Senate Select Committee on Superannuation and Financial Services

Main Inquiry
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Submittor: Ms Lynn Ralph
Chief Executive Officer
IFSA
Level 24, 44 Market Street
SYDNEY NSW 2000
☎ - (02) 9299 3022
🖹 - (02) 9299 3198

+61 2 92993198

Investment & Financial Services Association Ltd
ACN 080 744 163

12 April 2000

Ms Sue Morton
Secretary
Senate Superannaution and Financial Services Select Committee
Parliament House
CANBERRA ACT 2600

Dear Ms Morton

SUBMISSION ON

1) **PRUDNETIAL SUPERVISION AND CONSUMER PROTECTION FOR SUPERANNAUTION, BANKING AND FINANCIAL SERVICES**
2) **THE OPPORTUNITIES AND CONSTRAINTS FOR AUSTRALIA TO BECOME A CENTRE FOR THE PROVISION OF GLOBAL FINANCIAL SERVICES**
3) **ENFORCEMENT OF THE SUPERANNUATION GUARANTEE CHARGE**

The Investment and Financial Services Association (IFSA) represents the interests of the life insurance, superannuation, unit trust and investment management segments of the Australian financial services industry. IFSA has over 70 member companies holding more than $480 billion on behalf of 9 million Australians who have an interest in superannuation, life insurance and managed investments.

IFSA's primary objective is to build a savings and investment industry that is robust and efficient that will better serve its underlying consumers. We are therefore committed to ensuring the operation of efficient and effective prudential supervision and consumer protection mechanisms.

The regulatory environment for saving, investment and insurance is of paramount concern for IFSA. In this regard, we strongly support the encouragement and facilitation of private provision of a flexible range of saving, investment and insurance products to satisfy the diverse range of needs for retirement income and other medium and long-term savings vehicles. IFSA believes that as the population ages, and as retirement, health and aged care needs increase, there will be a concomitant increase in demand for savings, investment and insurance products.

The thrust of this submission therefore is that a strong set of prudential controls and regulation is of critical importance to building consumer confidence in and commitment to longer-term savings.

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Email: ifsa@ifsa.com.au | Fax: 61 2 9299 3198

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1. PRUDENTIAL SUPERVISION & CONSUMER PROTECTION FOR SUPER & FINANCIAL SERVICES

In 1991, the Senate Select Committee on Superannaution (the predecessor to this committee) undertook an inquiry which included the adequacy of prudential control and consumer protection arrangements applying to superannuation funds, including trustee structure, disclosure and dispute resolution. The recommendations of this Committee, contained in the Committees first report, *Safeguarding Super. The Regulation of Superannuation* (June 1992) were fundamentally introduced through the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

In 1996, the Government established a new inquiry to undertake a stocktake of the financial system and make recommendations for further improvements to the regulatory arrangements. The Financial System Inquiry (FSI) in 1997 provided a blueprint for a much more robust and flexible regulatory system than previously existed.

The Government continues to advance the recommendations of the Financial System Inquiry, starting with the establishment of APRA and ASIC and the Corporate Law Economic Reform Program (CLERP), and continuing with the Financial Services Reform Bill which aims to harmonise the regulation of the financial services industry. The focus of the FSI recommendations was on releasing large efficiency gains and cost savings from the existing system through improvement to the regulatory framework while maintaining an appropriate balance between achieving competitive outcomes and ensuring financial safety and market integrity. IFSA is supportive of these objectives and continues to work with Government to ensure they are achieved.

While the changes recommended by the FSI that have been made to date, such as the establishment of APRA and ASIC and the introduction of the *Managed Investments Act 1998*, have been important in terms of ensuring a robust and efficient financial system, they have involved significant 'one-off' establishment costs which have been borne by the industry and which are seen as being quite onerous. The preference of IFSA members is that these costs should be amortised over the longer term. This will avoid saddling the industry with substantial increases in regulatory costs at a time when per unit regulatory costs world-wide are decreasing - consequent to unprecedented merger and acquisitions activity which is driven by a need to achieve economies of scale.

IFSA has been actively engaged with government agencies assisting in the development of the Financial Services Reform Bill. As such, we have chosen to focus on a limited number of issues in this submission. In addressing the issue of prudential supervision and consumer protection for the financial services industry we have chosen to focus on the following issues:

- analysis of the experience to date of fund failure in the superannuation, life insurance and managed investments industries
- discussion of the importance of education
- discussion of the interaction of self-regulation and formal requirements of the law

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- analysis of the current risk protection mechanisms which operate in the financial sector to avoid the consequences of systemic failure
- discussion of the current process to review government levies for the financial sector.

In addition, a number of individual regulatory issues, which IFSA has recently been dealing with, are addressed in Appendix A. The most critical of these issues is the operation of the policy requirement for superannuation funds to be satisfied that fund members over the age 65 meet the gainful employment test set out in SIS. IFSA believes that current policy fails any reasonable cost benefit test and should be amended. The committee's attention to this matter would be appreciated.

1.1 FUND FAILURES

Since the introduction of SIS Australia has not experienced a major or significant superannuation fund failure. In superannuation, the fund failures have been confined to a handful of small employer-sponsored funds. There has not been a single instance of fund failure at the retail superannuation level. This outcome reflects well on the prudential supervision and control system set up under the SIS regime, however, it should not be a reason for complacency.

