

Submission to the Productivity Review - 7 December 2016

To The Commissioners,
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<http://www.pc.gov.au/inquiries/current/productivity-review/make-submission#lodge>

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Introduction

The communists have won!

Or at least some of their big ideas appear to have come to pass.

Karl Marx wanted workers to own business and to have a better quality of life by sharing wealth.

Now, we have workers' pension funds which are among the largest owners of Australia's and the Western world's largest companies.

We also have transfer payments through the tax system, which pay for near universal health, education and welfare, and these payments generally are the largest part of government spending.

And all this has happened since 1900!

I suggest that this progress has been made possible in large part because of advances in productivity and innovation.

Where next?

It seems to me that we are embarking on a new period of dramatic change in society and business - the digital age, the fourth industrial revolution, the internet generation, the gene and bio-science revolution, the age of disruption - as better ways of delivering services and improving living standards seem to emerge daily, and quickly replace established jobs and ways of doing things. These changes represent great opportunities for productivity gains, and losses, in my view.

In America, many of the largest companies on the stock exchange did not exist or were small, only a decade ago: think Facebook, Amazon, Netflix, Google/Alphabet, Uber, etc.

In Australia we have missed out. Most if not all of our largest companies on the stock exchange are long established businesses. I do not see Australian equivalents of the new American ones cited above.

So let us take a long-term perspective on how to catch up, to foster productivity through innovation and globally competitive growth, and better enable Australia to prosper.

Challenges for Australia

Some of the challenges:

Your paper, at page 10, identifies Australian company management as capable of improvement.

To identify other improvement opportunities, I suggest you refer to firms like the large and respected Scottish investment management company Baillie Gifford, which is a leading global investor in new age companies like the American ones cited above. Businesses like these American ones now offer some of the greatest opportunities for improved productivity and living standards, I believe. Can Australia join the party? Which parts of our economy may offer greatest potential? Baillie Gifford identifies four areas, amongst others, which they think offer particular potential for new and giant size companies to emerge:

1. Medical care/medical technology/biomedical science especially gene sequencing.
2. Energy uses and transportation: especially solar energy cost effectiveness, electric cars, self-driven cars and batteries.
3. E-commerce, including so called 'fintech' financing solutions for better retail customer and small business financing. Internet retail sales are estimated at 10% of total in U.K., 8% in USA and 6% in Australia. The potential seems significant.
4. Unlisted or private companies, which can take a longer-term approach to innovation, business building and investment than the relatively shorter-term horizons and assessments usually involved with stock exchange listing.

<https://www.bailliegifford.com/individual-investors/literature-library/funds/investment-trusts/scottish-mortgage/summary-of-the-scottish-mortgage-agm-2016-including-full-transcript/>

If the areas noted above are among the better long-term productivity

growth opportunities, then how does Australia prosper from them over the long run?

I suggest we have great potential to improve - in all the areas identified by Baillie Gifford, as well as management.

In the context of your productivity work, it seems most useful to focus on what changes to institutional structures in Australia might be helpful.

Recommendation to Improve Productivity and Innovation - How can Australia's Institutions Help?

Boards, management and people must be encouraged to take risks on productive innovation, and this may be assisted greatly I suggest, by encouraging more supportive institutional structures.

How many Australian regulators and government departments have a 5-10% budget commitment to helping create the institutional structures and regulations which will enhance long term productivity and innovation? How many are requiring the private companies they supervise to establish structures that encourage productive innovation? How many go out and make speeches advocating productive innovation? Think APRA and ASIC, just for a start?

An excellent example of this happening at a government level is in the last place one would expect it: the world's biggest bank regulator!

The Office of the Comptroller of the Currency (OCC) in the USA.

The OCC views 'fintech' (oxford dictionaries online define 'fintech' as computer programs and other technology used to support or enable banking and financial services) as a desirable way to improve the standards of living of many Americans. They want to help 'fintech' develop prudently and successfully. They are encouraging innovation and competition with, and by, the sometimes conservative, entrenched and established banking system! A well-resourced 'Office of Innovation' has been established in the OCC.

"During remarks at the Georgetown University Law Center, the

Comptroller described several reasons for considering special purpose national [banking] charters for fintech companies. "First and foremost, we believe doing so is in the public interest," Comptroller Curry said. "It is clear that fintech companies hold great potential to expand financial inclusion, empower consumers, and help families and businesses take more control of their financial matters."

"The number of fintech companies in the United States and United Kingdom has ballooned to more than 4,000, and in just five years investment in this sector has grown from \$1.8 billion to \$24 billion worldwide."

