platforms and capacity to benefit from these developments, there is still considerable market uncertainty regarding the tax treatment in Australia of offshore investors investing through Australian domiciled investment vehicles. This needs to be addressed, by way of finalising legislation to put in place an effective Investment Manager Regime. This issue was first raised in the Johnson Report in 2009 and reiterated in the CIFR RMB earlier this year. The IR notes that this issue is to be referred to the tax white paper for consideration. We urge the FSI to unambiguously state the importance of tax uncertainty as an impediment to international integration.

The lack of awareness of the rapid pace of change in China is a further impediment to international integration. This is particularly true for funds management, despite the enormous opportunities for growth in the sector as China removes its capital controls. The RMB working group has been tasked to raise awareness of the implications of RMB internationalisation however the size of the awareness campaign is likely to be beyond the limited funding of the group. A significant commitment to raise

[29] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 4-85.
[30] Ibid 4-88.

awareness through this group needs to be accompanied by a significant allocation of resources.

Constraints in the form of capital controls and fixed exchange rate regime in China are changing rapidly and it is essential that Australia is prepared. We need the right policy settings in place and a commitment to support change for Australia take advantage of new opportunities emerging as we speak.

The Interim Report also mentions the risks of interconnectedness of the global financial system.[31] CIFR research provides insight into the risks surrounding foreign banks.[32] CIFR research has shown that foreign bank ownership was not significant in shock transmission during the GFC, and that foreign currency lending instead was a major source of shock transmission.[33] This research has useful policy implications as it shows the separation of bank ownership and liquidity channels should be considered when deciding the extent to open markets to foreign bank entry.[34]

Supporting Work Available:

- Working Papers (refer to Appendix for the link to access the paper)
    - Barry Eichengreen, Kathleen Walsh and Geoff Weir, *Internationalisation of the Renminbi: Pathways, Implications and Opportunities*, CIFR.
    - Ying Xu and Hai Anh La, *Foreign banks and international shock transmission: Ownership matters no more*, CIFR.
    - Walsh, Kathleen "RMB Trade Invoicing: Benefits, Impediments and Tipping Points" presented at the May 2014 Hong Kong Australia RMB Trade and Investment Dialogue[35]

- CIFR Financial System Inquiry Workshop II 21 August 2014 (refer separate document submitted by CIFR)
    - Geoff Weir, *Opportunities in the Asian Century*

[31] Ibid 4-73.
[32] Ying Xu and Hai Anh La, *Foreign banks and international shock transmission: Ownership matters no more*, CIFR.
[33] Ibid.
[34] Ibid.
[35] http://www.treasury.gov.au/PublicationsAndMedia/Events/2014/~/media/Treasury/Publications%20and%20Media/Events/2014/RMB%20Dialogue/RMB_trade_invoicing_report.ashx

E. International Integration and Funding

Topic

Under the theme Growth and Consolidation, Chapter 3 considers funding and acknowledges the systemic nature of Australian mortgages of banks' asset portfolios.[36] The concentration of Australian ADIs on mortgage lending to Australian borrowers is a key impediment to financial system resilience. A related further concern is the link of Australian bank retail financiers to the performance of ADIs through bank deposits and superannuation savings in Australian equities which have a significant allocation in the Australian banking sector.

Emerging Themes, Chapter 10 supports the efforts to drive greater international financial integration. Other national economies are exposed to similar issues and indicate global risk transfer mechanisms may be implemented to enable ADIs to facilitate the sharing of mortgage risk between countries with differing business cycles, concentrations and risk appetites. Existing risk transfer markets are partially constrained in terms of scale and efficiency. The Inquiry acknowledges this with regard to residential mortgage-backed securitisation.[37]

Submission

A potential solution may be a further international financial integration of Australia in terms of asset and asset risk transfer markets, in particular with countries where commercial integration is low (e.g., US and Europe). Australia may benefit from asset risk transformation solutions that diversify the current asset portfolios (which are focused on Australian SME loans and mortgages) with assets from other economic regions. Other positive effects may include a mitigation of existing foreign exchange exposures resulting from overseas bank funding.

The ultimate benefits would be more diversified investment portfolios for retail (and institutional) bank investors, in terms of a higher return level at a given risk level or a lower risk level at a given return level, which in turn implies a greater efficiency of the Australian financial system.