Notwithstanding this success, the regulation and prudential soundness of the retail funds industry has been bolstered by the new Managed Investment Act regime which, increasingly, will govern the overwhelmingly majority of underlying wholesale investment funds that receive most of their funds from superannuation entities.

One could argue that the 1994-2000 period, which has coincided with a record 'bull' market on world stock exchanges, has not presented any major threats to the operational viability of superannuation funds. However, it is worth noting the following events and trends, any one of which had the potential to trigger fund failure.

- Asian financial crisis
- Increasing proportion of Australian moneys invested offshore
- Increased use of derivatives and failure of a large hedge operation
- Strong growth in assets, in excess of 20 per cent in some years
- Creation of ASIC and APRA and the changes in supervisory arrangements – any transition to a new regulatory regime has a certain degree of risk
- Volatile interest rates and currency movements
- New investment opportunities in countries that were formerly part of the Soviet bloc
- Changing fortunes for funds with high exposure to governments bonds caused by inability to predict interest rate movements
- Increased labour mobility and burgeoning numbers of 'lost member' accounts
- Year 2K millennium bug

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1.2 EDUCATION

The role of education in protecting consumers against systemic and prudential risk should not be underestimated as often the complaint by an aware consumer can lead to the identification of a prudential concern.

There is a major need to improve the understanding that Australians of all ages have about financial issues, including superannuation. Education to achieve greater financial literacy is vital and it needs to start during the early years of compulsory schooling. This should be a non-contentious issue and receive bipartisan political support and support from industry and other interest groups. However, achieving this outcome is seemingly more difficult.

While the private sector will generally provide a substantial component of the information and advice required, there is a role for Government, especially in relation to school children and retirees. Research by the Melbourne Institute shows very low levels of interest in retirement saving by age groups below 35. The major benefits of compound interest operate over longer periods and hence most younger people are not utilising the opportunities to save early, which greatly reduces the need for savings in later years.

IFSA believes that industry, consumer groups and government agencies can play a key role in bridging the knowledge and information gap when it comes to financial literacy. A well coordinated and extensive education campaign to boost adequacy of financial resources in retirement, would be repaid many times over by lower cost to Government of providing age pensions. Currently, the matter of consumer financial awareness is need of more wholehearted government fund support. Industry, government and consumer groups have a role in a properly coordinated strategy to build a more critically aware consumer force. Accordingly, having regard to the general public interest imperative in this matter, the major funding for this initiative should come from the public revenue, not industry levies.

1.3 SELF-REGULATION

IFSA sees the role of voluntary codes in promoting better organisational competencies and a higher level of compliance as a vital one. IFSA endorses the approach outlined in the CLERP 6 Consultative Document, whereby codes of conduct should establish industry best practice by providing clarification, processes and procedures for meeting the requirements of the Law. In addition, codes that establish best practice in areas not covered by the Law should also be established, in order to promote consistency and enhance services to consumers. It needs to be noted that the financial services industry is continually developing and redefining products and services. The rapidity of change is such that at times legislation and prudential controls also need to change quickly. Effective self regulation can play a key role in providing a degree of protection during the transition period.

Industry codes of conduct have the potential to provide assurance to consumers that subscribers to such codes are maintaining industry 'best practice' standards with respect to matters such as disclosure and conduct. Where there is wide industry

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RECEIVED TIME 12. APR. 17:04 PRINT TIME 12. APR. 17:17

acceptance of the terms of particular codes and the relevant industry body is able to provide reasonable assurance of industry observance, IFSA believes they also have the potential to assist effective regulation by reducing the need for intervention by the statutory regulator.

To this end, IFSA has developed a set of Standards and Guidance Notes[1] which promote best practice standards and enhance public confidence, objectivity, credibility and professionalism within the industry. These Standards and Guidance Notes are designed to inform and assist investors, thereby enhancing investor confidence in, and knowledge of, the industry, its products and services.

IFSA's standards include a Code of Ethics and Code of Conduct that have been developed to promote a high quality investment and financial services industry. The Codes recognise that the object of industry participants is to work to the highest standards of professionalism and generally meet and where possible exceed the public's expectations.

IFSA expects that members will undertake reasonable enquiries to ensure that they are complying with the Standards. Specifically, the Board of each member company is required to pass a resolution each year indicating whether or not they have complied with the mandatory IFSA Standards for the relevant period. Members can use the IFSA mark of compliance on their product brochures and other information.

A summary of IFSA's Standards and Guidance Notes is contained in Appendix B.

1.3.1 Self Regulatory Organisations (SRO) and the Financial Services Industry

While self-regulation offers significant advantages by virtue of the fact that regulatory policy will be made by industry experts, ie individuals and entities who have a high degree of industry knowledge and experience, the self-regulatory model brings with it equally significant obligations on the self-regulatory body.

The arguments for and against SROs as front line regulators in Australia have been canvassed many times in recent years. The conclusions of the Financial System Inquiry (FSI) and the response of the Government have resolved this debate for the moment. As in the UK, which has now abandoned its heavily prescriptive SRO model in favour of a centralised regime, Australian front line regulation will (except for the securities and futures exchanges) continue to be undertaken by the statutory prudential and market regulators.

1.4 AVOIDING CONSEQUENCES OF SYSTEMIC FAILURE

The impact of economic and market shocks arising out of fundamental failure both at home and offshore can be mitigated by having good public policy in relation to the following:

[1] Compliance with the Standards is mandatory for IFSA members from 1 August 2000; compliance with Guidance Notes is voluntary, but strongly encouraged.

