

Productivity Commission Draft Report: Superannuation: Assessing Efficiency and Competitiveness (May 2018)

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General comments

Rent seeking

I am disappointed to find that the report fails to consider the issues of rent seeking and regulatory capture – as many believe this to be rife within the industry. These issues were raised in an earlier submission¹; the underlying research now having been published.² At very least, a consciousness of rent seeking would increase the suspicion suggested by Adam Smith's emphatic warning over 200 years ago:

The interest of the dealers, however, in any particular branch of trade or manufactures, is always in some respect different from, and even opposite to, that of the public. To widen the market and to narrow the competition is always in the interest of the dealers. ... The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous but the most suspicious attention.

A number of observers see the increased funding of social security systems as contributing artificially to the growth of the finance industry, both ideologically and in its share of GNP. In particular Blackburn³, notes that “the provision of pensions seems to be about distributing wealth, not creating it” but that “In fact decisions taken by fund managers, and deeply determined by the legal and incentive structures within which they work, shape the world in which we live” and that “the boring world of pension provision now fuels the glamorous world of high finance, property speculation, rogue traders, media and technology mergers, and stock exchange bubbles. He links its influence to the rise of finance throughout the economy:

the financial industry thrived mightily in the 1980s and 1990s, but largely at the expense of their host societies, The mega-salaries of the financial sector and the boardroom existed side by side with mass unemployment, social cutbacks and deindustrialisation.”

¹ https://www.pc.gov.au/__data/assets/pdf_file/0010/197983/sub009-superannuation-competitiveness-efficiency.pdf

² Taylor, S., Asher, A. and Tarr, J.A., 2017. Accountability in Regulatory Reform: Australia's Superannuation Industry Paradox. *Federal Law Review*, 45, p.257.

³ Blackburn, R., 2003. *Banking on Death, or, Investing in Life: The History and Future of Pensions*. Verso.

Of particular interest to Australia, he views compulsory membership of private funds with suspicion:

With the lopsided recovered of the 1990s the financial services industry became more aware of the inherent limits of the pool of voluntary savers in the domestic market. Part of the answer lay in exporting the 'Anglo-Saxon' model, its 'equity culture' and flourishing private pension funds. ... The World Bank alternative was centrally to comprise a novel solution to the problem of sales resistance – citizens were to be forced to buy savings schemes from commercial providers.

Conflicts of interest

The report does however refer frequently to conflicts of interest, which it acknowledges may be a cause or inefficiency and competitive failure. With respect, however, I do not believe it has got to grips with the essential problem with such conflicts. Perhaps the best known expression of the general law⁴ against conflicts spells it out as a bulwark against temptation:

It is an inflexible rule of a Court of Equity that a person in a fiduciary position, such as the respondent's, is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule. But I am satisfied that it might be departed from in many cases, without any breach of morality, without any wrong being inflicted, and without any consciousness of wrong-doing. Indeed, it is obvious that it might sometimes be to the advantage of the beneficiaries that their trustee should act for them professionally rather than a stranger, even though the trustee were paid for his services.

The question is whether there are benefits to the members of contracting out of the general law. Certainly there is a need for professional trustees to be paid, but this should clearly be regulated (by the members if not by government). The benefits of the *right* to use related parties is debatable, and one would have expected the report to have addressed the question. The issue is not actually whether members are worse off or not, but whether there are definite advantages. One of the reasons for the prohibition against conflicts is because any losses will be hard to quantify. Neither the PC, nor the SIS Act appear to be adequately cognizant of the failings of human nature, particularly when faced with the temptations of power and greed.

When the Act was first promulgated, trust deeds often specifically permitted conflicts of interest. This was subsequently prohibited by the introduction of S58A, but S58B then opened the door to even more conflicts:

58B Service providers and investments

(1) *This section applies if a trustee ... does one or more of the following:*

(a) *acquires a service from an entity;*

(b) *invests assets of the fund in or through an entity ... [etc]*

(2) *If the trustee, or the trustees, would not breach:*

⁴ https://en.wikipedia.org/wiki/Bray_v_Ford

(a) a provision of any ... [law, legal instrument or] ... the governing rules of the fund; or

(b) any covenant referred to in this Part ...

