Summary version

Systemic impacts of 'big super'

An investigation of the systemic effects of a large superannuation system containing large funds

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This note summarises a comprehensive report on the systemic impacts of 'big super' that considers the potential implications of a large superannuation (super) industry containing some very large funds for the Australian economy, financial markets and/or population. We describe the report and draw out the key themes and findings. Please refer to the full report for details.

Report overview

Increasing attention is being directed at whether the activities of super funds may have 'systemic' effects, with particular focus on the potential for adverse impacts. Against this background, we contribute a comprehensive report that takes a systemic perspective and aims to identify and discuss all related issues. We set out to provide a balanced account by highlighting beneficial, detrimental and debatable aspects of big super. That is, the report is about much more than just systemic risk.

The word 'systemic' alludes to an overall system and is usually taken to imply a focus on interconnections between system components. We apply a different and wider lens. We define 'systemic' for the purpose of the report as: "*aspects of the super system that have widespread and significant implications for either the Australian economy, Australian financial markets or a significant number of Australians*".

Figure 1 (see over) frames up the interactions that are considered between three broad areas – the Australian economy, financial system and/or population; the superannuation sector (the collective of all funds); and individual super funds. Aspects that are denoted systemic need to have a significant impact on one or all of the three 'macro' components identified in the top box in Figure 1.

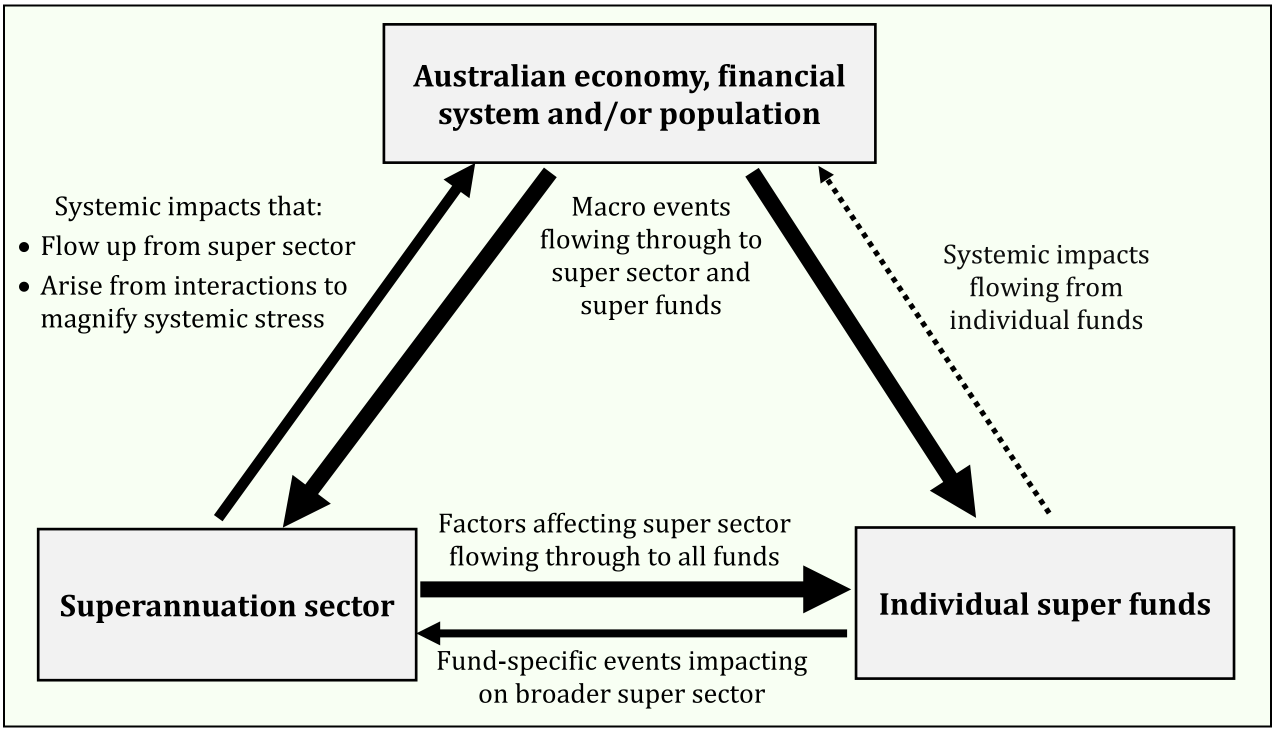
The width of the arrows that interconnect each area in Figure 1 represents our evaluation of the degree to which the interconnection is consequential. For instance, we consider impacts flowing from the broader macro environment to be quite consequential for the super sector and individual super funds. Meanwhile, the systemic impacts flowing up from the super sector are seen as moderately consequential and those flowing up from individual funds to be of limited consequence.