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- 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 are not exposed to levels of risk that are associated with systemic failure.

1.4.1 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 both onshore and offshore financial market failure. In this regard the Risk management controls include:

Superannuation:

- common law and legislative duties on a trustee to invest prudently
- prohibitions on funds borrowing to leverage
- Derivative Charge Ratio calculations (see Appendix C)

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 intermediaries 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

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RECEIVED TIME 12. APR. 17:04 PRINT TIME 12. APR. 17:17

- 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 adequacy, 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

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

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RECEIVED TIME 12. APR. 17:04 PRINT TIME 12. APR. 17:17

enhance the ability of participants to value and monitor exposures and risks

1.4.2 Recommendations with respect to risk management controls

The committee could consider the following recommendations:

- 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

1.4.3 The role of audits in prudential supervision

An effective audit strategy is essential for the maintenance of a sound prudential system. Effective audits have a two-pronged purpose, namely, to identify breaches of the law and compliance and to point to future possible risks.

As indicated previously, there are two layers of audits in place for superannuation fund moneys. Firstly, the super funds themselves are audited by APRA to ensure they meet the prudential requirements set out in the SIS Act. Furthermore, with approximately 80 per cent of the underlying investments of superannuation funds invested in managed investment schemes regulated by ASIC, these funds are the subject of ASIC scrutiny in order to meet the licensing conditions for managed investment schemes.

The industry supports this interwoven audit system. With two regulators, however, there remains a risk that funds could be over audited which could be at a cost of administrative efficiency of the funds. It is imperative for ASIC and APRA to have intensive levels of liaison with the objectives of (1) ensuring a co-ordinated approach, (2) funds at greater risk are audited more frequently.

1.5 FINANCIAL SECTOR LEVIES

IFSA recognises the critical importance of effective supervision of all financial institutions. An adequate level of supervision is essential to maintaining consumer confidence in the overall financial system and in individual financial institutions.

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RECEIVED TIME 12.APR. 17:04 PRINT TIME 12.APR. 17:17

Since regulatory supervision is of benefit to financial institutions as well as to consumers, IFSA accepts a system in which the industry contributes a fair proportion of the cost of supervision and believes that changes to the current levy framework are necessary.

In August 1999, Treasury initiated review of financial sector levies. The objective of the review was to ensure that 'there is an efficient, equitable and durable funding mechanism capable of meeting needs well into the future.' While IFSA endorsed this objective in its response to Treasury, a fundamental concern was that both the terms of reference and the timeframe allowed for the review would preclude this objective from being achieved.

Following the deadline for submissions, Treasury held a round table discussion with the numerous stakeholders in this issue in December 1999. There has been no further communication on this issue.

We have set out below the guiding principles for the characteristics that we believe an equitable levy structure requires.

1.5.1 Guiding Principles

IFSA proposes that any equitable levy structure must have the following characteristics:

- The minimum levy should reflect the actual cost of supervision of entities in each sector.
- An explicit rationale for determining the quantum of the levy
- No double counting of assets; no charge for non-financial assets.
- The total levy payable should be discounted where an entity operates in more that one sector to reflect the reduced cost of supervision of a conglomerate/group.
- The legislation provides for a guaranteed annual review of the levy quantum and structure, similar to that provided in SIS.
- Cost recovery for elective services
- APRA funding should be supplemented from general revenue reflecting the general benefits reaped by the entire economy from a stable financial sector.

1.5.2 Minimum Levy

The current system of determining levies, particularly the use of minimum and maximum levies, results in larger institutions effectively cross-subsidising smaller institutions, and certain sectors cross-subsidising other sectors. This occurs partly because the current minimum levies for some sectors are unlikely to cover the costs of supervision. This is an inequitable outcome for both larger institutions and their customers. Consequently, IFSA supports increases in the minimum levy rates so that they are more reflective of the actual base cost of supervision. This approach would reduce the current level of cross-subsidy.

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Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

RECEIVED TIME 12.APR. 17:04 PRINT TIME 12.APR. 17:17

It should also be noted that the extent of the cross-subsidy has increased in recent years as levies have moved further away from a cost recovery approach. This is because the maximum levy rates have increased by a much greater amount than the minimum levy rates. For example, the maximum levy for general insurers increased from $55,000 in 1998/99 to $75,000 in 1999/2000, while the minimum levy remained at $5,000. The change was even more extreme for life insurers, as the minimum levy actually fell in 1999/2000 (from $5,000 to $500) while the maximum increased from $148,000 to $280,000.

Therefore, the minimums need to be adjusted to ensure equity both within and across various sectors.

1.5.3 Explicit rationale for determining quantum of levy

Currently, there is no apparent or explicit rationale for the determination of the actual quantum of the levies. This situation results in the appearance of randomness and a high degree of cynicism about the levy setting process. It also results in relative inequities not only between various paying entities, but also in the absolute quantum.

After reviewing the total levies payable by several IFSA members for 1999/2000, we believe that not only are there major inequities being generated by the current levy system, but also that the overall quantum of levies exceeds what might be the reasonable costs of supervision of such institutions.

IFSA believes there must be an explicit rationale for the determination of the quantum of the levies.

