

Submission to Productivity Commission

Superannuation: Assessing Efficiency and Competitiveness

In April of this year, I published "***Management and Regulation of Pension Schemes: Australia - A Cautionary Tale***" (Routledge, 2018), the result of five years' work examining the Australian superannuation system. This work was mostly carried out at the Faculty of Law, University of New South Wales, where I am currently an Adjunct Professor. The book may be obtained at <https://www.routledge.com/Management-and-Regulation-of-Pension-Schemes-Australia-a-Cautionary-Tale/Morris/p/book/9781138287792>.

In that book, inter alia, I present empirical estimates which show that if the contributions made by fund members between 1997 and 2016 had been invested in a passively-managed fund (with a suitable risk profile and typical expenses) they would now be about \$700-800 billion dollars larger, or some 25-30% of funds under management. I also compare the performance of Australian funds with those in Canada, the US and Europe, and highlight higher costs and lower performance by the Australian funds.

The book comprises seven chapters. Chapter 1, which sets out the main arguments and findings, is provided as an annex to this submission.

The book covers a somewhat wider set of questions than in your current terms of reference, including whether the fundamental policy choices made at the inception of the scheme were wise; how the dispersion of regulatory responsibility across multiple agencies renders the control system ineffective; failures of governance and in particular inadequate representation of members' interests by trustees; inappropriate targeting of tax subsidies; heavy reliance on active management; weakening of trust law; and failures to enforce adequate disclosure of costs.

The book concludes with discussion of what could now be done to improve the situation, given that fundamental redesign is unlikely. I discuss improvements to regulation, law, competitive pressures, and transparency. I also suggest the introduction of a publicly-accountable scheme which offers a low-cost passively-managed alternative to the expensive (predominately actively-managed schemes) on offer at present, which would provide a benchmark against which funds management could be judged.

Thank you for your recommendations as to how to improve the system. I attach some comments on these as Annex A to this submission, which I hope you will find helpful.

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Annex A

Superannuation: Comments on Productivity Commission Draft Recommendations

DRAFT RECOMMENDATION 1 DEFAULTING ONLY ONCE FOR NEW WORKFORCE ENTRANTS

Default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account (and do not nominate a fund of their own).

To facilitate this, the Australian Government and the ATO should continue work towards establishing a centralised online service for members, employers and the Government that builds on the existing functionality of myGov and Single Touch Payroll. The service should:

- allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number when starting a new job
- facilitate the carryover of existing member accounts when members change jobs
- collect information about member choices (including on whether they are electing to open a default account) for the Government.

There should be universal participation in this process by employees and employers.

Agree with the importance of removing multiple accounts and facilitation of tidying them up. However, I am not sure about the first sentence – surely we want as many existing members as possible to switch from high-cost/low performing funds to (better) default funds which are subject to more scrutiny etc?

A centralised online database could be a useful tool, but may run into problems with member apathy/lack of understanding, and employer non-compliance. The key question is how to achieve ‘universal participation’ in a world of limited understanding and member interest. Is this intended to include corporate schemes (which should be encouraged as they typically perform better than others).

DRAFT RECOMMENDATION 2 ‘BEST IN SHOW’ SHORTLIST FOR NEW MEMBERS

A single shortlist of up to 10 superannuation products should be presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. Clear and comparable information on the key features of each shortlisted product should also be presented. Members should not be prevented from choosing any other fund (including an SMSF).

Any member who fails to make a choice within 60 days should be defaulted to one of the products on the shortlist, selected via sequential allocation.

The ATO should embed the shortlist and accompanying information into the centralised online service.

I am concerned about this recommendation, as it may simply embed existing poor performance and practices, and create ‘gaming’ and lobbying to be selected as one of the ten. We need to improve the overall ‘show’ rather than celebrate existing practices and costs which have emerged from a collusive oligopoly. In my book I recommend the creation of an independent and publicly-accountable alternative (low cost and passively managed) to which members should be encouraged to switch and which should be the default for new members in the absence of other choices being made. I believe that to be a better option.

I am also concerned about the actual implementation of this idea. In my empirical analysis, the funds that performed best relative to benchmark, after costs, were those which were run on behalf of the employees of the firm concerned, for example Commonwealth Bank Staff Fund and Goldman Sachs/JP Morgan, and many of the top performing funds are corporate. This means we have to go some way down the league before we would find ten which performed better and which are open to public subscription. Not 'best in show'!

DRAFT RECOMMENDATION 3 INDEPENDENT EXPERT PANEL FOR 'BEST IN SHOW' SELECTION

The Australian Government should establish an independent expert panel to run a competitive process for listing superannuation products on the online shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established beforehand by the panel) and are judged to deliver the best outcomes for members, with a high weighting placed on investment strategy and performance.