...in doing one or more of the things mentioned in subsection (1), the general law relating to conflict of interest does not apply to the extent that it would prohibit the trustee, or the trustees, from doing the thing.

There is more. In the general law, "... a contract made in breach of ... fiduciary duty, will be voidable ... unless"⁵ it is specifically permitted. But S55 (2) allows such contracts to stand regardless: "A contravention ... is not an offence and ... does not result in the invalidity of a transaction."

Similarly, in the general law: "... disgorgement of *profits* is a common, and unremarkable, remedy for breach of fiduciary duty."⁶ An example is the requirement of lawyers to disgorge their fees where a conflict is shown to exist. But S52 (3) limits the claim to any losses that have been suffered. "... may recover the amount of the *loss or damage* by action" ... and moreover S52 (5) reduces even this right. "It is a defence ... if the defendant establishes that the defendant has complied with all of the covenants."

These failures of the SIS Act were known before it was promulgated. The Australian Law Reform Commission (ALRC) and Companies and Securities Advisory Committee (CSAC) 1992 recommended, inter alia that prohibition of conflict of interest should be central to the new legislation. Interestingly, they also recommended, inter alia, that:

- the dominant purpose should be the 'provision of old age pensions' as another purpose might be unconstitutional (p 58), but section 62 permits any payments so the dominant purpose has become the payment of lump sums;
- members should have the right to dismiss the responsible entity in certain circumstances;
- members should be given an annual report disclosing the payment of all fees and charges, as well as significant asset holdings;
- the regulator should have the power to enforce contracts and to sue investment managers.

It appears that the legislature felt at the time that the requirement for equal representation of employers and members would be sufficient to combat the conflicts of interest, but the decline of corporate funds and the rise of retail and industry funds with limited effective member representation have removed this protection. In case this appears unrealistic, it can moreover be noted that the "Pension Trustee Code of Conduct"⁷ developed by the CFA Institute together with trustee bodies from the USA, UK, Switzerland, Netherlands and Hong Kong specifically prohibits such conflicts of interest.

At a relatively trivial level, the report seems not to allocate regulatory responsibility appropriately. It says:

For example, ASIC has traditionally been responsible for regulating conflicts of interest, but APRA has increasingly encroached on this role through its prudential standard setting. While much of APRA's work is pre-emptive and out of public view, ASIC has traditionally been reactive (responding to misconduct only after the fact) and public. It has become increasingly unclear

⁵ *Allco vs Trust*, NSW

⁶ Edelman J, (2012) "Fiduciaries and profit disgorgement for breach of contract" Speech given to *The Journal of Equity and Commercial Law Association Conference*, Sydney, 30 March.

⁷ <https://www.cfainstitute.org/ethics/codes/pension/Pages/index.aspx>

which regulator has primary responsibility for trustee conduct — with the risk of misconduct falling between the cracks and a lack of clear regulator accountability. (301)

The important sections of the SIS Act that relate to the conflicts faced by trustees are in part 6. While S6 of the SIS Act splits responsibility for Part 6 of the Act between APRA and ASIC, ASIC's responsibilities are listed in S6 (1) (d) and mainly constitute information provided to members and not conflicts within the trustee boards. It seems very clear then that APRA has these responsibilities and it is to be hoped that the Commission's opinion is not based on some turf war between the regulators.

In any event, the Commission might consider a recommendation that removes S58B from the legislation and allows the general law to have its full force.

The Commission has noted the potential saving by in-sourcing investment management (Box 7.1) and noted the research by Liu and Arnold (2010, 2012),

which concluded that for-profit funds that outsourced administration and insurance services to related parties paid higher costs (and charged higher fees) than those that outsourced to independent providers (for example, AIST, stage 1, sub. 30; ISA, stage 1, sub. 38).