The Inquiry is seeking further information on potential impediments to integration. For such asset and asset risk transfer activities to occur on a sustainable basis, and to avoid the pitfalls of the structured finance market that culminated in the recent global financial crisis, market solutions need to demonstrate some minimum requirements, such as:

- Uniform transparency: a common, transparent modelling approach that is scalable, robust and immune to the failure of a given modelling provider. The development of generally accepted risk measurement principles for ADI internal and external risk assessment models may be a key consideration;
- Effectiveness: clear and consistent legal structures governing the rights and responsibilities of "buyers" and "sellers";

[36] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 1-14 and 2-56.
[37] Ibid1-13.

- Structural homogeneity: replicated structures promote transparency and liquidity;
- Security: systemic management and operational processes with respect to portfolio monitoring and related risk-transfer transactions facilitate confidence and market participation (i.e., liquidity);
- Scaleability: the above features are common to many of the larger global markets (e.g., repos, exchange-traded futures and options and derivatives), which large-scale participants will require;
- Efficiency: the long-term economies produced as a result of the interplay of the above requirements would likely far out-weigh the short term cost of developing a market with these key sustainability underpinnings.

Supporting Work Available:

- *Roesch, D./ Scheule, H.: Forecasting mortgage securitization risk under systematic risk and parameter uncertainty, forthcoming Journal of Risk and Insurance* (refer to Appendix for the link to access the paper)

Issues:

The FSI may wish to (i) consider the costs and benefits of asset and asset risk transfer platforms, (ii) analyse various alternatives provided by institutions and capital markets, and (iii) consider recommending key elements for national and international regulation required to support such critical financial infrastructure.

F. Superannuation – Self Managed Super Funds (SMSFs)

Topic

Under the theme Growth and Consolidation, Chapter 4 of the IR has examined superannuation issues most relevant to the financial system including growth in the SMSF sector. The Inquiry is seeking further information, to what extent they should be concerned about the operating expenses of SMSFs.[38] The Inquiry has also raised questions regarding asset allocation for members as they reach retirement and has asked for evidence about to what extent more tailoring of asset allocation to members would produce net benefits for members.[39]

Submission

Running costs of SMSFs

Two recent Government reviews (Cooper Review 2010; Parliamentary Joint Committee on Corporations and Financial Services 2012) have highlighted a lack of basic information regarding the costs associated with running an SMSF. Using a large sample of 209,420 SMSFs, CIFR-funded research indicates that asset allocation does not conform to public perception that SMSF's are used to hoard artworks and purchase residential housing. Evidence suggests these notions are popular misconceptions. Further, on average, SMSFs are a cost effective means to save for retirement, compared with other options. This is significant owing to the ongoing public debate around fees and costs of various superannuation platforms. To the extent that disclosure of costs by SMSFs is better than cost disclosure in other superannuation platforms (disclosure of performance fees, for example), these results may be conservative.

Cost and quality of audit services

SMSFs are the fastest growing segment of the retirement savings industry.[40] To date, however, there has been no prior research devoted to understanding auditing in the retirement funds industry in Australia.[41] Regulators have previously voiced concern relating to auditors jointly supplying audit and non-audit services. CIFR-funded research has found that these concerns are unfounded.[42] In fact, partners servicing large numbers of clients are shown to charge lower prices, consistent with a scale economies explanation.[43] Additionally, the provision of other services by auditors has no impact on independence for approved SMSF auditors.[44] Compliance standards in this industry are high, as evidenced by low levels of breaches reported and audit qualifications, suggesting no need for further regulation.

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[38] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 2-123.
[39] Ibid 2-110.
[40] Bruce Arnold, Hazel Bateman, Andrew Ferguson and Adrian Rafferty, *Understanding assurance in the Australian self-managed superannuation fund industry*, CIFR, 1.
[41] Ibid 7.
[42] Ibid 21.
[43] Ibid 25.
[44] Ibid 12.