One such option could be to mirror the current APRA risk-based approach to supervision. This approach allows APRA to target financial institutions by risk profiles and, subject those entities that do not, in APRA's view, have an understanding of risk management or an acceptable risk management program, to more intense supervision.

IFSA supports a system that matches levy payments more closely to the level of supervision incurred. As well as being consistent with the user pays principle; this would also be desirable from a broader perspective, as it would help to promote the strength of the financial sector by providing a strong incentive for sound prudential management within the financial services industry. A financial institution that consistently meets prudential requirements will pay less in levies and be rewarded for the resources used in meeting their obligations.

1.5.4 No double counting of assets

We believe that the current method used to determine the levy i.e. a percentage of funds under management, should remain only on an interim basis subject to the following changes: an increase in the minimum amounts payable and the removal of double counting of assets. In addition, we believe that assets within a group which are included in the group accounts but which relate to non-financial services businesses should also be excluded for the purposes of calculating the levy.

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RECEIVED TIME 12. APR. 17:04 PRINT TIME 12. APR. 17:17

An example of multiple counting of assets is given below.

Many superannuation funds invest in policies held in Statutory Funds of Life Insurance Companies. These policies may, in turn, purchase units in Unit Trusts operated by a subsidiary company of the life insurer, or by an external service provider. Thus, the same assets would appear on the balance sheets of three organisations: namely the superannuation fund, the life insurance company and the unit trust operator. In other circumstances the same assets could appear on four balance sheets.

Whilst we accept the need for each of these entities to be supervised, multiple counting of the same assets is not an equitable basis for establishing the quantum of their levies.

1.5.5 Group approach to levy calculation

The current sectoral approach under which separate levies are imposed on specific industry sectors may be appropriate where there are clear distinctions and boundaries between different types of financial institutions (e.g. banks vs life insurance companies), as has traditionally been the case. This approach is neither desirable nor efficient now that a large portion of the industry is moving to offer a wider range of services. As a result the distinctions between different types of institutions are becoming blurred. APRA, itself, has re-structured into two distinct operational groups, Diversified and Specialised reflecting this change in the market.

Given the trend towards financial institutions becoming conglomerates, there are a number of advantages in moving towards a levy structure based on a single levy for the overall entity rather than the current system of imposing separate levies on each line of business within the entity. The advantages of a single levy system are:

- This approach is consistent with the broader regulatory trend towards adopting a uniform regulatory environment across the whole financial services sector. For example, the aim of the Corporate Law and Economic Reform Program 6 is to introduce uniform licensing, advice and disclosure requirements for all financial institutions and providers.

- It would improve the efficiency of supervision arrangements through reducing the costs of collecting and administering the levy. For example, under a single levy approach conglomerates would only have to make one levy payment rather than up to four separate levy payments as is currently the case.

- It would be expected that supervisory costs would also be less for regulatory agencies.

- The re-structure of APRA lends itself to development of a single levy system.

On the basis of the above points IFSA supports moving to a single levy arrangement across all types of financial institutions and endorses APRA's intention to move

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RECEIVED TIME 12. APR. 17:04 PRINT TIME 12. APR. 17:17

towards a more common levy framework, as stated in the 1999 Industry Consultation Paper. Such a system would improve the efficiency of prudential supervision as well as help to eliminate any inequities that exist in the current levy arrangements.

Where there are two or more types of businesses (or multiple entities) within a conglomerate then there should be a discount given to the sum of the individual financial sectors levies that apply. The discount would then recognise the efficiency gains achieved by APRA supervising this organisation as a single entity.

In the interim transition phase we believe that a discount of 25 cent is appropriate to be applied to the total of levy charged to a conglomerate and that one invoice be issued.

1.5.6 Legislative guarantee of annual review

IFSA recommends that a continuing, annual review be incorporated in the APRA legislation. This review should include consideration of both the quantum of the levy and how it is structured.

1.5.7 Cost recovery for elective services

We believe that fees for discrete services offered or applied by APRA should be charged directly to the financial institution concerned. Such services would include licensing applications, corporate restructures, mergers, transfers of business, review of rules and education.

This is a more equitable way of funding APRA's costs relating to these activities. It ensures that cross-subsidisation is limited, by charging for activities that are related specifically to decisions made by financial institutions, for example, to restructure their businesses or their funds. However, it must be stressed that such fees should only be used for this purpose and should not be allocated to Consolidated Revenue. It should also be stressed that some form of crediting should be granted in those instances, such as licensing of a single responsible entity and an approved trustee, where ASIC and APRA are undertaking essentially a similar task, and where a single entity may already have paid a fee to ASIC or APRA.

Additionally, there would need to be some means to control the level of such fees. A regular review process similar to that for ASIC charges and fees would be appropriate.

1.5.8 General economic benefits

As there are economic benefits that flow from having a strong and stable financial sector, IFSA recommends that part of APRA's funding should come from general revenue.

The financial services industry provides the infrastructure to assemble the savings of Australians, which then provides the capital to fund development. This role then generates income from two direct sources that being the financial institutions and the

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RECEIVED TIME 12. APR. 17:04 PRINT TIME 12. APR. 17:16

recipients of the capital. All industries, not just the financial services sector, benefit from the lower cost of capital that a stable financial system provides.

Therefore, it should not fall, solely to the regulated entities to fund the entire cost of the prudential supervisor.

