Superannuation Liquidity: Fallacies galore

A number of conservative politicians and commentators have recently attacked liquidity risk management practices of (particularly industry) superannuation funds. The trigger has been industry concerns about the cash flow consequences resulting from government policy changes allowing emergency withdrawals by members.

There are many ways in which the retirement income system could be improved (and hopefully the ongoing Inquiry will identify those). But many of the arguments advanced claiming poor liquidity management are, at best, based on faulty premises or logic.

There are four main fallacies which need to be addressed.

The first is the argument that good risk management, using scenario analysis should have led to super funds holding more cash and liquid assets. But is it reasonable to expect scenarios to be considered for situations which the law says cannot happen – such as the new emergency withdrawal option? Trying to allow for a (virtually infinite) number of ways in which laws might change (the "unknown unknowns") would be a recipe for paralysis.

If law or regulatory changes which could not be reasonably anticipated lead to liquidity problems, then it would seem incumbent for the law-makers or regulators to also consider feasible ways of providing liquidity to offset those problems. Allowing some level of access by super funds to liquidity provided by the Reserve Bank (RBA), as occurs for banks, is an obvious response.

A second fallacy is the argument that the need for super funds to sell assets to meet cash withdrawals by members won't have adverse effects on asset prices. This argument claims that the volume of likely asset sales such as equities is small relative to turnover on the ASX. As Economics 101 classes demonstrate, there can be significant price movements without there being a significant volume of transactions. All it takes is for investors to know that there are sellers needing to offload assets and demand contracts and prices can plummet. Access to liquidity from the RBA to meet member withdrawals would mitigate this problem.

A third fallacy is the argument that super funds should 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" in asset returns. 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 unpredictable 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. Having access to Reserve Bank liquidity to meet unexpected liquidity needs would also assist this socially beneficial allocation of long term savings to long term illiquid investments.

Fourth, it is argued that allowing access to RBA liquidity support would involve “bail outs” of badly managed organisations, with taxpayers bearing downside risk and cost of preventing insolvency of those organisations. But illiquidity is different to insolvency. Banks which rely heavily on very short term finance to make longer term housing mortgage assets are exposed to liquidity risk, and, provided they are solvent, in times of need are able to access liquidity from the RBA.

That liquidity support occurs by way of loans from the RBA secured against assets of at least equal value transferred to the RBA for the term of the loan (known as repurchase agreements). The RBA bears no or minimal risk of loss as long as it uses margin calls to ensure the value of assets held exceeds the loan balance.

In principle, a defined contribution super fund cannot be insolvent, since it is a form of managed fund, with no borrowings and where the value of liabilities (members’ funds) rises and falls with the value of the assets. RBA liquidity support is not a “bail out” and can be priced (a penalty interest rate) to penalise institutions requiring such support and avoid moral hazard concerns. In normal times this would be the case. But in the current crisis, the case for a penalty interest rate is no longer so apparent.

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