Lifestyle investment

The IR considers the current focus of large superannuation funds on maximising the balance at the point of retirement, and questions if post-retirement income outcomes would provide a more useful measure for members.[45] The Inquiry is seeking information on whether there are net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements. Australian providers have generally adhered to an approach involving a high and stable share of the portfolio allocated to growth assets, despite the fragile period of the retirement risk zone.[46] CIFR-funded research suggests responsibility for this asset allocation approach and pursuing changes to it is the responsibility of the industry, ASIC, APRA and individual households.[47]

Supporting Work Available:

- Working Papers (refer to Appendix for the link to access these papers)
    - Bruce Arnold, Hazel Bateman, Andrew Ferguson and Adrian Rafferty, The size, cost and asset allocation of Australian Self-Managed Superannuation Funds, CIFR
    - Bruce Arnold, Hazel Bateman, Andrew Ferguson and Adrian Rafferty, *Understanding assurance in the Australian self-managed superannuation fund industry*, CIFR
    - Geoffrey Kingston and Lance Fisher, *Down the retirement risk zone with gun and camera*, CIFR

Issues

Ahead of finalising any policy recommendation in relation to SMSFs, the Inquiry should consider the research on the costs of running SMSFs and quality of audit services and the finding that joint provision of audit and non-audit services has had no impact on independence for approved SMSF auditors. Both working papers imply there is little need to change regulation in relation to SMSFs as the sector is both vibrant and functioning well.[48]

The research suggests that providers profit from asset allocations oriented towards growth asset classes and that these asset classes generate higher fees for the providers.[49] This is an issue that might be addressed through reform that results in a shift in approach to asset allocations which may lower the level of risk that members face as they approach retirement.[50]

[45] Australian Government, *Financial System Inquiry – Interim Report* (July 2014), 2-110.
[46] Geoffrey Kingston and Lance Fisher, *Down the retirement risk zone with gun and camera*, CIFR, 4.
[47] Ibid 5.
[48] Bruce Arnold, Hazel Bateman, Andrew Ferguson and Adrian Rafferty, *Understanding assurance in the Australian self-managed superannuation fund industry*, CIFR 12.
[49] Geoffrey Kingston and Lance Fisher, *Down the retirement risk zone with gun and camera*, CIFR 4.
[50] Ibid 5.

Appendix – List of Research Papers referred to in Section 3

Relevant FSI Topic	CIFR Researcher	Working Paper	Summary	SSRN Link
1. Funding Australia's economic activity	Megan Bowman, George Gilligan and Justin O'Brien	Foreign Investment Law and Policy in Australia: A Critical Analysis	Under Australia's foreign investment review framework all foreign governments and their related entities should notify the federal government and gain approval before making a direct investment in Australia regardless of the value of that investment. Yet can Australia's current policy settings be maintained in their current form given developments in global capital markets, in particular the rise of state capitalism. This paper sets out the Australian foreign investment legal and policy framework. It focuses closely on the national interest test and the manner in which it has been applied, with particular reference to the rising importance of China as a major trading partner. Focusing on empirical evidence of government decision-making under the Foreign Acquisitions and Takeover Act 1975 (Cth) and supporting policy documents, this paper makes recommendations for reform in three areas: (1) the national interest test and public opinion; (2) enhancing transparency and consistency; and (3) non-discrimination.	http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2440983
2. Consumer outcomes	Hazel Bateman and Geoffrey Kingston	Regulating Financial Advice: Lessons from the United States, the United Kingdom and Canada	In July 2014 the Corporations Amendment (Streamlining of Future of Financial Advice) Bill had not been enacted. Now is as a good time as any to stand back and draw out implications for Australia from how financial advice is regulated in the leading common-law countries. We also draw out implications from the debates in those countries about the regulation of advice.	http://www.cifr.edu.au/assets/document/RegulatingFinancialAdvice31July.pdf