Key theme #1: Big super is a boon overall

Australia benefits from having a large super industry for four main reasons, which together well-outweigh any problems and risks:

- Super establishes a significant pool of retirement savings that may not have otherwise existed.
- Super funds operate as a vehicle for professional management of those savings by fiduciaries who are subject to various regulatory requirements.
- Super funds are well-positioned to act as effective stewards of the capital that they invest.
- The super sector rounds out the sources of finance within the Australian economy in ways not well-accommodated by other providers such as banks and direct investment by private investors.

Figure 1: Framing the interactions examined



The benefits of big super might be appreciated by considering the counterfactual. In the absence of the super industry having developed into its current form, many individuals would be left to their own devices in saving for retirement. The outcome probably would have been:

- Many people under-saving for their retirement;
- Poorer decisions by those individuals who attempt to invest for themselves;
- Heightened agency risk and higher fees for individuals who invested via commercial operators rather than fiduciaries; and,
- Greater potential exposure to scams and fraud.

In short, Australia and Australians are much better off with a large super industry than without.

Key theme #2: Super as an unlikely source or propagator of systemic stress

A key theme of the report that sits at odds with the tenor of current commentary is that we view super as having limited consequences for systemic risk. First, we see super as an unlikely *source* of major systemic stress. This reflects an absence of financial leverage and a lack of clear mechanisms for spreading problems from super to the broader system. Basically, problems within super may cause harm to fund members, but the damage is likely to remain within the sector's perimeter. While any harm would be potentially painful for the members involved, super is unlikely to be the root cause of major disruption in the Australian economy or financial markets.

We are more open to the idea that super might *magnify* stress arising from elsewhere. This could occur if the super sector becomes a forced seller of assets and/or withdraws funding from a key sector. However, super could equally act as a stabilising force through buying assets most under pressure or providing funding where it is most needed (as in the GFC). What happens will depend on how the situation unfolds. In any event, we consider it unlikely that super would be a major propagator of stresses across the system.

An important element in our stance is that we see limited potential for broad impacts to arise from a *liquidity squeeze* within the super sector or a run on a large super fund. The notion that super funds offer redemption at call with up to 30%-35% invested in unlisted assets coupled with potential for cash calls on FX hedges has been highlighted as a possible source of liquidity risk. Potential for this situation to result in major liquidity strains is limited by:

- Low member propensity to switch or redeem;
- Accumulation balances needing to remain within the super system;
- Asset sales merely transfer assets, which may lead to wealth transfers if assets are sold cheaply, but likely quite limited wealth destruction;
- Liquid assets can be sold to satisfy cash demands, merely resulting in 'out-of-shape' portfolios; and,

- The authorities can take action if required, e.g. APRA can suspend redemptions, RBA can step in if super funds withdraw funding from the banks.

While a sector-wide liquidity event or run on a big super fund could cause harm to the members of the funds or fund involved, it is hard to envisage significant systemic impacts arising given the above.

Nevertheless, super does have potential to give rise to adverse consequences that could impact on many Australians. Our two main areas of concern in this regard are discussed as theme #3 and theme #4.

Key theme #3: Super serves to heighten exposure to economic and market risk

Super funds expose their members to economic and market risk in order to seek higher expected returns, with a sector weight in growth assets of about 70%. This is entirely appropriate, as it boosts expected outcomes for members, e.g. likelihood of higher income in retirement. Such exposures also come with some danger. We sense that the risks associated with economic and market exposure are underappreciated, probably because the lived experience is that markets have always gone up. History contains ample examples of risk assets such as equities suffering declines that result in substantial loss of wealth spanning multiple decades. Never say never!

While extended weakness in markets is unlikely, if it were to occur the impacts could be dire for the wealth, retirement income and possibly confidence of super fund members. Further, any extended loss through super is likely to occur in conjunction with major economic problems that are causing broader harm. Super is effectively doubling down on economic exposure on behalf of its members.

Key theme #4: The sector's operational infrastructure is an area of concern

Underdeveloped operational infrastructure is our other main area of concern. Failures in member servicing – as highlighted by regulators and media – stand as an indication that something is not quite right somewhere in the system. We suspect this may reflect issues with systems, processes and staffing on the operational side, particularly in relation to member administration. The likely root cause is that super is transitioning (quickly) from something of a cottage industry into a major financial sector but is struggling with legacy systems and processes.

