COMMITTEE FOR ECONOMIC DEVELOPMENT OF AUSTRALIA

Managing Australia's Wealth in the 21st Century: A young industry for an ageing population

GUEST SPEAKER

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Address to CEDA

Good afternoon

First, I would like to thank CEDA for the invitation to address today's luncheon and acknowledge the unique contribution the organisation has made to the development and progress of Australian public policy.

MLC values its association with CEDA and looks forward to a long relationship into the future.

The title on my presentation today is 'Managing Australia's Wealth in the 21st Century: A young industry for an ageing population.' I would like to clarify when I say young industry there a three key areas:

Insurance : 100 years

Investments : 20 years

Advice : has evolved from a sales to an advice profession over the last 10 to 15 years.

Today, I would like to take some time to talk about the Australian wealth management industry and the vital role it has in growing and protecting the wealth of millions of Australians.

In particular, I wish to discuss:

- the recent growth of the industry, on both the FUNDS MANAGEMENT and the ADVICE side - and its arrival at what I regard as a critical point in its development;

- the value of quality, financial advice and its role in securing the future prosperity of Australians, and finally;

- some thoughts on how the industry's operating environment might be improved so Australia can better prepare for the demographic challenges ahead.

<u>Retirement Savings – the Australian Way</u>

Twenty years ago, the Federal Government was confronted with a challenging economic environment. Most concerning was an aging population and inadequate pool of retirement savings

Faced with these challenges, the Hawke / Keating Government embarked upon one of the most significant and far sighted public policy initiatives in Australian history –

Award superannuation – where portions of wage rises were directed into superannuation. This was a new way of doing things that took some getting used to. (compare to UK and Singapore) This policy would later be expanded to include those workers outside of the award system, and become a universal benefit in the form of a compulsory, legislated, ***Superannuation Guarantee***, currently struck at 9% of employee earnings.

Back then, the superannuation industry was just starting, with a few large public sector funds and many, smaller corporate funds making up most of the numbers.

We also saw more personal superannuation products emerging with high sales commissions attached.

Fast forward twenty years and much has changed.

Today, wholesale and retail superannuation funds are major players in the industry, accompanied by industry funds and the remaining public sector funds.

There has been a change in product design and now more than ever, advice is attached to a person’s superannuation decisions.

Superannuation assets

The most recent statistics from the prudential regulator, APRA, show that Australia's total superannuation assets now stand at **$844.6 billion**; an increase of 4.1% over the December 2005 quarter.[1]

With returns on assets running at 3.3% for the same period and mandated employer contributions flowing, this figure will soon pass the $1 trillion mark.

By any measure, this is an impressive achievement for a country with just over 20 million people, and it's attracting wide interest.

A lead article in the *Wall Street Journal* last December remarked that Australia's accumulation of capital had ***'transformed'*** the Australian economy; enabling it to ***"..wield greater financial influence than ever thought possible.."*** [2]

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[1] ***Quarterly Superannuation Performance***, December 2005. Australian Prudential Regulation Authority, released 12 April 2006
[2] *Awash in Cash*; Barta P & Kissel, M. The Wall Street Journal, 6 December 2005

The article went on to say that Australia was emerging as a ***"..major financial centre.."*** ; and attributed this to Australia's system of compulsory superannuation. [3]

As this pool of capital has grown, so have all aspects of the wealth management industry: product manufacturing, funds management and the need for financial advice. For the first time, Australians have a major financial asset beside the family home and need advice on how to look after this new asset.

[3] Ibid

Industry Evolution

This growth in superannuation has coincided with significant changes in the financial advice and funds management industry.

In the mid 1980s, a financial adviser was in reality, a sales person, with no formal qualifications, operating on high commission deals, **selling** financial products.

In the mid 90s advisers started to focus on how they could best meet the needs of their clients and the transition began from a purely transactional relationship to an advice based one.

Since then, steady progress has been made and today, advisers are qualified to deliver holistic advice solutions to their clients – a situation where advice, not products, is at the centre of their value proposition.

The development of more complex products and investment options, together with increasingly complex superannuation and taxation systems, had a large role in changing the ***sales only*** approach of the early years.

More recently, federal legislation such as the Financial Services Reform Act, has meant that the financial advice industry is taking its final steps to being a fully qualified profession – however issues remain.

On the funds side, there have been broad changes to the collective investment industry in Australia – such as life offices becoming directly involved in funds management.

These changes signalled the arrival of defined contribution, accumulation funds and the development of the first master trusts.

It was a time when the investment preferences of retail investors were also changing.

Australians were seeking more sophisticated savings vehicles than traditional passbook accounts and term deposits and becoming aware of the advantages of diversification and not having all of your wealth tied up in the family home.