2. Consumer outcomes	Geoffrey Kingston and Haijie Weng	Agency Theory and Financial Planning Practice	We extend an influential contribution to the literature on agency theory and then use this extension, along with other theoretical contributions, to shed light on agency problems affecting funds management and financial planning in Australia. The case for pure fee for service in actively managed funds and plans turns out to be weak. The amount of money exposed to risk by an active manager should be less than the entire investible wealth of the client, especially in the case of investors on the cusp of retirement. Asset-based fees on actively managed funds should include a fulcrum component.	http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2441005
3. Stability and the prudential framework	James Cummings and Kassim Durrani	Effect of the Basel Accord capital requirements on the loan-loss provisioning practices of Australian banks	There are two distinct regimes for bank provisioning in Australia: a forward-looking model for regulatory purposes and an incurred loss model for financial reporting. This study examines the former using a unique but confidential database. We find evidence that: (i) regulatory provisions reflect the default risk of banks' loan portfolios, (ii) banks allocate part of surplus capital above Basel minimum requirements to pre-fund future credit losses through provisions (which holds for banks using either external or internal ratings-based approaches), and (iii) banks allocate part of higher earnings for the same purpose. These findings suggest that bank managers use their discretion in setting provisions to dampen the impact of fluctuations in credit market conditions on their lending activities.	http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2396384
3. Stability and the prudential framework	Scott Donald, Bruce Arnold, Hazel Bateman, Ross Buckley and Kevin Liu	The implications of complexity for systemic risk in the superannuation system	The funds, entities and regulators involved in the superannuation industry together comprise a system that is complex and dynamic. The differentiation between roles and the distribution of responsibility offers the system as a whole resilience against local failure. However the interconnections that bind and constitute the system create and transmit risks within the system undermine the system's resilience to exogenous shock. This paper starts to map and analyse those links, assessing the nature of the threat the links pose to systemic resilience. It concludes by speculating on the regulatory responses that might be required to address the risks.	http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2400817

3. Stability and the prudential framework	Jerry Parwada, Stefan Ruenzi and Sidharth Sahgal	Market discipline and Basel Pillar 3 reporting	In this paper we examine the role of Basel Pillar 3 risk reporting in improving market transparency. Pillar 3 reporting requirements vary widely across countries; most banks in Europe release Pillar 3 risk reports annually after their annual reports are published and information contained in these reports does not elicit a stock market reaction. Australian banks, on the other hand, release Pillar 3 reports quarterly, independent of their annual reports. We find that this higher frequency of information disclosure is useful to investors and they react positively to reports of an increase in capital and negatively to a decrease in credit quality. We also find that investors ignore changes in the risk-weighted assets of a bank, but pay attention to total credit exposure. This study informs regulators and market participants on the efficacy of Pillar 3 risk reporting with several policy implications.	http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443189
3. Stability and the prudential framework	Mardi Dungey, Matteo Luciani, David Veredas	Googling SIFIs	To measure the systemic risk in financial markets, and rank systemically important financial institutions (SIFIs), we propose a methodology based on the Google PageRank algorithm. We understand the economic system as interconnected risk shocks of firms in both the financial sector and the real economy. By taking into account both sectors, we demonstrate the efficacy of intervention programs, such as the TARP, as circuit breakers in the propagation of crises – something not evident in applications which address only financial firms.	http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166504
4. International Integration	Barry Eichengreen, Kathleen Walsh and Geoff Weir	Internationalisation of the Renminbi: Pathways, Implications and Opportunities	Internationalisation of the renminbi is an important event for our age, both practically and symbolically. It marks both the growing prominence of China in global affairs and the vast programme of market reform and institution building that is underway. As China and its institutions and markets continue to grow, we can expect its currency and its capital markets to become as important as its economy and global trade links. These ongoing developments in China will require adaptation and change around the world: to trade patterns and how they are financed and settled, to portfolio investment flows, and to official and international financial institutions and their practices.	http://www.cifr.edu.au/assets/document/CIFR%20Internationalisation%20of%20the%20RMB%20Report%20Final%20web.pdf