We were struck by the almost universal agreement that there were problems in administration in receiving feedback on the report. Nevertheless, the exact nature and depth of any problems in the sector's operational infrastructure is not very visible. There is a need got both the authorities and super fund boards to get to the heart of the matter and identify required actions.

Upgrading the operational infrastructure in the industry will be challenging and is likely to entail considerable cost, time and effort. We would like to see greater recognition of the situation, rather than presuming the underlying problems can be easily addressed and that 'super funds are failing their members' simply because they are incompetent or uncaring. What matters is whether super funds are working towards addressing any problems.

Other aspects covered

Our report covers a wide range of other aspects. We provide a very brief overview of each and invite readers to explore them further via the full report. These other aspects typically offer limited potential for systemic impacts of any major significance and/or have mixed or debatable implications.

- **Foreign exchange (FX) exposure** – FX amounts to a significant exposure for super funds. It is difficult to see how either direct FX exposure or FX hedges of super funds could be a major source of system stress, especially as any liquidity impacts should be manageable (see key theme #2).
- **Concentration of service suppliers** – The super industry relies on a limited number of suppliers in custody, insurance, consulting and cloud computing (as well as member administration). It is hard to see how these relationships could result in significant harm or disruption to the system.
- **Vulnerability to scams** – While scams are a major concern in themself, the impacts tend to be felt by those affected rather than the overall system.
- **Common approaches to investing** – Super funds tend to invest in a similar fashion, giving rise to the possibility of herding and potential reduction in market depth and resilience. While some systemic impacts may be expected, they should be limited by the presence of other investor types.
- **Unreliable source of funding** – We hold some concern over the potential for 'feast or famine' cycles in the funding provides by super as assets fall in and out of favour. While there is potential for harm within any sectors affected, any systemic impacts will depend on the size of the sector and the extent to which other funding sources exist.
- **Loss of confidence and trust** – Any loss of confidence and trust in super funds could play through via outflows and diminished ability of

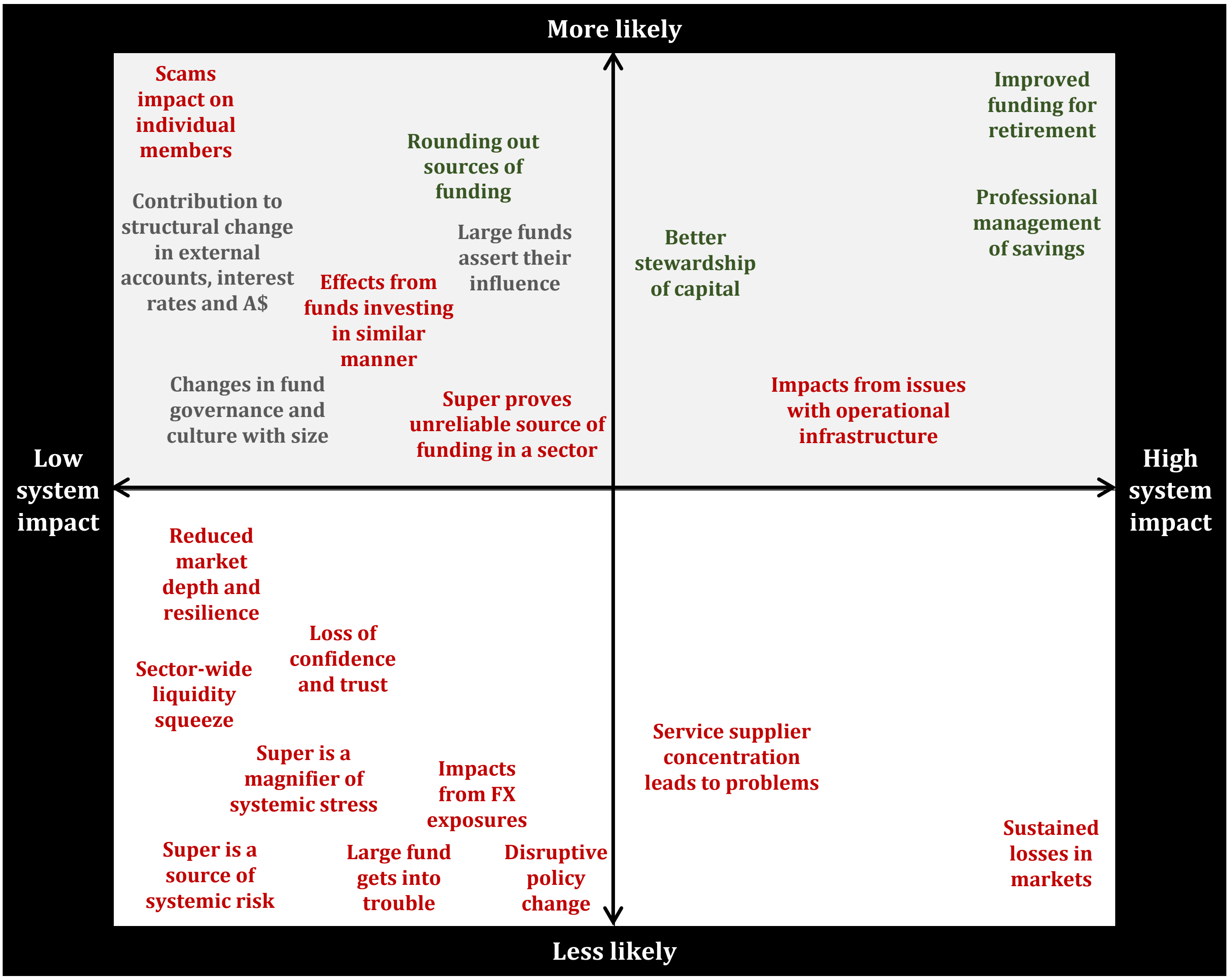
super funds to effectively service their members. While such developments would be disruptive, major systemic impacts are unlikely.