Responding to this trend, the banking industry sought to capture the alternative flow of investment dollars and the change in savings patterns.

Today, each of the four major banks either own or have a joint venture arrangement with a major funds management organisation. In the case of my company, the National Australia Bank bought MLC from Lend Lease in 2000.

MLC provides investment and insurance products and supports advisers who deliver quality advice.

Today, MLC manages more than $84 billion on behalf of customers.[4]

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[4] As of Sept. '05

Industry Structure

This brings me to what is a much discussed issue in wealth management circles – **its structure**, or what is often referred to as the ***vertically integrated ownership*** of the industry.

By this, I mean a large financial institution, typically a bank, owning a funds management / product manufacturing business as well as a distribution channel, such as a financial planning dealership.

In the case of the NAB, this would be NAB's ownership of MLC and MLC's ownership of the licences for Garvan Financial Planning or Godfrey Pembroke Limited. NAB also has a large number of financial advisers located in the branch network.

Today, all advice businesses are regulated by ASIC, mainly by FSR. We have a disclosure regime that requires all recommendations be in the best interests of the client and fully documented.

In my view, the evolution of this ownership structure has been a positive development. It is also a structure that many customers agree with and support.

I think it is a good thing that prudentially regulated institutions with sound reserves and strong brands have invested in the advice industry.

For the customer, large institutions are better able to deliver on efficiencies of scale and offer an end-to-end investor experience from an integrated product suite.

The large size of these institutions such as NAB is a measure of their success, they have grown with the number of customers they attract.

A large institution has an interest in supporting their products and services across its range of businesses.

Investors who have fallen foul from the actions of unaligned or ‘independent’ advisers do not have this security.

Most importantly, the structure has helped transform the funds management and advice industries from what was almost exclusively a sales driven, pure product offer to one that is now focused upon a *service based delivery of its benefits*, in particular, holistic financial planning advice.

Again, a change that is to be welcomed.

However, elements of this structure have attracted the attention of the corporate regulator, ASIC, and consumer groups; specifically, how financial advisers are paid within this ownership model.

Some observers of the industry contend that because product manufacturers own the majority of the Australian financial advice industry, then advice from that source is some how tainted due to the manufacturer paying the adviser by way of commissions.

ASIC has released three papers[5] in the last 12 months following separate reviews of the industry's selling and advisory practices.

[5] ***Super Switching Report***, ASIC, August 2005 and ***Shadow Shopping Report***, ASIC April 2006, Conflicts of Interest Discussion Paper, April 2006

The reports have been timely reminders to wealth management companies about the possible consequences of conflicts in business practices.

ASIC’s concerns centre on the integrity of recommendations by advisers involving related parties.

I agree with ASIC - any system that pays an adviser more for one particular product over another has the potential to influence the advice outcome and this may not be in the best interests of the client. This practice is wrong and should not be defended.

The content of the ASIC reports is reflective of wider commentary surrounding the issue of commission-based remuneration for institutionally owned or aligned financial advisers.

The industry has taken steps to manage and in some cases remove these conflicts and biases. This has been done by disclosure. But disclosure is not enough.

Conflicts can be removed but the ongoing use of commissions as payment for advice means the perception of conflicts remains.

The commission structure for financial planners and product manufacturers served a purpose for a long time. It enjoyed wide support, and facilitated much of the industry's early growth - however that time has largely now passed.

Although the payment of commissions to financial advisers remains a legal and convenient option for many industry participants, the commission structure no longer delivers the value to the industry it once did.

In fact, it is damaging the industry and in my view, preventing advisers from being regarded as members of a fully-fledged profession.

I believe that this young wealth management industry has an important decision to make if it wants to one day be an old one.

Either, the industry can continue to rely upon legal and technical means to answer rising consumer and regulatory concerns about commission payments or it can transition to a new framework.

A framework that aims to put TRUST at the centre of the adviser – investor relationship.

Central to this new framework is the industry adopting a more transparent and better-understood remuneration system for financial advice.

Complex subject matter and the need for professional knowledge are reasons why many people seek financial advice in the first place.

It is not sustainable for advisers to be paid by a system that depends upon an equally confusing and complex disclosure regime.

A better model is a remuneration system based on law but also supported by the trust and confidence of the client.

I believe the decision to include a ***fee-for-service*** option needs to be considered by all financial advisers.

In practical terms, this means the unbundling of advice, product and administration fees as separate line items on a client's annual statement.

Under the commission structure, these three charges appear as a single percentage figure on an annual statement, rising each year with the account balance.