"At the Office of the Comptroller of the Currency, we are making certain that all institutions with federal charters [mostly larger American banks] have a regulatory framework that is receptive to responsible innovation along with the supervision that supports it. Since last year, we have conducted extensive research and discussions with technology companies, banks, community and consumer groups, academics, and other regulators. We articulated clear principles to guide the development of a framework for responsible innovation, sought public comment, and held a public forum in June to discuss the issues surrounding responsible innovation."

[\[https://www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-152.html\]](https://www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-152.html)

[\[https://www.occ.treas.gov/news-issuances/speeches/2016/pub-speech-2016-152.pdf \]](https://www.occ.treas.gov/news-issuances/speeches/2016/pub-speech-2016-152.pdf)

A skeptic might observe that the Comptroller simply may be 'dressing up' the public expectations of his office - to cover what is really a large-scale regulatory crackdown on fintech. However, this misses the point. The horse has bolted, as it were. The above numbers on growth of fintech tell the story. The OCC sees public benefit and the inevitability of faster change, wants to facilitate it, and wants the established public and private institutions to help make it happen in an orderly and beneficial manner.

ASIC, APRA and the RBA have innovation commitments that indicate they also see the need for innovation. My point is that it seems the OCC has decided to go even further and has allocated significant resources to encourage and facilitate large scale change in the public interest - it appears the OCC is pro-actively helping make this change happen, responsibly.

My question is whether it is time now to ask our institutions to do more? Can we more actively and comprehensively facilitate change? Can we have similar policy to the OCC to encourage change, and can we look at requiring or encouraging private banking and other institutions to do likewise? It seems the OCC is doing all these things.

Imagine if this OCC approach, or something like it, became an APRA policy and in time a whole of government policy?

My recommendation is that Government considers instructing APRA, ASIC and the RBA and all government departments and statutory bodies, to adopt and fund Innovation Offices modelled on the OCC policy - to help establish institutions and regulatory structures, which encourage and facilitate productive innovation by industry.

Recommendation on Adjusting Incentives for Individual Investment in Productive Enterprise

I recommend the Commission look into the long-term benefits of adjusting our national policy so as to encourage more enterprise investments by individuals, so that more capital formation is encouraged in areas which offer long-term productive innovation.

The reason for this recommendation is that it seems to me that our long-term prosperity may be enhanced if policy can be adjusted to encourage more investment in businesses which generate positive and growing cash flows, and long term employment.

Capital allocation by Australians individuals to housing seems high, and home ownership levels are also high, if challenging for younger Australians. Can we find an orderly and fair way to adjust the incentives which helped bring this about? Can we perhaps maintain first

homeowner and affordable dwelling construction incentives, and adjust other incentives?

Official policy offers significant incentives for housing investment:

1. Bank capital adequacy requirements for mortgages are lower than for other forms of lending and therefore more profitable for banks per dollar loaned than other types of lending,
2. Home owners have capital gains tax free status when they sell their homes regardless of how high the sale price may be, and
3. Investors can claim against tax for expenses on investment housing and thereby reduce the income tax, which otherwise they would have to pay.

In addition recent monetary policy and the decline in interest rates, roughly since about 1990, have contributed to exceptional appreciation of house prices.

Perhaps in future some appropriate share of this appreciation in house prices might be subject to a new policy which would encourage individuals to transfer capital to invest in businesses, rather than keep their money in housing stock? This would be to help drive productivity by transferring capital to more productive areas.

Recommendation on Adjusting Accounting Standards and/Or Listing Rules to Advance Productivity and Innovation

Company statutory and listing rule reports to investors now are so complex that few except professionals can understand them. They also tend to be focused only on the past: the results of the latest accounting year or half year. My question is can they also provide some comment about the likely environment for long-term productive investment, and thereby confirm Directors' focus on longer term horizons and inform their owners and stakeholders?

I recommend that you consider whether adopting different accounting standards or listing rule disclosure requirement could enhance long-term productive investment.

For example, Directors might be asked to list and describe briefly in their Annual Reports the significant factors they believe are most likely to influence the company's productivity and sustainability over the medium to long term, say 5 – 10 years? It would be important to consult widely on such a proposal, to ensure it helps achieve the desired objectives, and is not onerous and can be done in a way that avoids disclosure of commercially sensitive information.

For example the Integrated Reporting organisation (“<IR>”) is global, and defines its objectives as follows:

“<IR> applies principles and concepts that are focused on bringing greater cohesion and efficiency to the reporting process, and adopting ‘integrated thinking’ as a way of breaking down internal silos and reducing duplication. It improves the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital. Its focus on value creation, and the ‘capitals’ used by the business to create value over time, contributes towards a more financially stable global economy.

