IFSA

Investment & Financial Services Association Ltd

4 March 2000

The Secretary
House of Representative Standing Committee on Economics, Finance, and Public Administration
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam

Inquiry International Financial Market Effects on Government Policy

Thank you for inviting IFSA to make a submission on the abovementioned inquiry.

As per our previous briefings to the committee, IFSA represents Australia's leading funds manager and life insurance providers. IFSA's 70 members manage more than $480 billion on behalf of more than nine million Australians. IFSA strives to develop sound public policy that will build a stronger, more transparent and more efficient savings and investment industry.

Investment Management in Australia

The ABS Managed Funds publication identifies the commercial activities which come under the investment management umbrella. Managed funds are defined as:

> The investments undertaken by those collective investment institutions and investment managers who engage in financial transactions in the managed funds market.

Managed funds have different forms. An investment vehicle with an independent trustee or single responsible entity and managed by an investment manager is known as a trust structure. Funds invested by an investment manager in accordance with specific guidelines set by the investor in an investment mandate are known as individually managed or discretionary portfolios.

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The funds management industry comprises a diverse group of institutions offering a wide range of investment products. These products are offered to the public through a variety of distribution channels e.g. licensed financial advisers and insurance agents. Other intermediaries include funds management companies, banks, life companies, stockbrokers, financial planners, investment advisers and asset consultants. The better- known categories of managed funds are:

Unit trust products – pooled investment vehicles that enable institutions and individuals to invest in shares, bonds, property, international investments and cash;

Superannuation based products – employer sponsored funds, industry superannuation funds, approved deposit funds and personal superannuation schemes;

Individually managed portfolios – funds of an investor or institution managed by a funds manager chosen by the investor in consultation with their adviser; and

Life insurance products – life insurance policies, annuities and pensions.

Funds under management data

The consolidated funds under management for September Quarter 1999 were as follows:

Table 1

Type of institution	**$bn**
Life office	159
Super funds	233
Public unit trusts	93
Friendly societies	6
Common funds	8
Cash management trusts	22
Total	**521**

Table 2

Type of asset	**$bn**
Cash and deposits	39
Loans and placements	27
Short term securities	59

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Long term securities	74
Equities and units in trusts	152
Land and buildings	56
Assets overseas	96
Other assets	18
Total	**521**

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Why invest in managed funds?

Managed funds offer investors a number of advantages.

They bring together skilled professional managers whose sole responsibility is to enhance the wealth of investors. Professional investment managers make a full-time commitment to the management of the investment assets, something few individual investors have time to make. This means the process of selecting what financial assets to buy and the day-to-day timing of transactions can be left to full time professionals. They have greater access to research, to analyse financial reports, to gauge economic trends and make investment decisions.

Managed funds have the advantage of providing economies of scale and give investors diversification through a single investment vehicle, saving them from the relatively high costs of direct investment in Australian and overseas assets. If an investor can achieve greater diversification, this may reduce volatility in investment returns which can come from investing in only a few classes of securities. Diversification can be achieved by investing in different countries or regional areas and investing in different types of products, industries or asset classes.

Although the differences are blurring, the investment management is broadly divided into the wholesale and the retail sector. Institutions such as super funds, government agencies, and companies tend to invest in the wholesale sector whereas retail funds come from personal investors.

The minimum wholesale investment is $500,000 whereas in the retail sector as little as $1,000 can be an initial investment.

Offshore exposure

As can be easily ascertained from Table 2, managed funds invest in offshore assets. Currently, managed have almost $100 billion in overseas assets which amounts to about 19 per cent of total funds under management.

Over the years this proportion has increased for the following reasons:

- Funds continually seek investment opportunities which present superior return and risk profiles. These returns are substantial credits to Australia's balance of payments.

- As the Australian equities market comprises less than 2 per cent of the world market, funds invest money offshore to diversify by exposing portfolios to different economies, markets and types of investments.

As part of international investing, an investment manager has to buy whatever assets – shares, bonds or property – in foreign currency. Investment managers invest in foreign currencies in two ways:

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- They can invest in overseas assets by buying a security or asset with a foreign currency; or
- They can buy or sell a particular currency, based on their view of its future direction. The first way is the most common investment manager transaction, the second is a form of speculation.

Derivatives

Derivative products derive their value from underlying securities. They play an integral role in financial markets by providing liquidity and managing risk. Derivatives can also be used to speculate but this is not the way these products are generally used by investment managers. Derivatives are a very effective tool by which managers may manage the risks associated with exchange rates, interest rates, commodity prices or share prices. By using an options or futures contract a manager can fix a future price and eliminate future price uncertainty.