The panel should have flexibility to select up to 10 products, with the exact number at the discretion of the panel based on the merit of each product and what is most tractable for members, while maintaining a competitive dynamic between funds for inclusion.

The panel should be comprised of independent experts who are appointed through a robust selection process and held accountable to Government through adequate reporting and oversight.

The process should be repeated, and the panel reconstituted, every four years.

This has the danger of giving huge power to a select group of people, who will need knowledge and expertise which presumably will have been gained from previous careers in the industry etc. They will be subject to extensive lobbying and inducements from those who want their product to be selected, and no doubt political pressure. I'm sure they won't be explicitly corrupt, but there will be scope for 'old boy network', revolving door and similar influences.

DRAFT RECOMMENDATION 4 MYSUPER AUTHORISATION

The Australian Government should legislate to allow APRA to apply the MySuper outcomes test.

Authorisation rules for MySuper should be further strengthened to require funds to:

- obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison against other products in the market, and determination of whether members' best interests are being promoted, at least every three years
- report to APRA annually on how many of their MySuper members switched to a higher-fee choice product within the same fund.

Funds that fail to meet these conditions — or persistently underperform (for five or more years) an investment benchmark tailored to their asset allocation by a material margin, as determined by APRA — should have their MySuper authorisation revoked.

After implementation, the Australian Government should commission an independent review, every five years, of the effectiveness of the MySuper authorisation rules (including the outcomes test) at meeting their objectives.

Agree with strengthening the MySuper outcomes tests, these are useful reforms. In my book I argue that one of the regulators needs to take explicit responsibility for the performance of the industry, and this would enhance APRA's ability to do this. I would have made this recommendation stronger and insisted on APRA, or another agency, being given a statutory responsibility to ensure the overall performance of the system.

DRAFT RECOMMENDATION 5 REGULATION OF TRUSTEE BOARD DIRECTORS

The Australian Government should legislate to:

- require trustees of all superannuation funds to use and disclose a process to assess, at least annually, their board's performance relative to its objectives and the performance of individual directors
- require all trustee boards to maintain a skills matrix and annually publish a consolidated summary of it, along with the skills of each trustee director
- require trustees to have and disclose a process to seek external third party evaluation of the performance of the board (including its committees and individual trustee directors) and capability (against the skills matrix) at least every three years. The evaluation should consider whether the matrix sufficiently captures the skills that the board needs

(and will need in the future) to meet its objectives, and highlight any capability gaps. APRA should be provided with the outcomes of such evaluations as soon as they have been completed

- remove legislative restrictions on the ability of superannuation funds to appoint independent directors to trustee boards (with or without explicit approval from APRA).

This goes to the heart of the problem, and is long overdue, but may still not be enough to bring trustee performance to the required level. Because of member apathy, and lack of expertise/knowledge, it is essential that trustees take their duties seriously and have sufficient time/expertise/resources to act effectively on behalf of their members. Conflicts of interest need to be monitored carefully, especially when the fund is embedded within a wider financial services group. Trustees with limited expertise and poor attendance records etc. should be removed as quickly as possible.

DRAFT RECOMMENDATION 6 REPORTING ON MERGER ACTIVITY

The Australian Government should require trustee boards of all APRA -regulated superannuation funds to disclose to APRA when they enter a memorandum of understanding with another fund in relation to a merger attempt. For mergers that ultimately do not proceed, the board should be required to disclose to APRA (at the time) the reasons why the merger did not proceed, and the members' best interests

Clearly important that APRA is fully aware of such activities as early as possible.

DRAFT RECOMMENDATION 7 CAPITAL GAINS TAX RELIEF FOR MERGERS

The Australian Government should legislate to make permanent the temporary loss relief and asset rollover provisions that provide relief from capital gains tax liabilities to superannuation funds in the event of fund mergers and transfer events.

Encouragement of mergers, as part of an overall simplification/improvement of the system is clearly to be encouraged.

DRAFT RECOMMENDATION 8 CLEANING UP LOST ACCOUNTS

The Australian Government should legislate to:

- ensure that accounts are sent to the ATO once they meet a definition of 'lost'
- empower the ATO to auto-consolidate 'lost' accounts into a member's active account, unless a member actively rejects consolidation
- allow a fund to exempt a 'lost' account from this process only where the member has provided an explicit signal that they want to remain in that fund (prior to the account meeting the definition of 'lost')
- reduce the 'lost inactive' activity threshold from five to two years
- require that all accounts held by Eligible Rollover Funds, regardless of their lost status, are sent to the ATO
- prohibit further accounts being sent to Eligible Rollover Funds.

This obviously needs tidying up. Does it require legislation, or is it something that ATO should be doing anyway?