However, the findings of that research were strongly contested by several participants (for example, FSC, sub. DR110; Mercer, sub. DR104). (p301)

My reading of the two submissions referred to do not address the research and barely mention the issues. I am unable to find the source of APRA's view, referred to in the same paragraph, that "strengthening of the regulatory protections around outsourcing, conflicts of interest, and the use of associate parties" had effectively addressed these issues. I think it refers to the introduction of S58A of the SIS Act discussed above.

- I believe that the conflicts of interest present in the industry remain a major source of inefficiency and that regulations to reduce them would be beneficial, and that the change to the definition of independence suggested in Liu and Ooi (2018)⁸ be considered for adoption.
- There would also be merit in noting that funds where some of the trustees have their own money in the fund do better. There would be benefits in ensuring that trustees make this disclosure.

Innovation and complexity

On the question of innovation as identified in figure 4.11, regulatory complexity is clearly recognized as a burden. Taylor et al (2017)⁹ suggest that it is exacerbated by rent seeking and a failure to adequately analyze the costs and benefits of the flood of new regulations of the past two decades. In the case of advice, the evidence presented to the royal commission would be that the financial sector reforms of 2001 were an expensive failure. As suggested by Taylor et al (2017):

Arguably, the entire FSRA and its regulations are poor legislation; excessively complex and prescriptive, as often prohibiting useful innovation¹⁰ as well as being unenforceable. It may well

⁸ Liu, K. and Ooi, E., 2018. When boards use related parties: outsourcing and superannuation fund performance. *Accounting & Finance*.

⁹ Taylor, S., Asher, A. and Tarr, J.A., 2017. Accountability in Regulatory Reform: Australia's Superannuation Industry Paradox. *Federal Law Review*, 45, 257-289

¹⁰ One example is that superannuation funds have not been sure whether they were entitled to provide obviously useful benefit illustrations to members. See Actuaries Institute submission to

provide more of an obstacle to the improvement of financial advice than a deterrent to those who are breaking the common law (as the elements requiring quality advice are more problematic to enforce.)

I have expanded a little on the problems in a Conversation article¹¹:

While codes of conduct may help, the tsunami of detailed regulation of the past few decades has swept aside not only our leisure, but also much of our sense of personal accountability. This is ironic in that Australian John Braithwaite is the world's leading exponent of enforced self-regulation.¹² We would surely be better off without the half million words that make up the SIS Act and Regulations and the 2001 financial sector changes to the Corps Act. The Royal Commission has produced a paper on the latter¹³ that well illustrates its complexity, and goes some way to explain why it has been a failure. Prescriptive and complex regulations create more problems than they solve.

Reducing complex regulation would also free regulators to focus on enforcement. It may be that punishments comfort the indignant as much as creating incentives not to offend, but both are important.¹⁴ It will be important to deal with ASIC's failure to obtain successful prosecutions¹⁵, and their cosiness¹⁶ with the regulated.

I would suggest that the issue of over-regulation and complexity is matter that could be given more attention in the final report.

More radically

Attached to this submission is a paper suggesting that there are significant opportunities to reduce risk and costs in the retirement system, but that would require trustees to take far more responsibility for the investment of funds.¹⁷

Treasury, 'Product Disclosure Statement for Superannuation Funds, 26 February 2009, <https://archive.treasury.gov.au/documents/1812/PDF/Institute_of_Actuaries_of_Australia.pdf>, 63.

¹¹ <https://theconversation.com/why-we-cant-just-throw-more-regulation-at-the-ethical-issues-raised-by-the-banking-royal-commission-96646>

¹² Braithwaite, J., 1982. Enforced self-regulation: A new strategy for corporate crime control. Michigan law review, 80(7), pp.1466-1507

¹³ <https://financialservices.royalcommission.gov.au/publications/Documents/legal-framework-for-the-provision-of-financial-advice-background-paper-7.docx>

¹⁴ Trevino, L.K., 1992. The social effects of punishment in organizations: A justice perspective. Academy of Management Review, 17(4), pp.647-676