- **Large fund getting into trouble** – A large fund getting into trouble, potentially involving a run by its members, would cause harm to the members of that fund but is unlikely to be a systemic event.
- **Governance, management and culture** – The way that super funds are managed is evolving as super funds transition into major financial organisations. The impacts are unclear and likely mixed, and probably systemically marginal.
- **Influence** – Large super funds wield significant influence over their investments and possibly policymakers. Whether this influence is used for good or ill is uncertain. Either or both is possible.
- **External linkages** – The growth of super may have contributed to Australia becoming a net capital exporter, leading to a shift in interest rate differentials and the A$-commodity link.

How it all lines up

Figure 2 maps out the potential systemic impacts that could arise from the aspects identified and discussed within the report. Each aspect is notionally positioned according to likelihood of experiencing a systemic impact (vertical axis) and the potential strength of any impact (horizontal axis). Aspects with potentially beneficial systemic impacts appear in **green**, and are skewed towards the upper right reflecting an assessment that they are relatively likely and/or relatively strong. Meanwhile, aspects with potentially adverse impacts appear in **red** ,and are greater in number but tend to sit to the left and lower in the diagram as they are considered either of lesser likelihood and/or lower magnitude. The overall mapping conveys a message that big super is beneficial on balance, with a few major benefits being squared off against more minor problems and threats.

Figure 2: Likelihood and strength of potential systemic impacts from 'big super'



Legend**: Beneficial effects in **green**, potentially adverse effect in **red**, mixed effects in **grey

Recommendations

We offer recommendations for policymakers and regulators, super funds and the media that flow from the discussion in the report. Figure 3 provides a list. All recommendations are offered with the caveat that some suggested activities may already be being undertaken by those concerned of which we are unaware (for which we apologise). Refer Section 7 of the report for more detail on the recommendations.

Figure 3: Recommendations

For policymakers and regulators
Implementing policy change • Consider systemic impacts • Provide notice of policy changes, if at all possible **Areas where attention might be refocused** • Raise attention on system-level matters • Consider systemic impact of YFYS performance test • Take care not to undermine confidence in the super system **Potential points of vulnerability to investigate** • Operational infrastructure • Scams • Concentration in service providers **Matters where prior preparation seems required** • Possible run on a super fund or funds • Overseas operations: monitoring, regulation, contingency planning **Issues to monitor** • FX hedging • Use of influence by large funds **Other topics to research** • Impact of super on external linkages, specifically interest rates and A$ • Reliance of sectors on funding from super funds
For super funds
• **Invest and uplift practices** in two areas in particular: - Operational infrastructure - Risk management practices, notably liquidity stress testing • **Industry collaboration** should occur in areas where issues are sector-wide, e.g. operational risk, cyber risk, scams, counterparty risk • **Guard against loss of confidence and trust,** i.e. social license to operate
For media
While important to hold super funds to account, we call for responsible reporting that avoids unnecessarily undermining confidence and trust in the super system: • Reporting should remain factual • Avoid drifting into emotive and inflammatory language that entices fear • Avoid leaving an impression the industry is universally failing when problems relate to individual funds; highlight both good and poor practice • Communicate significance of any developments rather than focusing on numbers without context, e.g. scale relative to the super fund or sector