[<http://integratedreporting.org/resource/international-ir-framework/>]

Recommendation on Improved Governance and Venture Capital Equity Funding Structures - and Case Study

Australia has a uniquely successful and large scale track record in risking equity capital on start up and development investment opportunities: our smaller company resources sector has been and continues to be funded largely by investors who take enormous risks in pursuit of enormous gains.

Let no one perpetuate the myth that Australia does not have a private equity and risk capital culture!

Ever since BHP shares went from under two pounds to over 200 pounds per share in the 1880s, Australians have seen how exceptional returns can be made from high risk and early stage resources investments.

The questions now are how to harness this culture of risk taking for the current disruption era, and do it prudently?

We have the capital.

Australia has a large pool of long-term capital, including in Self Managed Superannuation Funds (SMSF), mostly managed by individuals. These individuals include some the very people, I believe, who are more likely to invest in innovation, if suitable SMSF equity investments are available. The challenge is how to create sensible institutional structures through which they might prudently invest in high risk and high return opportunities, like the early stages of those opportunities described above by Baillie Gifford?

Unfortunately Australia appears to have a difficult track record of government sponsored equity investment structures: The MIS scheme for agriculture was a governance failure with in-built and unintended structural conflicts of interest. The Venture Capital Investment Company program, (I think it was called something like that) suffered from severely limiting official control over types of investment, had short term ten year wind up requirements, as well as durability, transparency and liquidity concerns for investors, and governance conflicts, if I recall correctly.

Few or none of the government sponsored industry Development Company's like AIDC, VEDC, and various Rural Banks seem to exist today. The long-term track record of Australia and its governments in establishing enduring institutions to support private sector innovation (outside the resource area) seems challenging? Governance (particularly regulations which have included unintended structural conflicts of interest like MIS schemes), durability and transparency seem to have been common challenges.

So a new institutional approach warrants consideration.

I recommend Government consider adopting a UK model which has been remarkably successful in mobilising equity investment into sensible long term and diversified portfolios of higher risk and innovative small ventures.

"Recent HM Revenue and Customs research found that three quarters of SMEs supported by VCTs [Venture Capital Trusts based on official

Enterprise Investment Schemes] had undertaken some form of innovation as a result of their investment. This was reflected in the survey findings."

[Page 8, <http://www.theaic.co.uk/sites/default/files/hidden-files/AICVCTFeedingthefledglingecomomyOct16.pdf>]

Official statistics show that Venture Capital Trusts in the U.K. are raising new equity funds for small business enterprises at a rate over 400 m. pounds per annum.

[https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/560389/161015_VCT_table_8.6_Funds_raised_and_Number_of_VCTs_Oct_2016_.pdf]

The UK has a special class of Listed Investment Companies, or Listed Venture Capital Trust Companies, which are eligible for tax advantaged equity investment by U.K. tax payers and which must invest in small business and venture capital. They have the best governance structure for the long term with a listed company board solely accountable to investors and which must comply with stock exchange rules (unlike most unlisted investment structures), are perpetual entities (unless wound up by shareholder vote) unlike most unlisted structures, and they must invest in a portfolio of investments, so diversifying the risk and making them a more prudent way to invest in high risk and high potential return businesses: not all the eggs are in one basket. Together these attributes offer an interesting proposition for prudent investors. It has worked.

"The Association of Investment Companies (AIC) has published its annual VCT survey feeding the Fledgling Economy: VCT 2015 Investment Review which analysed 409 [UK] companies which received VCT investment. Over 20,000 new jobs have been created across the country by SMEs covered in the report, with an average of 60 jobs created per company since VCT investment. Where VCT investment has been in place for over five years the average increase in jobs was 103 per company.

"In 2015 VCTs [covered in this report] provided £225 million of funds to 115 SMEs. 44 deals (totalling £131 million) were in companies that had not previously received VCT funding ('initial'

investments). 71 transactions (amounting to £94 million) provided further finance ('follow-on' investments).

Providing follow-on funding allows VCTs to respond to the changing needs of businesses as they grow.

VCTs successfully targeted the SME finance gap, commonly estimated as between £2 million and £10 million.

The sector's total assets exceeded 3 billion pounds.