As a result, the remuneration arrangements between investor and adviser are sometimes not revisited….. discussed …… or worst of all, not understood.

The process might be legal and convenient for the industry, but it does not benefit all parties in the relationship.

One of the arguments often put forward in defence of commissions is that their removal would prevent some people from being able to afford advice.

In the modern world of advice commissions are paid by the customer. If a customer agrees to pay 2% for the advice, whether it be paid for by a commission, an adviser service fee collected by the platform or they write a cheque, it is the same thing. 2% is 2% is 2%. The difference is it is paid for by the client, not the manufacturer.

The industry should never forget the enormous duty of care placed on it by the decision of a majority of Australian's to defer the management of their superannuation funds to third party professionals.

It is crucial the industry honours that duty by presenting all investor information, including adviser remuneration details, in a simple and accessible format.

This would go a long way in fostering **trust** between the investor and the adviser.

At MLC, we have already started this process.

In March this year, MLC launched MasterKey Fundamentals – a fee for service version of our Masterkey Platform where no commissions are built into the fees.

Largely, this is a response to the market; in 2005, 30% of MLC's business came from advisers using a fee for service model; we expect this to increase again this year.

I acknowledge that a transition from commissions to fee for service presents challenges for advisers and will need the support of manufacturers and fund managers.

However, it is not difficult for all new clients from today to pay a 'fee-for-service'. I urge all financial advisers to structure their business models to accommodate fee for service – sooner rather than later.

This would put advisers on a better professional footing and enable the wider industry to put this controversy behind it as it prepares to meet its competitive challenges.

Industry Funds

In addition to the obvious trust reason there are other advantages. A fee for service payment system would also better position the industry to challenge the claims made by the industry funds.

In recent times, some of the rhetoric from various industry funds has, in my view, not been clear.

Investors would be well served if advocates of industry funds ensured that, when they promote their product with headline cost comparisons against retail funds, they make it a genuine "apples with apples" exercise. It seems to me that rarely, if ever, is this actually the case.

Comparisons that merely highlight fees and commissions within retail funds without referring to what those charges pay for, lack credibility and do not serve the investor well.

I am encouraging the wealth management industry to lead with initiative, not await legislative or regulatory action.

Regulation can be a cumbersome and blunt instrument for change and brings many unintended consequences.

Ideally, it ought to be the culture of an industry or company that should inform market behaviour – not reactive, regulatory responses.

Eliot Spitzer, the New York State Attorney General, who has lead significant actions against that State's investment banking and mutual funds industries, is of a similar view.

Notwithstanding the successful prosecutions he has lead against these industries; he thinks Government ***"..is the last entity you want to see catching these sorts of problem.."*** and in an ideal world, "..***you don't want the Government to be that invasive***.."[6]

Whether it is the United States or Australia, the lesson is the same: it is incumbent upon industry to operate and organise itself in a fair and responsible manner – if for no other reason than **it's good for customers and therefore it's good for business!**

The industry is suffering from what I call CORPORATE GRIDLOCK, where the participants are locked into an operating model which no one player wants to break, in the fear of losing a competitive advantage. This needs to change.

I want to make clear that I am not advocating that commissions end tomorrow or be banned, I believe in a free-market and giving people choices; rather I am urging advisers to consider the long-term benefits of a fee for service model and get ahead of the curve.

ADVICE

I would now like to make a few comments about advice.

MLC has been a long time advocate of the fundamental value of financial advice.

Whether it is estate or retirement planning, portfolio management or investment strategies; the services of a qualified financial planning professional can significantly add to a person's wealth and properly protect them.

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[6] '*How to restore the fiduciary relationship*', Harvard Business Review, May 2004

There are plenty of examples to consider, such as the self-employed landscaper who is recuperating from a car accident.

Thanks to an income protection insurance policy that was recommended in his financial plan, he can rely upon this income and support his family while he is unable to work.

Or a couple approaching retirement with enough savings courtesy of investment strategies recommended by their adviser, such as gearing, some years ago.

I have no doubt that if a greater number of Australian's consulted a qualified financial planner, Australia would be better prepared for what the Treasurer calls our '*demographic date with destiny*'[7].

Chief among the challenges of our ageing population is the readiness of the baby boomer and other generations to adequately fund their retirements.

As a nation, we have been caught short and have a significant retirement savings deficit – or *gap*.

Published research[8] by the ***Investment and Financial Services Association*** (IFSA) found that Australia had a retirement savings gap of approximately $452 billion.

This is a problem that the country has yet to fully comprehend or start preparing for. The retirement savings gap presents the government and our industry with enormous public policy pressures and parallel challenges for the wealth management industry.