In conclusion, the total levy paid by each individual organisation must reflect a base contribution to the financial system's overall health, plus a reasonable portion of the costs of that organisation's supervision (on a risk-adjusted basis). User pay charges should be introduced for all non-supervisory elective services.

The levy should be set to raise only APRA's net costs incurred after allowing for all other income arising from commercial activities by APRA and also by allowing for a reasonable funding out of general revenue.

2. OPPORTUNITIES & CONSTRAINTS FOR AUSTRALIA TO BECOME A CENTRE FOR THE PROVISION OF GLOBAL FINANCIAL SERVICES

2.1 GENERAL COMMENTS

IFSA is a strong supporter of Government policy for Australia to become a global financial centre. The funds management industry in Australia is well placed to offer its services offshore and thereby be seen as a centre of financial excellence. Appendix C includes an overview of the business of funds management in Australia.

To some extent the industry is already working in a manner consistent with the policy intentions of the government. The interface with other financial centers is already quite profound because of the fact the many of the Australian funds management companies are part of international funds companies. Consequently, there is a flow of information and human resources between Australia and other financial centers. Often the Australian subsidiary has led the way in important world-wide projects, hence in a sense a very real sense the domestic operation could be seen as being a centre for financial excellence.

2.2 OFFSHORE INVOLVEMENT

Additionally, Australian funds managers now control offshore assets sourced by Australian savers. These assets have generated quite substantial returns and have played a key role in diversifying the funds management asset base but in addition to this this offshore involvement has given the domestic industry a capacity to understand offshore markets and this assists in future product development opportunities. The following ABS data for the September Quarter 1999 shows the extent of offshore involvement in an investment sense.

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Table 1

Type of asset	$bn
Cash and deposits	39
Loans and placements	27
Short term securities	59
Long term securities	74
Equities and units in trusts	152
Land and buildings	56
Assets overseas	96
Other assets	18
Total	**521**

As can be easily ascertained from Table 1, managed funds hold about $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.

2.3 ARE ADDITIONAL OVERSEAS PLAYERS NEEDED?

The Australian funds management industry is a highly competitive industry in which there is strong price competition and a large number of participants. There is a comprehensive information system that almost simultaneously broadcasts market developments as they unfold. The products and services on offer are highly regulated and, accordingly, have close similarity in features. Hence, in striving for a competitive edge IFSA members focus on service quality and price. In order to reduce prices, members strive to gain the cost reductions that accrue with economies of scale. The recent spate of merger and acquisition activity that the industry has experienced reflects the need for fund managers and life insurers to raise funds under management to gain these economies.

Having regard to the foregoing, IFSA believes that the market in Australia has more than a sufficient number of players to ensure that consumers have access to competitively priced products, hence IFSA's position that the AGFC initiative, at least for the funds management and life insurance industries, should focus on developing offshore opportunities for IFSA members to expand funds under management and other services offshore.

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RECEIVED TIME 12. APR. 17:04 PRINT TIME 12. APR. 17:16

2.4 IMPEDIMENTS TO BUILDING A STRONG DOMESTIC FUNDS MANAGEMENT INDUSTRY THAT CAN BE THE BASE FOR A STRONG EXPORT INDUSTRY

2.4.1 The tax system – Collective Investment Vehicles

During its first two years of operation IFSA has expended considerable resources in advocating for the creation of a new class of investment vehicle which the Government has decided should be referred to as a Collective Investment Vehicle. CIVs will have what is known in industry parlance as 'pass through', or 'flow through'. Under 'pass though' a fund distributes all of its yearly income and capital gains to its beneficiaries who in turn pay tax at their appropriate marginal or corporate rate of tax. Under the new Australian tax system, funds obtain from their investors details of TFNs or ABNs. In the event that the fund is not in receipt of one of these numbers tax is withheld at the highest marginal rate.

Under the original ANTS package it was intended that each investment management fund would retain tax according to the applicable company rate of tax and issue franking credits on this basis. Had this initiative proceeded the popularity of managed investments would have declined quite significantly. The most adversely affected funds included listed property trusts and cash management trusts.

IFSA research showed that retail fund members preferred the pass through approach. Wholesale funds managers were concerned that had the withholding tax initiative succeeded they would have been at a distinct disadvantage compared to those investment activities which had direct shareholdings that did not attract the withholding tax.

The Ralph Review recommended that CIVs proceed under certain conditions which, unfortunately, place at risk large tranches of the moneys held by Australia's funds managers. In this regard about 80 per cent of Australia's listed property trusts will lose their CIV status should a more flexible regime not be achieved. Likewise, about 70 per cent of wholesale funds do not qualify under the current provisions.

Consequently, IFSA has made representations to the Government to rectify this problem consistent with building integrity into the tax system. IFSA's fundamental concern is that indirect investors in managed funds should be treated identically to other investors (usually more wealthy) who choose to invest directly in property and shares. If a flexible solution is not found the industry will experience the following difficulties, both of which will detract from the AGFC concept:

- Funds that do not receive CIV status will need to restructure or indeed divest their assets to another entity. That entity may well be an offshore entity which has pass through status. (The US mutual funds have had pass through status since 1943)

- The listed property trust industry will be substantially disrupted and will face strong competition from their REIT (Real Estate Investment Trust) which are continually competing for offshore funds

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- Investors will increasingly choose to invest directly and lose the benefits of pooling and diversification that integral to funds management

2.4.2 Responsible Entity's liability for acts and omissions of agents under MIA

Section 601FB(2) of the Corporations Law, which came into effect as part of the Managed Investments Act (MIA), presents a considerable deterrent to global investment management firms who wish to provide managed investments approved by ASIC in the Australian market.