[\[http://www.theaic.co.uk/sites/default/files/hidden-files/AICVCTFeedingthefledglingecomomyOct16.pdf\]](http://www.theaic.co.uk/sites/default/files/hidden-files/AICVCTFeedingthefledglingecomomyOct16.pdf)

[\[http://www.aicstats.co.uk/vct/index.asp\]](http://www.aicstats.co.uk/vct/index.asp)

Other examples of successful U.K. equity capital deployment into innovative businesses and using listed portfolio investment structures, include the following:

Allied Minds (ALM) with an equity market capitalisation (market cap) over 800m pounds [\[http://www.alliedminds.com\]](http://www.alliedminds.com)

4D pharma (DDDD), market cap 450m pounds
[\[http://www.4dpharmapl.com\]](http://www.4dpharmapl.com)

Imperial Innovations Group (IVO) 550m pounds
[\[http://www.imperialinnovations.co.uk/\]](http://www.imperialinnovations.co.uk/)

Ip Group (IPO), market cap 813m pounds [\[http://www.ipgroupplc.com\]](http://www.ipgroupplc.com)

3i plc, (III) with a market cap of 6.5 billion pounds -

"Starting with £15m capital in 1945, today 3i is a leading international investment manager, with £13.5bn of assets under management focusing on private equity, infrastructure and debt management."

[\[http://www.3i.com/about-us/our-history\]](http://www.3i.com/about-us/our-history)

Do take a moment to review the above websites. They are inspiring! Their existence in the U.K. suggests we should ask ourselves what institutional policies and structures we might create to encourage such innovative

company's in Australia.

These types of funds have policy and investment advantages. They are designed to be durable, in that the capital is permanent and the governance is best in class, tradeable and transparent, with all company law and stock exchange listing rules applied.

Retail higher net worth stockbrokers and financial advisers likely would be interested – as they advise SMSFs.

However, this proposal may be of less interest to some of the established fund managers and similar interests at large investment banks, as they may not have as much connection with SMSFs.

The figures and track record from the U.K. demonstrate this structure can work very well. And we have a large pool of SMSF funds that might find it attractive.

It seems an attractive proposition: to create enduring institutional structures, which drive productivity and innovation through small company and venture capital formation.

Recommendation To Improve Australian Management - Case Study of Superannuation

I believe we have some large-scale institutional structures which tend to inhibit best practice management and capital formation.

I also believe ‘the fish tends to rot from the head’, as it were.

So I am offering some challenging and generalised observations about the top end structures of our superannuation industry.

If we are serious about improving the quality of Australian management, then it seems to me we should adopt policies and institutional structures which tend to encourage best management practice and particularly which do not entrench structural conflicts of interest.

Unfortunately our preferred structure for managing Australia's superannuation funds has created significant potential for conflicts of

interest between investors (or members of superannuation funds) and those who look after their money.

Most super funds are in trust structures with legally separate entities which I believe are called Responsible Superannuation Entities (RSEs) managing the trusts. In many cases the RSEs are owned or controlled by large for-profit businesses or non-profit organisations which have different commercial interests and/or purposes from the members of the super funds. Very few RSEs have a majority of Directors of the RSE board which is elected by the members of the super fund. This structure gives rise to the conflicts of interest.

In my view this structural conflict is an unexploded time bomb, with national tragedy the likely outcome. Big money combined with structural conflicts of interest usually result in serious challenges and opportunities: to bring out the both the worst and best in us. This industry now manages over \$2 trillion.

I recommend adopting policy which over time requires that all RSEs be owned by the super fund entities for which they are responsible. This removes the conflict. This is the only way I see to ensure that top management is focused solely on the interests of super fund members. RSEs still could make arms-length commercial service agreements with third parties for administration and investment services, possibly and probably with some of the conflicted firms or organisations which currently own or dominate the boards of RSEs.

The other two reforms which in my view are required for the improvement of management and governance of super are to move over time to member election of all Directors of each RSE, and requiring all RSEs and super funds to comply with the disclosure requirements of the ASX listing rules, as they apply to all listed company's. Transparency and timeliness of disclosure by the super industry is poor, in my opinion, compared with the obligations of the listed companies in which they invest.

I recommend that it would be in the best long term interests of super fund members and Australia if over time we can remove the structural potential for conflict, adopt member election of all directors and require existing listing rule levels of transparency? Why not?

APRA has recognised the conflicts of interest I have described and made strenuous efforts to regulate and minimise the adverse impact. To me this is further evidence that a serious conflict exists.

For example, Superannuation (prudential standard) determination No. 7 of 2012

Prudential Standard SPS 521 Conflicts of Interest
Superannuation Industry (Supervision) Act 1993

[\[https://www.legislation.gov.au/Details/F2012L02230\]](https://www.legislation.gov.au/Details/F2012L02230)

The official Supersystem Review or 'Cooper Review' of superannuation included the following view:

"The Panel believes that the governance standards that apply to major listed entities are a reasonable starting point for the requirements that should apply to trustees and their trustee- directors, given the profound impact the latter have on the retirement incomes of members. This is particularly so in light of the growing influence that super funds have in advocating corporate governance practices for entities forming part of their investment portfolios that are not necessarily matched in their own practices. Turning the governance spotlight on trustees' own operations is, in the Panel's view, critical to the long- term sustainability of the superannuation system.