4. International Integration	Ying Xu and Hai Anh La	Foreign banks and international shock transmission: Ownership matters no more	This paper studies the recent (2007-2009) Global Financial Crisis and its transmission through bank lending to emerging Asian economies. It highlights two channels of shock transmission identified in the literature: bank ownership and liquidity. We find that bank ownership does not play a substantial role in the transmitting process. It is the liquidity channel measured by lending in foreign currency that is mainly responsible for the GFC transmission to the loan market in Asia, albeit the effect on the credit market is likely to be small. Additionally, our results suggest that the contraction of foreign currency liquidity is partially substituted by domestic currency lending. However, the substitution occurs only within banks and not between banks owing to high switching costs. We employ a unique dataset on new loan issuance to Asian borrowers and apply a recently developed method (Khwaja and Mian 2008) to address the identification problem in examining bank lending and shock transmission. Our results are robust according to a number of sensitivity analyses.	http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443229
4. International Integration	Kathleen Walsh	RMB Trade Invoicing: Benefits, Impediments and Tipping Points	This paper analyses a survey of RMB invoicing awareness, use and expectations conducted on Australian and Chinese corporates. It considers the benefits of invoicing trade in RMB as well as a range of factors that would appear to be discouraging RMB use between Australia and China. It also identifies potential tipping points for increased RMB invoicing going forward.	http://www.treasury.gov.au/PublicationsAndMedia/Events/2014/~/media/Treasury/Publications%20and%20Media/Events/2014/RMB%20Dialogue/RMB_trade_invoicing_report.ashx
4. International Integration	Daniel Roesch, Harald (Harry) Scheule	Forecasting Mortgage Securitization Risk under Systematic Risk and Parameter Uncertainty	The Global Financial Crisis exposed financial institutions to severe unexpected losses in relation to mortgage securitizations and derivatives. This paper analyses a unique and extensive ratings and impairment events database for securitizations. The paper finds that risk models such as ratings are exposed to a large degree of systematic risk and parameter uncertainty. An out-of-sample forecasting exercise of the financial crisis shows that a simple approach addressing both issues is able to produce ranges for risk measures consistent with realized losses. This explains how financial markets were taken by surprise in relation to realized losses.	http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2347297

5. Superannuation	Geoffrey Kingston, Lance Fisher	Down the retirement risk zone with gun and camera	The retirement risk zone represents a fragile period in the financial life cycle of people in defined-contributions superannuation. It primarily affects people of middle means. Sequencing risk has been described as an independent risk but it has largely been a consequence of the dominant asset allocation strategy, described here as aggressive constant-mix. Lifetime glide paths should instead resemble a displaced V: the share of growth assets should fall by something like 20 to 50 percentage points over working life, then another 5 or 10 percentage points on the day of retirement, but should subsequently rise through retirement, by something like 20 to 30 percentage points.	http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2440977_code2227871.pdf?abstractid=2440977&mirid=1
5. Superannuation	Andrew Ferguson, Bruce Robert Arnold, Hazel Bateman, Adrian Raftery	Understanding assurance in the Australian self-managed superannuation fund industry	Using proprietary data, this study examines auditor industry specialisation, professional brand effects and non-audit services (NAS) in the self-managed superannuation fund (SMSF) sector, the fastest growing segment of the Australian $1.75 trillion retirement savings industry. We consider the impact of industry leadership for a large sample of SMSF audits for the three years to June 2010. After controlling for factors known to determine audit fees, we find evidence of fee discounting for the leading suppliers of SMSF audits, consistent with Simunic (1980)'s assertion of competition in the small audit client market. When considering the impact of professional affiliations, we find that registered company auditors and members of professional bodies who comply with auditing and ethical standards receive a fee premium. In terms of auditor independence, the supply of NAS is shown to improve the auditors' ability to report breaches, suggesting no independence concerns arising from joint supply of audit and NAS in this setting.	http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2427566_code2227871.pdf?abstractid=2427566&mirid=1

5. Superannuation	Andrew Ferguson, Bruce Robert Arnold, Hazel Bateman, Adrian Raftery	The size, cost and asset allocation of Australian self-managed superannuation funds	Using proprietary Australian Tax Office (ATO) data, we document the size, asset allocation and expenses for a sample of 209,420 Australian self-managed superannuation funds (SMSFs) for the three years to June 2010. Two recent Government reviews have highlighted a lack of basic knowledge of the costs associated with running an SMSF. Our study aims to address this paucity of research in relation to SMSF's and has two objectives. First, on a descriptive level we provide evidence on the size and asset allocation of SMSF's. Secondly, on an empirical level, we specify a model of SMSF costs. On a descriptive level we find heterogeneity amongst SMSFs in terms of both size and asset allocation. Further, our empirical analysis suggests cost advantages in running an SMSF. The analysis provides new insights into the fastest growing segment of the Australian $1.83 trillion retirement savings industry and extends prior superannuation studies of both small and large APRA funds to SMSFs.	http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2463886_code2227871.pdf?abstractid=2463886&mirid=1