This provision provides that a responsible entity may be held responsible for acts and omissions of agents and sub-agents, whether acting within or outside of the scope of their engagement and without regard to whether they were prudently selected and monitored. In this regard agent or sub-agent would include brokers and dealers.

Members have advised us that this provision is particularly troublesome for global investment managers seeking to offer funds with global mandates in the Australian market as there is concern about this being a new and uncertain risk which is significantly more severe than the standards in other jurisdictions. This provision will, therefore, have unintended consequences which would constrain the ability for Australia to become a centre for the provision of global financial services.
It is a reasonable premise that the Responsible Entity should only be liable for the acts or omissions of others which it engages to perform the functions that the Responsible Entity should perform under its mandate as Responsible Entity. In this context, the Responsible Entity function does not include acting as a broker or dealer which can engage in portfolio trading, and the Responsible Entity should not, therefore, be ultimately liable for the activity of either. This provision, however, effectively shifts the transactional investment risk for the functioning and creditworthiness of the secondary market intermediaries from investors, where it properly belongs, to the Responsible Entity. This is clearly an unintended consequence of the provision.

A more appropriate obligation to impose on Responsible Entities, which we understand would bring Australia into line with most other jurisdictions, would be one of prudent selection and monitoring with respect to the engagement of brokers and dealers which act as agents for fund transactions. Relief for this could be provided by ASIC under Part 5C.11 of the Corporations Law.

While the aims of MIA were to eliminate the divided responsibility between trustees and managers, the amendment of this provision along these lines would not challenge the policy objectives of MIA as it would not impair the appropriate protection of fund investors.

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3. ENFORCEMENT OF THE SUPERANNUATION GUARANTEE CHARGE

IFSA supports the introduction of a requirement for employers to pay employee superannuation contributions quarterly. The joint IFSA/ASFA Super EC project will assist smaller employers and the industry to cope with this increased frequency. It will achieve this by promoting data messaging and transfer protocols amongst funds managers, super funds and payroll providers, and will greatly reduce the need for paper based administration systems.

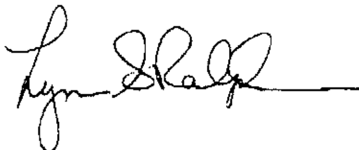
The ANTS (A New Tax System) package of reforms require the payment of quarterly tax instalments. Under this new arrangement, which commences on 1 July 2000, it is logical that SGC contributions also be remitted quarterly.

We believe this will have a number of benefits:

- assisting to obtain better member data and thus reducing the growth in the lost members' register
- ensuring the system is more accountable with more timely evidence of non-compliance
- reducing significantly lost superannuation entitlements when a company goes into liquidation;
- boosting member balances by allowing them to accrue interest earlier than would otherwise be the case;
- encouraging employers to operate more efficient bill-paying systems, especially those employers that experience high labour turnover

If you require further information please call either Annabelle Kline or myself on (02) 9299 3022.

Yours sincerely



Lynn Ralph
Chief Executive Officer

Level 24, 44 Market Street, Sydney NSW 2000 Ph 61 2 9299 3022
Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

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APPENDIX A

GAINFUL EMPLOYMENT TEST FOR MEMBERS OVER AGE 65

Background

For the purposes of complying with the compulsory cashing requirements and monitoring the fund's ability to accept contributions, trustees have an obligation to be satisfied that members aged 65 or over are gainfully employed for the requisite hours each week.

SIS Regulation 6.21(1) requires that, where a member over 65 is not gainfully employed for at least 10 hours each week, their benefits (other than post 65 employer financed benefits) must be paid from the fund. For the purposes of this regulation, SIS Regulation 6.21(3A) requires trustees to make "reasonable attempts to keep itself informed about the member's ongoing employment status" for those over age 65.

SIS Regulation 704(1B) allows superannuation funds to accept contributions that are made in respect of a member who has reached age 65 but not age 70 only if the contributions are mandated employer contributions or the member is gainfully employed for at least 10 hours each week.

In order to meet its requirements, therefore, a trustee must have arrangements in place to enable it to be satisfied that each member aged over 65 meets the gainful employment test.

If a narrow interpretation of these provisions were to be applied, there would be a number of inappropriate outcomes.

Monitoring

APRA Circular I.A.1 paragraph 24 and Circular I.C.2 paragraph 20 both provide guidance as to a method of monitoring which, if undertaken, would enable trustees to be satisfied that members aged over 65 meet the gainful employment test. Both circulars state:

> *"The trustee must have arrangements in place, such as monthly monitoring, to determine whether a member satisfies the gainful employment test in respect of each week"*

We acknowledge that these Circulars simply suggest that monthly monitoring would be appropriate, that is they do not actually impose a requirement for trustees to undertake such a monthly check. There are, however, potential problems associated with such an approach.

IFSA believes that, while a monthly process of monitoring members over age 65 could satisfy the test of 'reasonable attempts' in SIS Regulation 6.21(3A), it would be an inappropriate requirement in all circumstances. It is our opinion that there are a number of situations in which monthly monitoring by trustees would lead to erroneous determinations that gainful employment had ceased.