¹⁵ <https://theconversation.com/government-backflip-on-asic-could-be-too-little-too-late-58210>

¹⁶ <https://www.theguardian.com/australia-news/2018/apr/27/asics-conflict-of-interest-policies-under-microscope-after-amp-revelations>

¹⁷ Asher, A (2018) Indexed annuity bonds – a market failure to create the ideal pension investment? Presented to the 26th Colloquium on Pensions and Retirement Research, UNSW, Sydney 2,3 July

Comments on Draft Recommendations

Recommendation 1. Defaulting only once for new workforce entrants

Members holding duplicate accounts is a source of inefficiency in the superannuation system and supports efforts to avoid the creation of unwanted duplicate accounts. The inefficiencies arise mostly from potentially unwanted insurance policies and partly from unnecessary administration costs. The government has already taken significant steps to address the larger issue of unwanted insurance, and so I suggest that the proposals for the compilation of ten “best in show” funds would be an overreaction to the more limited problem and may have a number of unintended consequences, and that the proposal will fall away.

In case it does not, I would comment that the administrative costs of the duplicated costs are likely to be significantly less than the \$690 million calculated in the report – which at \$69 per account per year are already small.

- It is likely that some of the 25% of people reported to have other reasons for duplicate accounts (reported in table 1.17 of “Technical supplement: Members survey”, details of which are not yet published) intentionally have the accounts for the attached insurance benefits. This is certainly the case for many of those with SMSF’s.¹⁸
- Some proportion of the fees charged on duplicate accounts are contributions to overhead costs of the funds, and these will be redistributed to other accounts. I have been told informally that the marginal costs of dormant and lost accounts is as little as \$10 pa, being the cost of posting an annual report.

The best in show recommendation creates significant risks:

- It will be very difficult to construct a truly independent panel. The industry is already highly politicised and the panel will inevitably be subject to political pressure, exacerbated by the rent seeking that will arise from the huge economic benefits of making the list.
- A short list will create further concentration in the investment management market, and encourage “herding” of investment managers for fear of not being temporarily behind in investment performance when the lists are compiled. By exacerbating career risk, the equity market will be rendered less efficient and the risks of share market bubbles will be increased. Career risks are most clearly explained by Grantham (2012)¹⁹, the value added by impacts of contrarian investors who are independent of the herd by Wei et al (2014)²⁰, and the systematic risks in an IMF report (Jones, 2016)²¹

Jones (2016) and Asher (2007)²² make a number of suggestions as to how to address the peer risk, which is already identified in the report a problem. Some of these worth considering are:

¹⁸ I do not know the extent of this, but am in possession of survey evidence that some third of active members are in this position, and of 50,000 records provided by the ATO.

¹⁹ Grantham, Jeremy, 2012, “My Sister’s Pension Assets and Agency Problems: The Tension between Protecting Your Job and Your Client’s Money,” GMO Quarterly Letter, April (Boston: GMO). <https://www.gurufocus.com/news/172277/jeremy-grantham-of-gmos-commentary-my-sisters-pension-assets-and-agency-problems-the-tension-between-protecting-your-job-or-your-clients-money>.

²⁰ Wei, K.D., Wermers, R. and Yao, T., 2014. Uncommon value: The characteristics and investment performance of contrarian funds. *Management Science*, 61(10), pp.2394-2414

²¹ Jones, B., 2016. Institutionalizing Countercyclical Investment. International Monetary Fund.

²² Asher, A., 2007. Mean reversion in investment markets: the implications for investors and regulators. *Australian Actuarial Journal*, 13(2), p.721.

