Super Liquidity: Not so simple.

Liberal Senator Andrew Bragg (The Age, March 30) criticises super funds for their concerns about being able to meet emergency cash withdrawals by members without having to sell assets at their currently depressed prices. He argues that they should have held more cash and liquid assets as a result of scenario planning about possible risks.

His argument is unbalanced and unfair for a number of reasons. First, is it reasonable for super fund risk managers to base their portfolio allocations on the possibility of an unexpected and unpredictable sudden change in government policy? That change has led to the possibility of significant cash outflows of a magnitude which could not have occurred under the existing superannuation rules.

This is not to say that the policy change is bad, although (as explained later) there are better alternatives which could enable members to access needed cash without forcing super funds to sell assets at depressed prices. That alternative involves a policy change permitting government (Reserve Bank) liquidity support, and doesn't have to involve a government subsidy to "the super funds" (actually to their members).

Second, Senator Bragg appears to want super funds to invest, in "normal times", more in cash and liquid assets and less in illiquid assets. The likely consequence would be that returns to, and eventual retirement balances of, members would be reduced because of the "illiquidity premium" to which he refers. Generally, illiquid assets, such as direct holdings of infrastructure will provide a higher return to those investors for whom the cost of illiquidity (inability to rapidly convert the asset into cash) is lower.

Super funds are ideally placed to make significant investments of this sort. Without changes in policy such as being discussed here, they have a fairly predictable cash flow and long-term liabilities. Yes, members may switch between funds or investment options meaning that each individual fund needs to hold some level of liquid assets. But in optimising risk and return on behalf of members, it can be expected that relatively low cash holdings are optimal. Normally, they will also be able to sell share or bond holdings, at "non-fire-sale" prices to obtain further cash.

Third, surely, one of the benefits of the super system is that it creates long-term savings, capable of funding long term illiquid investment in infrastructure which Australia needs. That seems like a natural and good fit (as long as the super funds have the expertise to pick good long term projects). In this regard they are filling a gap left by our banks which, paradoxically, rely heavily on very short term finance to make longer term housing mortgage assets. That exposes them to liquidity risk, and in circumstances such as this, ability to access liquidity from the Reserve Bank is available by use of repurchase agreements.

Why doesn't Senator Bragg want similar facilities available to the super funds in the current situation? He appears to think that this would be like a "bail-out" where taxpayers bear the losses of a private financial institution if it fails due to excessive risk taking, but where the owners of such an institution reap the rewards if successful. But that confuses insolvency and illiquidity.

The common policy response if a solvent financial institution (such as a bank) has a liquidity problem is to provide liquidity support via the Reserve Bank using repurchase agreements. These are a loan by the Reserve Bank which is secured against assets (generally, but not necessarily, bonds) of greater value provided by the borrower. Because the asset ownership is temporarily transferred, and reversed at the same price when the loan repaid, the borrower gets cash but retains exposure to future changes in the value of those assets. The Reserve Bank, and the taxpayer, do not take on an unwanted, unmanageable, risk.

So, a sensible approach, would be to allow super funds to borrow from the Reserve Bank in this way in this crisis period – where extra cash wanted by members is needed because of the change in government policy. My policy preference would be to allow members to borrow from their super fund against the security of their member balances with member repayments of their loan to begin only when their incomes have recovered sufficiently. The super fund would get the needed cash from the RBA in the way described above. A zero interest rate could apply in both cases – although I think that would be anathema to Senator Bragg.

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