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It is not always possible for trustees to communicate with members each month, for example a member may have changed his or her address, be overseas, or may simply not be responding to the continual monthly correspondence. The trustee would then risk redeeming the investments of members who continue to satisfy the legislative requirements for remaining in the fund.

This likely scenario would then have the following repercussions:

- The member is faced with the cost of reinvestment.
- The member may experience a gap in insurance cover.
- The trustee will be forced to redeem the member's investment without their instructions, which could result in significant disadvantages to the member. For example, members will not be able to instruct the trustee how they wish to receive their payment, whether they wish it to be rolled into a pension product, paid 'in specie', or paid in cash.

In addition to the potential adverse impact to members of monthly monitoring, trustees would incur unnecessary costs in terms of implementing extremely expensive and administratively time consuming measures to implement monthly monitoring and to process redemptions and applications unnecessarily.

Were a monthly process the only monitoring method used by trustees it would be possible for a member over age 65 (who intends to work at least 10 hours per week until he or she is 70 years old) to receive, and be required to respond to, in excess of 60 pieces of correspondence from the trustee over the 5 year period.

In our opinion a more appropriate monitoring process would be for an annual (or such other period of time) check when the Trustee already communicates with members, for example, with the annual member reports combined with an instruction to members that they must advise the Trustee as soon as they cease being gainfully employed for at least 10 hours each week. We believe that such an approach is appropriate as it places some of the responsibility on to the member to notify the trustee when they cease to meet the employment test. It therefore enables trustees to meet this requirement without excessive and undue costs.

Disjointed work patterns

These provisions significantly impact employees over age 65 with ad hoc work patterns (eg. where an employee does not work at all in one week, but works 40 hours in the next). This clearly does not encourage older Australians to continue to save for their retirement as after the first week during which they work less than 10 hours, the trustee will be required to pay the members benefits from the fund. Nor does this inflexible and inequitable requirement encourage labour force participation of older Australians.

Recommendation

IFSA recommends that the employment test be modified to overcome the uncertainty and inflexibility of these provisions.

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CENTRAL REGISTER OF UNCLAIMED BENEFITS

The second issue that we would like to raise concerns the establishment of a central register of unclaimed benefits. Under the legislation funds are required to give a statement each half-year of all the unclaimed benefits being paid out of the fund. The statement is given to the recipient of the unclaimed money – usually a State or Territory where the trustee is incorporated or situated depending on the circumstances.

We are concerned that there is not a central register of Unclaimed Money amounts. As the State or Territory to which unclaimed amounts are paid depends on the trustees circumstances and not on the members address the public will find it very difficult to locate unclaimed benefits belonging to them.

We suggest that the ATO should hold a record of all unclaimed benefits including the State or Territory where benefits are held. This would make it far easier for people to access their own unclaimed benefits.

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APPENDIX B

SUMMARY OF IFSA'S STANDARDS & GUIDANCE NOTES

IFSA Standards

Standard No. 1.00
Code of Ethics and Code of Conduct

- To promote a high quality Investment and Financial Services Industry.
- To form a universal statement of the standards expected from practitioners in the industry.
- To set out the code of conduct, the standard-setting process and procedures for monitoring of compliance.

Standard No. 2.00
Equity Trusts - Quotation of Dividend Imputation Credits

- To indicate to Managers, when reporting dividend imputation credits derived from investments in Australian shares, the formats they may choose to report the credits to their Investors.
- The formula for calculating the franking level of distributed Income.
- The basis for quoting Franking Credits.

Standard No. 3.00
Investor Reporting

- Specification of the minimum reporting requirements by Scheme Operators for:
- Transaction based reports; and
- Scheme based reports.

Standard No. 4.00
Management Expense Ratio

- To specify the principles to be adopted when calculating MER's; and
- Provide guidance on the application of those principles, with particular emphasis placed on inter fund and master fund arrangements.

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Standard No. 5.00
Operational Capability

- Specification of the Standards to be adopted by a Member in the operation of its business;
- Guidance in the interpretation and application of those Standards; and
- A note to Members of the relevant regulation that is applicable in the operation of their businesses.

Standard No. 6.00
Product Performance–Calculation and Presentation of Returns

- To specify the principles to be adopted when calculating Total, Growth and Distribution Returns;
- Enable proper assessment of Scheme returns when comparing Month-End returns, after fees and tax paid by the Scheme, with market indices and other Schemes (ie. peer comparisons);
- Ensure there is as much consistency as possible with the Australian Investment Performance Measurement and Presentation Standards and Global Investment Performance Standards (note that both of these Standards refer to the measurement of composite performance, not Scheme performance);
- Provide guidance in the interpretation and application of those principles;
- Standardise the practices, procedures and terminology, relating to the calculation of Total, Growth and Distribution Returns; and
- Specify the basis of proper disclosure of the methodology used to calculate Total, Growth and Distribution Returns.

Standard No. 7.00
References to IFSA's Logo, Membership, Standards or Guidance Notes

- To specify Standards to be adopted by a Member in the use of or reference to IFSA's logo, membership of IFSA, theIFSA Standards or Guidance Notes.

Standard No. 8.00
Scheme Pricing

- The principles to be adopted in the calculation of Scheme prices;
- Guidance in relation to the application and interpretation of the above principles;
- Specification of the practices, procedures and terminology required to standardise the pricing of Scheme interests; and
- Specification of the basis of disclosure of Scheme prices.