- More detailed reporting of investment performance to trustees and members, highlighting costs and sources of short term returns – together with a focus on the importance of long term returns in communication with members.
- Develop alternative benchmarks that focus on value and not on current market weights. More detailed reporting would also better identify the long term risks – both historical and prospectively
- Increasing the investment skills of the funds, particularly by bringing asset management in-house.
- Jones also notes CFA recommendations that investment managers should have their own money in pools that they administer. Trustees should be encouraged to do the same and report this to members.
- I also believe that there are advantages where the majority of employees for an employer are members of the same superannuation fund, so that fund may be encouraged to provide on-site education session for members about the superannuation, the fund and its features. It is also likely to create a stronger relationship between the fund and its members, especially if the default fund has a strong affiliation to the workforce. For example, medical professionals with a health specific industry fund, noting that their “first fund” might have been in retail or hospitality. I therefore think it important that employers are able to suggest alternative funds to members alongside “best in show” recommendations,

Recommendation 2. “Best in Show” shortlist for new members

See above.

Recommendation 3. Independent Expert Panel for “Best in Show” selection

See above.

Recommendation 4. MySuper authorisation

Random variations will exceed 25bps

Figure 2.11 on page 118 suggest that out of 90 MySuper funds, 75 underperform. This is surprising and I would question the process or approach that led to the result. The report refers to the fact that construction of benchmarks (BP1 and BP2) was a “challenge” with adjustments required. It is less than convincing to determine a fund is an underperformer using a 0.25% threshold when it is clear the drivers of this determination are far from an “exact science”. An inspection of figure 2.11 on page 118 suggests that the best performing funds have outperformed the benchmarks by about 150 bps over 4 years. In the absence of other information, I would think that this outperformance could be explained by random factors and that the measure of underperformance should be closer to 150bps.

Life-cycle modelling should allow for averaging

Life-cycle funds are largely dismissed as representing a significant risk of underperformance. I am not entirely sure of the approach that is modelled in Technical Supplement 6, but the description suggests a one off reduction in risk five years from retirement:

“One illustration of the effects of life-cycle strategies is to compare outcomes of maintaining a balanced investment strategy until retirement and the outcomes of shifting from a balanced to a safe portfolio five years before retirement.” This approach significantly reduces one of the benefits of the life-cycle approach which is that the decision to de-risk is averaged over a number of years. If our understanding is correct, then the results in figure 6.4 will be rather different.

This risk is inherent in the asset allocation decision, and that there are very good arguments for adopting a life-cycle approach. The theoretical advantages are set out for instance in Campbell and

Viceira (2002)²³, while Mitchell and Utkus (2012) show that there is significant demand from members for guidance as to how to adapt asset allocation over the life-cycle.²⁴ While I accept that some of the life-cycle portfolios may not be optimal, it would be wrong to ban them. APRA supervision could however be more active in ensuring trustees actively develop more appropriate designs.

Draft Recommendation 11 Guidance for pre-retirees

I recommend that the Commission study the UK pension dashboard²⁵ as a potential prototype that would provide members with a single source for all the information that they require for a holistic financial plan. My view is that could be extended to include all financial assets, demographic and household status and income. This information is already available from different sources in MyGov (mainly in ATO databases). If this data was made available to members in a standard format, it would greatly facilitate the provision of financial advice:

- Personal financial advice is made considerably more difficult and more expensive by the need for a complex “fact find”, most of which can be readily automated. If a member could access all their information through MyGov, it could be easily provided to the financial planner in one file.
- It would also encourage and facilitate the provision of robo-advice.

I note that there are a number of times in the life-cycle, other than 55, where there is a need for additional advice:

- Starting full-time work when it is helpful to consider saving for a deposit on a home. The ATO could provide a notice about the availability of the MyGov data when taxable income first exceeds a particular threshold
- Marriage and children, when cash flows become strained and saving can be reduced. Medicare is informed of the change in household composition and could provide the notice.
- Divorce and children leaving home also create the need for revising spending and saving habits and again Medicare has the necessary information to provide the notice.

²³ Campbell, J.Y. and Viceira, L.M., 2002. *Strategic asset allocation: portfolio choice for long-term investors*. Clarendon Lectures in Economics.

²⁴ Mitchell, O.S. and Utkus, S., 2012. *Target-date funds in 401 (k) retirement plans* (No. w17911). National Bureau of Economic Research.

²⁵ <https://www.plsa.co.uk/Policy-and-Research/Defined-Contribution/The-pensions-dashboard>