As the buyer of a derivatives contract pays only a deposit on an initial contract rather than the full value of the securities, options and futures can be used to 'gear' a portfolio by effectively buying on borrowed money. This why investment managers have strict guidelines and internal systems to prevent abuses.

In theory 'gearing' via derivatives means the obligations of a portfolio can exceed the value of the portfolio's assets. Hence, under the Superannuation Law (which applies to about 80 per cent of managed funds) there are special provisions to govern the operation of derivatives. Under the SIS Regulations trustees are required to report to the members of the fund and APRA if the derivatives charge ratio exceeds five per cent during any reporting period. The DCR is the percentage of assets by value that the trustee has mortgaged or charged as security for derivative investments.

Avoiding the consequences of systemic failure

The impact of economic shocks arising out of fundamental failure offshore can be mitigated by having sound domestic policy in in relation to the following:

- Maintaining fiscal and budget responsibility that lessens the reliance on overseas sources of capital;

- Maintaining strong levels of corporate and household savings that lessen the reliance on overseas sources of funding; and

- Maintaining a well-integrated prudential and disclosure regulation regime which ensures that Australian investors investing offshore are not exposed to levels of risk that are associated with systemic failure.

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Risk management controls

It is instructive to identify the risk protection mechanisms which operate to ensure that Australia does not become unduly exposed to the consequences of offshore financial market failure**.** In this regard the Risk management controls include:

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Superannuation:

- common law and legislative duties on a trustee to invest prudently
- prohibitions on funds borrowing to leverage
- DCR calculations

APRA prudential regulation of banks, superannuation, life and general insurance

- licensing institutions and trustees
- capital adequacy provisions
- liquidity requirements and large exposure limits
- regular reporting and disclosure requirements
- institutions must prepare and have audited a detailed risk management statement which sets out policy and procedures for managing risk across all aspects of the business, with particularly reference to derivatives
- surveillance and monitoring

ASIC financial market integrity regulation of exchanges, clearing houses and institutions

- licensing requirements for exchanges and clearing houses - eg capital adequacy, business rules, transparency of information, supervisory and reporting requirements
- licensing requirements for intermedairies dealing in markets - eg financial resources, competence, skills and experience
- regular reporting and disclosure requirements
- monitoring and surveillance

Exchanges

- front-line regulators of business rules and requirements - capital adequacy of members, position limits, monitoring, surveillance, disciplining members
- regular reporting to authorities including notification of breaches of legislative requirements

Clearing Houses and Settlement Systems

- front-line regulators of operating rules and requirements - capital adequcy, marking to market open positions, margining, position limits, supervision of clearing members credit risk and compliance
- periodic stress testing to assess implications of major price movements

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Industry initiatives

- IFSA standards and Guidelines
- IFSA Blue Book, Corporate Governance - A Guide for Investment Managers and Associations
- Standard Investment Management Agreement which sets out duties, powers and limitations of managers, promotes clear investment instructions and objectives as well as regular reporting to trustees - (if authorised to enter derivative contracts, the standard agreement prohibits a manager from holding derivatives unless at all times there are sufficient assets to support the underlying liability of the trustee)
- industry standard documentation for derivative transactions (International Swaps & Derivatives Association)
- AFMA and ABA guidelines for members, eg AFMA Standards and Guidelines for Australian OTC Financial Markets

Intermediaries

- Capital adequacy, internal risk management systems
- Monitoring client positions
- Auditing of positions and risk management procedures

Technology

Technology developments have greatly assisted in the reduction of systemic risk and market instability. Recent developments include:

- Real Time Gross Settlement (RTGS) which reduces payments risk by settling high value transactions as they occur
- electronic clearing and settlement system (eg CHESS) which effect delivery against payment
- systems which reduce settlement cycles, eg from T + 5 to T + 1
- market netting systems
- more efficient and integrated technology platforms which assist institutions and regulators to monitor and manage risk, eg the Global Straight Through Processing Association is promoting the development of an electronic platform to pass information on all aspects of a whole transaction - this will assist risk management by mitigating risks and enhance the ability of participants to value and monitor exposures and risks

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Recommendations

The committee could consider the following recommendations in formulating its plan of action for future government initiatives:

- the need to ensure appropriate liaison and co-operation between regulators, eg APRA, ASIC and international counterparts to keep pace with globalisation and electronic commerce developments
- the need to support the ongoing development of international standards and co-operation
- the need to support the ongoing development of standards and codes by industry associations which promote transparency, disclosure and best practice risk management systems
- the need to support the development of technological platforms/software which will reduce risk, promote transparency and enhance the ability of participants to monitor their risk exposures, continually enhance risk management systems

We trust that the foregoing assists the committee in its deliberations in this area. Should the committee need any further assistance please contact me on 0417 247 998.

Yours faithfully

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