With rising life expectancy, improving medical technologies and increasing demand for world's best medical facilities, might we all have to rethink the traditional uses of retirement savings?

As we approach retirement, we might have visions of our superannuation paying for the occasional holiday, helping out the grandchildren or indulging our hobbies.

This won't be the case for all of us.

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[7] Hon P. Costello, Treasurer, Budget Address to the National Press Club, May 2005
[8] *Retirement Earnings & Long Term Savings Policy Options*, IFSA, March 2006

Last month in his CEDA address, the Treasurer, Mr Costello gave a telling statistic; a 65-year-old male's usage of pharmaceuticals is 19 times that of a 25-year-old.

This is very confronting given that the baby boomer generation is moving en masse to PBS eligibility.

Treasury's 2002 **Inter Generational Report** reported that Commonwealth spending on health is projected to increase to 4.3 per cent of GDP by 2011-12 and to 8.1 per cent of GDP by 2041-42.

Will a holiday in retirement need to give way to buy the latest arthritis or cancer drug not on the PBS, or pay for a hip replacement that is needed quicker than the waiting lists will allow?

People in their 40s today can reasonably expect to live past their 80s, into their 90s. For children born today, the expectancy is 100 years.

As medical advancements extend life spans, will the wealth management industry be faced with an accumulation period of a superannuation account that is less than the draw down phase?

Our industry needs to consider our product response. Including product innovation, flexibility.

Treasury is currently working on an updated Inter Generational Report for 2007 and the wealth management industry needs to be a participant in any response.

The Operating Environment

The Federal Government has delivered some good policy in recent years, no doubt mindful of the shortfall in Australia's retirement savings.

Initiatives such as the new *Transition to Retirement* rule permits workers to draw down on their superannuation without having to leave the work force permanently - a great option for those seeking to have their super last longer.

Similarly, allowing the splitting of superannuation contributions between spouses provides single income families with the tax benefits of two working individuals and is proving a terrific initiative for women in particular.

The co contribution scheme for low-income income earners has also proved successful with the Government contributing $1.50 for every $1 contributed by eligible employees on a voluntary basis.

In the first year of the co–contribution scheme the Government projected expenditure of $115m, the final figure was $309 million.[9] Its latest projection is $790m in 2007/08.[10]

All of these developments are welcomed, and we encourage the government to continue to review the taxation arrangements on superannuation in a fiscally responsible way. This could include a review of the contributions tax.

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[9] EM for the Superannuation (Government Co-contribution for Low Income Earners) Bill 2003 and the Superannuation (Government Co-contribution for Low Income Earners) (Consequential Amendments) Bill 2003 (circulated 29 May 2003), and *Budget Paper No. 2 2004–05*, p. 266

[10] The Hon. P Costello MP, Treasurer, Explanatory Memoranda to the Superannuation Budget Measures Bill 2004, p. 3.

Employer and certain other contributions are taxed at a rate of 15%.

It is a tax that affects everyone, and can work against good retirement saving behaviours.

The abolition of the superannuation surcharge in last year's budget has been a good thing for Australia's retirement savings.

In next week's budget, the Government has the opportunity to do more to help Australians close their retirement savings gap.

All I wish to say this close to the budget is that reducing super taxes is one of the few tax measures that can positively influence savings behaviours and deliver long term value beyond the here and now, for all Australians.

Last month's report of the Prime Minister's Regulation Task Force discussed the complexity of Australia's tax treatment of superannuation, and its history of piecemeal changes, multiple points of taxation, in particular, with respect to end benefits.

The Taskforce's report recommended that ***"..the Australian Government should give high priority to comprehensive simplification of the tax rules for superannuation."***[11]

This is a good signpost for the future and I would encourage the Government to follow through on the Taskforce's recommendation.

Already, some good progress has been made in addressing some of the regulatory and compliance burdens in the financial services industry.

In particular, I wish to commend the reforms of the Parliamentary Secretary to the Treasurer, Chris Pearce, first for last year's FSR Refinements package and now with the Regulation Review Consultation Paper.

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[11] REGULATION TASKFORCE: *Reducing the Regulatory Burdens on Business - "Rethinking Regulation". Recommendation 5.51*

Conclusion

The Australian Wealth Management industry is a young industry, already made strong by its size.

The need for financial advice will only increase as the wealth and savings of Australians continue to grow.

The industry has reached a crossroads and we need to continue to work together as we confront issues such as the ageing population, the increasing health burden on government and the wonderful opportunity we have to close the retirement savings gap by allowing more Australians access to quality financial advice.

If we make the right decisions now and build trust with the community – we will continue to grow and be in a position to assist the country meet the demographic challenges that await us all.