[\[http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/Reviews%20and%20Inquiries/2009/supersystem/Documents/Final%20Report/PDF/Final_Report_Part_2_Chapter_2.ashx\]](http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/Reviews%20and%20Inquiries/2009/supersystem/Documents/Final%20Report/PDF/Final_Report_Part_2_Chapter_2.ashx)

Banks also have encountered governance and management challenges by pursuing superannuation and wealth management businesses where conflicts of interest are involved. The RBA has commented as follows:

"Financial conglomerates [banks] have to consider and balance the interests of recognised stakeholders of the parent and other entities in the group. Since these interests can vary significantly and intragroup conflicts of interest may arise, there is potential for decisions to be made that are sub-optimal for particular divisions. "

"The major banks' wealth management activities have not lived up to initial expectations for income growth and cross-selling opportunities,

and are generating lower returns than core banking activities."

Most observers are aware of the bad financial advice, mis-selling and insurance claim rejection challenges the banks have had to deal with recently. These areas all tend to involve customer's superannuation, and all reflect conflicts of interest, albeit of a slightly different structural origin, and human nature.

[rba-bulletin-2016-09-banks-wealth-management-activities-in-australia]

The above recommendations will improve superannuation governance and reduce structural conflicts of interest. We have significant potential to improve management and productivity in a critical sector, I believe.

Background on Super - from APRA

"Industry overview

"Total superannuation industry assets were \$2.0 trillion as at 30 June 2015. Of this total, \$1,246.0 billion were held by APRA-regulated superannuation entities and \$589.9 billion were held by self-managed superannuation funds (SMSFs), which are regulated by the ATO. The remaining \$187.2 billion comprised exempt public sector superannuation schemes (\$131.1 billion) and the balance of life office statutory funds (\$56.1 billion).

At 30 June 2015, small funds which include SMSFs, small APRA funds and single-member approved deposit funds accounted for 29.3 per cent of total assets. Retail funds held 26.5 per cent of total assets, industry funds held 21.5 per cent, public sector funds held 17.3 per cent and corporate funds held 2.7 per cent.

At 30 June 2015 there were 155 APRA-regulated Responsible Superannuation Entities (RSE) licensees with 242 funds with more than four members under their trusteeship. These funds had \$1,243.9 trillion in assets and 28.0 million member accounts.

There were 1,130 directorships on boards of APRA-regulated trustees at 30 June 2015, with females accounting for 26.8 per cent and males accounting for 73.2 per cent of directorships. The average board size

was seven directors at 30 June 2015, with average director remuneration of \$40,884 per annum.

[<http://www.apra.gov.au/Super/Publications/Documents/2016ASBPDF201506.pdf#page6>]

[[Rba-bulletin-2016-09-banks-wealth-management-activities-in-australia](#)]

Concluding Comments

In summary, I believe there are some clear opportunities to improve productivity and living standards. What I have recommended includes:

1. Let us take a long-term perspective on how to catch up with world leaders in productivity and innovation.
2. Let us foster improved Australian productivity through innovation and globally competitive growth, and thereby better enable Australia to prosper.
3. In the context of your productivity work, it seems most useful to focus on what changes to institutional structures in Australia might be helpful.
4. My first recommendation is that Government considers instructing APRA, ASIC and the RBA and all government departments and statutory bodies, to adopt and fund Innovation Offices modelled on the OCC policy - to help establish institutions and regulatory structures which encourage and facilitate productive innovation by industry.
5. I recommend the Commission look into the long-term benefits of adjusting our national policy so as to encourage more enterprise investments by individuals, so that more capital formation is encouraged in areas which offer long-term productive innovation.
6. I recommend that you consider whether long-term productive investment could be enhanced by adopting different accounting or listing rule standards.

7. I recommend adopting policy which over time requires that all RSEs be owned by the super fund entities for which they are responsible. This removes the existing conflict. This is the only way I see to ensure that top management is focused solely on the interests of super fund members. RSEs still could make arms length commercial service agreements with third parties for administration and investment services, possibly and probably with some of the conflicted firms or organisations which currently own or dominate the boards of RSEs.

8. I recommend that it would be in the best long term interests of super fund members and Australia if over time we can remove the structural potential for conflict, adopt member election of all directors and require existing listing rule levels of transparency? Why not?

Thank you for taking the time to consider this submission.