Chapter Eight

Fund Investments and Returns

Introduction

8.1 This chapter examines three issues in relation to the likely impact of the portability regulations on fund investments and returns:

a) Fund investments and liquidity;

b) Smoothed investment returns; and

c) Capital guarantees.

Fund investments and liquidity

8.2 In its written submission, MTAA Super expressed concern that if the draft portability regulations were introduced, funds would be judged only on their latest credit rates – even their last monthly interim return. In turn, MTAA Super argued that this could lead to trustees having to seek out shorter term investments, to the detriment of long-term retirement incomes and Australia's retirement income investment pool generally.[1] This matter was also raised by Mr Watson from MTAA Super in the public hearing on 31 July 2003.[2]

8.3 MTAA Super also argued in its written submission that higher levels of churning between funds would require funds to retain more liquid assets so as to be able to meet their liquidity obligations under the SIS Act. In turn, highly liquid assets such as cash and fixed interest generally under perform growth assets such as shares, property and infrastructure over the mid to long term. As a result, forcing funds to maintain more liquid assets would lead to lower long-term average returns.[3] Once again, this matter was raised by Mr Watson from MTAA Super in the hearing on 31 July 2003.[4]

8.4 Similar concerns were expressed by the Corporate Super Association in its written submission. The Association noted that trustees, when formulating their

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1 *Submission* 6, MTAA Super, p. 4.

2 *Committee Hansard*, 31 July 2003, p. 7.

3 *Submission* 6, MTAA Super, p. 4.

4 *Committee Hansard*, 31 July 2003, p. 10.

investment strategies, are required under section 52 of the SIS Act to take into account:

- Expected cash flow liabilities; and
- The ability to discharge liabilities when they fall due.

8.5 The Association suggested that currently, most employer sponsored funds would base their investment strategies on the assumption that members will remain with the fund while their employment with their sponsor lasts. Accordingly, trustees seek to maximise returns according to the age and average service length of the fund's membership, which determine anticipated liquidity requirements.

8.6 However, the Association argued that ready portability of benefits would alter the liquidity requirements of a fund. In general terms, the anticipated period of membership would be expected to decline and the timing of exits from the fund would be less predictable. As a result, trustees would be required to keep more funds in liquid assets, with an associated reduction in fund returns.[5]

8.7 These issues were also raised by other parties, including AIG[6] and AIST.[7] In addition, the Committee notes the evidence of Ms Ryan from AIST in the hearing on 31 July 2003:

> A lot of the infrastructure investments—which are proving to be good investments, although it takes quite a few years for the returns to come in—would be undermined if a fund had to keep 25 per cent or more of its accumulated funds liquid so that that money could be rolled out as members chose to roll their money out.[8]

8.8 In response to this issue of fund investment and liquidity, the Committee notes the evidence of Mr Gilbert from IFSA in the hearing on 31 July 2003:

> Clearly, infrastructure assets are listed on the Australian Stock Exchange, have a daily price and can be redeemed overnight. So I do not see that there is any danger to infrastructure investments as a consequence of portability. I think that borders on being a red herring.[9]

8.9 On a related issue, in its written submission, CPA Australia argued that the portability regulations should offer funds some protection from members who opt for long-term strategies for their superannuation investments, but then wish to withdraw their superannuation benefits on a short-term basis.

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5 *Submission* 9, Corporate Super Association, p. 6.

6 *Submission* 5, AIG, p. 2.

7 *Submission* 11, AIST, p. 3.

8 *Committee Hansard*, 31 July 2003, p. 20.

9 *Committee Hansard*, 31 July 2003, p. 33.

8.10 In response, however, Cbus indicated in its written submission that it is satisfied that the liquidity risk to a superannuation fund resulting from the introduction of the draft regulations has been addressed by allowing a fund to apply to APRA to suspend roll overs/transfers where they could impact on the financial position of the fund.[10] The Committee notes that these provisions remain substantially unchanged in the gazetted regulations.

Impact on Trustees

8.11 In its written submission, APRA acknowledged that to facilitate roll overs/transfers under the portability regulations, trustees of funds may be forced to realise assets which are not liquid in a less than favourable market. APRA stated that this will entail a lower rate of return on the realised asset, and therefore disadvantage the interests of remaining members. Accordingly, APRA noted in relation to the draft regulations that:

- Trustees will need to review fund liquidity to support portability requests. This will involve review of investments and investment strategies to ensure that adequate levels of liquid assets are available and consistent with potentially increased numbers of outward roll overs/transfers.
- The situation may arise where trustees, in adjusting investment strategies to take into account portability, may attempt to offset the need for increased liquidity by taking on extra risk in other areas of the portfolio in an endeavour to increase investment returns. Trustees must ensure that these adjustments are consistent with the objectives of the fund.[11]

8.12 This matter was reiterated by Mr Brunner from APRA in the public hearing on 13 August 2003.[12]

Smoothed investment returns

8.13 In its written submission, the Corporate Super Association raised the issue of smoothed investment returns. Smoothing investment returns refers to the practice of some funds using investment reserves to reduce fluctuations in crediting rates on accumulation balances from year to year. The objectives are to promote fairness between members and/or to promote the understanding that returns are stable over time.

8.14 However, the Corporate Super Association suggested that under a portability regime, fund members could time their departure from a fund at the point where reserves have been allocated, and re-enter when reserves have climbed again. This

10 *Submission* 16, Cbus, p. 5.

11 *Submission* 14, APRA, p. 4.

12 *Committee Hansard*, 13 August 2003, p. 33.

would reduce equity between members, forcing funds to abandon the smoothing of investment returns, with its associated benefits.

8.15 Accordingly, the Association recommended that portability should not apply to accumulation balances which are subject to a smoothing of investment returns, whether or not the balances are linked to a defined benefit fund.[13]

8.16 This issue was also raised by AAS in its written submission. AAS reiterated that funds that used smoothing of investment returns may have to alter their investment strategy to hold higher levels of cash, to the detriment of ongoing members. This is because members' long term retirement savings will need to be effectively 'at call' in a portability environment.[14]

8.17 The Committee notes that the Queensland Local Government Superannuation Scheme is a good example of a superannuation scheme providing smoothed investment return. Over the year to 30 June 2003, the scheme's growth fund made a return of -1.7 per cent. However, with the growth smoothing strategy calling on reserves, the fund is crediting 2.04 per cent over the year to 30 June 2003. However, Mr Smith from the Queensland Local Government Superannuation Board argued that under the portability regulations:

> If people can move out [of the fund], we would have to forego smoothing and it would be very difficult because people would be selecting against us going in and out and so on.[15]

Capital guarantees

8.18 In its written submission, the Corporate Super Association raised the issue of capital guarantees applying to an accumulation interest in a defined benefit fund. The Association suggested that it is open to a member to use the protection of a capital guarantee for a period when returns are uncertain, and then to move to another fund when market conditions improve.

8.19 The Association further indicated that it is aware of at least one instance of a fund which offers a capital guarantee as described above which under the draft portability regulations would need to approach APRA to have the fund's ability to roll over/transfer amounts suspended under draft regulation 6.37. Failing that, the Association suggested that the fund would have to remove its capital guarantee in order to ensure equity between members.

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13 *Submission* 9, Corporate Super Association, p. 7.

14 *Submission* 18, AAS, p. 7.

15 *Committee Hansard*, 31 July 2003, p. 46.

8.20 Accordingly, the Association recommended that portability should not apply to accumulation balances which are subject to a capital guarantee, whether or not the balances are linked to a defined benefit fund.[16]

16 *Submission* 9, Corporate Super Association, p. 7.