

## **Ric Battellino: Challenges and opportunities for the funds management industry in Australia**

Opening remarks by Mr Ric Battellino, Deputy Governor of the Reserve Bank of Australia, to the 20th Australasian Finance and Banking Conference, Sydney, 12 December 2007.

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### **Introduction**

It is a pleasure to be here to open the 20th Australasian Finance and Banking Conference. Over the past twenty years, the Conference has provided a stimulating forum for discussion of a wide range of issues facing the banking and finance industry, and it has played an important role in helping to promote Australia as a major financial centre. I'm sure this year will be no exception.

This morning's Business Forum on the challenges and opportunities for the funds management industry has already generated a number of interesting points for discussion.

The schedule for the next two and a half days will take the discussion into a broader range of topics in the field of banking and finance but for the moment I will focus my remarks on the funds management industry.

### **Industry size**

Let me begin by recapping some facts on the size and growth of the industry.

As we have heard, the funds management industry in Australia has expanded at a remarkable pace over the past couple of decades. Since 1990, the value of funds under management has grown at an annualised rate of 12½ per cent, and now stands at around \$1.7 trillion. This is equivalent to about 160 per cent of GDP, up from about 50 per cent in 1990.

By international standards, Australia's funds management industry is among the largest in the world, not only as a ratio to GDP but also in absolute terms. Some reports rank Australia as the fourth largest funds management industry in the world in terms of assets under management. The data underlying this ranking are compiled by the Investment Company Institute, an industry association for US mutual funds. This measure covers investments in mutual funds and unit trusts, and therefore favours countries such as Australia where this type of investment vehicle is quite common. On the other hand, it understates the size of the funds management industry in countries that tend to use other investment structures.

An alternative approach for measuring the size of the funds management industry is to add up all of the assets of pension funds, life insurance companies and other managed investments, regardless of the precise legal structure in which they reside. This provides a broader view of the funds management industry and one that is more comparable across countries. This exercise is not straightforward, however, as consistent international data are difficult to obtain.

After taking into account some of these measurement issues, my colleagues at the Bank estimate that the Australian industry is among the world's ten largest, though more likely towards the bottom of this group than in the top half. It is difficult to be more precise than this but, nonetheless, it is clear that the Australian funds management industry is large by international standards.

## Reasons for growth

What has been behind this rapid expansion in the industry?

A large part of the growth over the past couple of decades has been due to superannuation. Superannuation fund assets have grown by an average of 14½ per cent per annum since 1990, and now comprise about half the funds under management in Australia. This rise in superannuation assets reflects a number of government initiatives, such as the introduction of compulsory superannuation contributions in the early 1990s and the concessional taxation of superannuation.

Other parts of the funds management industry, however, have also grown quickly, reflecting more general reasons such as the increased financial awareness of households and the associated search for higher returns than those offered by traditional investments such as bank deposits; the strength of world equity markets; and the demographic trend of “baby boomers” entering the wealth-accumulation phase of their lives.

As well as investing in what might be considered to be fairly conventional financial products, it is also notable that in Australia there has been significant direct participation by retail investors in the markets for sophisticated financial products. For example, retail and high net worth investors account for about two-thirds of the assets of Australian-based hedge funds, compared with less than half globally. The available evidence for Australia also suggests a larger retail presence in the market for collateralised debt obligations than is the case in other markets. Over the past five years, retail investors are estimated to have purchased around 15 per cent of the CDOs issued in Australia.

One of the reasons for this higher participation by Australian retail investors in these markets is that the regulatory regime in Australia does not restrict retail access to any financial products as long as the provider meets certain disclosure requirements.

This approach has been beneficial in terms of providing investors with a greater range of wealth-generating opportunities, but it does raise some important challenges.

I want to spend the rest of my time today outlining these and other challenges facing the funds management industry.

## Challenges

One of the most important challenges raised by a disclosure-based regime is that it places a significant premium on financial literacy. This is because it relies heavily on the ability of investors to understand the information that is presented to them and make appropriate decisions based on that information. Some retail investors may not be in this position. A particularly telling statistic comes from a recent survey conducted by the Financial Literacy Foundation, in which only about a third of adult respondents indicated that they considered both risk and return when choosing an investment. The fact that some retail investors had apparently devoted the bulk of their savings to buying unsecured, high-yielding debt issued by some recently collapsed property companies also suggests that some people have difficulty understanding the financial risks of investment products.

The Australian Government, through the Financial Literacy Foundation, has a number of initiatives underway to improve financial education and literacy standards. ASIC has also been active in educating retail investors about financial products, and a range of private-sector initiatives are underway to help improve financial literacy standards.

One way that the financial services industry can help retail investors make better investment decisions is by providing clear and concise information about their financial products. For some time now there have been concerns about the length and complexity of product disclosure statements and prospectuses.

ASIC has been trying to address some of these concerns through various initiatives. It has also recently introduced regulatory guidance to improve the quality of disclosure to retail investors in unlisted debentures.

A related challenge facing the industry is financial advice, and how this is paid for.

There appears to be a general reluctance on the part of retail investors to pay for financial advice on a fee-for-service basis. Instead, there has been a preference for commission-based advice, despite the conflicts of interest that can arise in this situation. This reluctance to pay for advice upfront appears to be a form of money illusion, whereby investors may feel that they are somehow paying less for financial advice if the cost is buried in reduced earnings in the future.

The regulatory environment in Australia has tried to deal with potential conflicts in commission-based advice by making it a requirement for advisors to provide their clients with a written statement of advice that sets out, among other things, the basis on which the advice is given, any potential conflicts of interest, and the dollar value of commissions they stand to receive.

But the question remains as to whether full disclosure is enough to deal with the potential conflicts of interest associated with commission-based fees, or whether there is merit in the industry moving further in the direction of offering advice on a fee-for-service basis.

The cost of providing investment services to retail investors is also a challenge that needs to be addressed. Recent research published by APRA compared the average net returns – that is, returns after all fees, expenses and taxes – for different types of superannuation funds. APRA found that over the decade to 2006, \$1,000 invested in the average retail fund would have risen to \$1,650 after fees, expenses and taxes, compared with \$1,888 for an industry fund and about \$2,100 for corporate and public sector funds. Of course, these figures are averages and there would have been significant variation in the returns of individual funds.

While it is difficult to isolate the exact cause of the underperformance of retail funds, an important contributing factor would have been that fees and expenses on retail funds are typically higher than for industry and corporate funds. That said, I think it is encouraging that competition has been putting downward pressure on expense ratios across most categories of superannuation funds.

Another issue which has received attention is what level of superannuation contributions is necessary to ensure an adequate retirement income.

Determining the adequacy of contribution rates is difficult because the modelling relies on various assumptions about future investment returns, income growth, length of retirement etc. There is also a need to specify what is meant by “adequate”.

Most of the recent research, however, suggests that, to ensure an adequate replacement income in retirement, the current level of superannuation guarantee contributions will need to be supplemented by the old-age pension for lower-income households, or by voluntary contributions for those households not eligible for the pension.

The issues I have raised today are, I am sure, well known to those of you in the industry. There are many considerations to be taken into account in resolving them, and there will no doubt need to be a large input from the industry in doing so.

## **Conclusion**

For the moment, however, let me conclude by recording that the transformation of the superannuation industry over the past couple of decades has been one of the great success stories in the Australian financial sector. While further work needs to be done, conferences such as this play an important role in raising and resolving issues.

I hope that your discussions over the next couple of days prove to be both thought-provoking and rewarding.