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Email: ifsa@ifsa.com.au Fax: 61 2 9299 3198

RECEIVED TIME 12. APR. 17:04 PRINT TIME 12. APR. 17:15

Standard No. 9.00
Valuation of Scheme Assets and Liabilities

- To specify the principles to be adopted in the Valuation of Assets and Liabilities of a Scheme;
- To provide guidance in the interpretation and application of those principles;
- To standardise the practices and procedures relating to the valuation of the Assets and Liabilities of a Scheme and the determination of the Net Asset Value of a Scheme; and
- To provide for the proper disclosure of the process adopted by a Scheme Operator in the valuation.

IFSA Guidance Notes

Guidance Note No. 1.00
Australian Investment Performance Standards

- The Australian Investment Performance Standards (AIPS) are voluntary standards for adoption by investment management firms for presentation to wholesale clients.
- The AIPS promote the fair and consistent representation of investment performance to investors. AIPS provide a framework for measurement and presentation including valuation and calculation guidelines.
- The goal is to achieve comparability of returns as well as demonstrating the industry's commitment to self-regulation and professionalism through the voluntary adoption of best practice in measurement and presentation.
- The AIPS are supported by IFSA as guidance for members.
- Only firms that actually manage the assets can claim compliance. Other entities (including superannuation funds, consultants, custodians or regulators) can endorse, encourage or require the use of the standards, but cannot claim compliance.
- The standards comprise both requirements and recommendations and in order to claim compliance, a firm must meet all the composite construction, calculation, presentation and disclosure requirements of the AIPS.
- Verification by an independent third party is recommended but not compulsory.

Guidance Note No. 2.00
Corporate Governance: A Guide for Investment Managers and Corporations

- The first four Guidelines in the Guidance Note provides a series of guidelines for IFSA
- Members in determining their approach to Corporate Governance, voting and other issues proposed by public companies in which they invest;

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- The next fourteen Guidelines in the Guidance Note provides a series of guidelines for public companies in relation to a range of Corporate Governance issues including disclosure, board and board committee composition, non-executive directors, board and executive remuneration policy and disclosure;
- The appendices to these Guidelines includes a suggested format for remuneration disclosure and a model proxy form.

Guidance Note No. 3.00
Financial Reporting

- The specification of accounting treatment for transactions and events specific to IFSA Members;
- The recommended formats for financial statements for Schemes; and
- The required disclosures for certain information in relation to IFSA Members' Schemes.

Guidance Note No. 4.00
Incorrect Pricing of Scheme Units – Correction and Compensation

- Specification of the guidelines which a Scheme Operator is expected to follow when complying with the relevant provisions of the IFSA Standards;
- Specification of guidelines for occasions when incorrect pricing takes place; and
- Specification of the guidelines for when compensation arising from incorrect pricing is required.

Guidance Note No. 5.00
Industry Terms and Definitions

- The main objective of standardising industry terminology is to enable Investors to have a clearer understanding of financial Products and services when making investment decisions.
- To enable Fund Managers and consultants to interpret information in a like manner and produce statistics/material that is accurate and useful.
- To improve efficiency within organisations when developing Offer Documents.
- To include this dictionary on IFSA's Web Site.

Guidance Note No. 6.00
Mortgage Trusts – Disclosure

- To establish minimum disclosure requirements relating to Scheme's who invest predominantly in Mortgage Investments;
- To standardise the framework by which certain information is considered by Scheme Managers as it relates to Mortgage Trusts; and

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- To specify minimum disclosures in Scheme Offering Documents and financial statements.

Guidance Note No. 7.00
Personal Trading

- To specify the principles to be adopted in relation to the conduct of Personal Trading;
- To provide guidance in the interpretation and application of those principles;
- To standardise the practices and procedures relating to the conduct of Personal Trading; and
- to specify the basis of suitable compliance of such Personal Trading activities.

Guidance Note No. 8.00
Related Party Transactions

- To specify the principles to be adopted in relation to the conduct of a Related Party Transaction between a Scheme and a party related to the Scheme or in Scheme interests by, or on behalf of, a Related Party;
- To provide guidance in the interpretation and application of those principles;
- To standardise the practices and procedures relating to the conduct of Related Party Transactions; and
- To specify the basis of proper disclosure of such Related Party Transactions.

Guidance Note No. 9.00
Reporting to Superannuation Schemes by Service Providers

- To assist service providers in the presentation of financial and taxation information to Superannuation Scheme Trustees;
- To ensure that sufficient information is given to Trustees, so that they may efficiently and effectively perform their duties; and
- To specify the minimum Trustee reporting requirements and/or industry best practice.

Guidance Note No. 10.00
Soft Dollar Dealing

- To specify the principles to be adopted in relation to the conduct of Soft Dollar transactions;
- To provide guidance in the interpretation and application of those principles;
- To standardise the practices and procedures relating to the conduct of Soft Dollar Dealing; and
- To specify the basis of proper disclosure of such Soft Dollar transactions.

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- To provide guidance to IFSA members when cover under a current Group Insurance Policy is transferred to another insurer; and
- To specify when an incoming insurer becomes responsible for claims, and the acceptance terms on which it takes over the cover.

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AN OVERVIEW OF FUNDS MANAGEMENT

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.

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**

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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 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:

- 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.

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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.

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