DRAFT RECOMMENDATION 9 A MEMBER-FRIENDLY DASHBOARD FOR ALL PRODUCTS

The Australian Government should require funds to publish simple, single-page product dashboards for all superannuation products.

ASIC should:

- prioritise the implementation of choice product dashboards to achieve full compliance by 1 July 2019
- revise the dashboards to simplify the content and provide more easily comprehensible metrics (drawing on robust consumer testing) by end 2019

- immediately publish all available MySuper and choice product dashboards on a single website, with the information clearly and readily accessible from the area of myGov that allows for consolidation of accounts.

Agree, though surely ASIC should be doing this already? Design of the dashboard and what it contains is obviously crucially important – there is useful academic work on this subject (Bateman/Thorpe, for example) which ASIC should note.

Generally, this runs into the same problems of member apathy and inattention noted above. In my view, although member engagement is clearly to be welcomed, it may in practice be very hard to achieve and cannot be relied upon by itself to fix the problems.

DRAFT RECOMMENDATION 10 DELIVERING DASHBOARDS TO MEMBERS

The Australian Government should require the ATO to present the relevant (single page) product dashboard on a member's existing account(s) on its centralised online service.

The Government should also require all superannuation funds to actively provide their members with superannuation product dashboards when a member requests to switch from a MySuper product to a choice product within the fund. This should include:

- the dashboard for the MySuper product
- the dashboard for the choice product the member wants to switch to.

DRAFT RECOMMENDATION 11 GUIDANCE FOR PRE-RETIREES

The Australian Government should require the ATO to guide all superannuation members when they reach age 55 to:

- the 'Retirement and Superannuation' section of ASIC's MoneySmart website
- the Department of Human Services' Financial Information Service website.

Surely ATO, ASIC, APRA etc are responsible government agencies which ought to be doing these things anyway? Do we need more explicit statements of the various regulators overall responsibility for the performance of the system?

DRAFT RECOMMENDATION 12 EXIT FEES AT COST-RECOVERY LEVELS

The Australian Government should legislate to extend MySuper regulations limiting exit and switching fees to cost-recovery levels to all new members and new accumulation and retirement products.

Yes! But we need robust methods of determining what cost-recovery levels should be. We don't want this creating a 'gold-plating' ethos, and simply embedding excessive costs.

DRAFT RECOMMENDATION 13 DISCLOSURE OF TRAILING COMMISSIONS

The Australian Government should require superannuation funds to clearly inform, on an annual basis, all members who are subject to trailing financial adviser commissions. This information should include the amount of commissions paid and a notice that trailing commissions are now illegal for new members.

All funds should publicly disclose the extent of trailing commissions and number of affected members in their annual reports and provide this information to ASIC.

Agree. Arguably these should have been subject to full disclosure long ago.

DRAFT RECOMMENDATION 14 OPT-IN INSURANCE FOR MEMBERS UNDER 25

Insurance through superannuation should only be provided to members under the age of 25 on an opt-in basis. The Australian Government should legislate to require trustees to obtain the express permission of younger members before deducting insurance premiums from these members' accounts.

DRAFT RECOMMENDATION 15 CEASE INSURANCE ON ACCOUNTS WITHOUT CONTRIBUTIONS

The Australian Government should legislate to require trustees to cease all insurance cover on accounts where no contributions have been obtained for the past 13 months, unless they have obtained the express permission of the member to continue providing the insurance cover.

DRAFT RECOMMENDATION 16 INSURANCE BALANCE EROSION TRADE-OFFS

APRA should immediately require the trustees of all APRA-regulated superannuation funds to articulate and quantify the balance erosion trade-off determination they have made for their members in relation to group insurance, and make it available on their website annually.

As part of this, trustees should clearly articulate in their annual report why the level of default insurance premiums and cover chosen are in members' best interests. Trustees should also be required to provide on their websites a simple calculator that members can use to estimate how insurance premiums impact their balances at retirement.

DRAFT RECOMMENDATION 17 INSURANCE CODE TO BE A MYSUPER CONDITION

Adoption of the Insurance in Superannuation Voluntary Code of Practice should be a mandatory requirement of funds to obtain or retain MySuper authorisation.

DRAFT RECOMMENDATION 18 INSURANCE CODE TASKFORCE

The Australian Government should immediately establish a joint regulator taskforce to advance the Insurance in Superannuation Voluntary Code of Practice and maximise the benefits of the code in improving member outcomes. The taskforce should:

- monitor and report on adoption and implementation of the code by funds
- provide guidance on and monitor enhancements to strengthen the code, particularly implementation of standard definitions and moving to a short-form annual insurance statement for members
- advise the industry what further steps need to be taken for the code to meet ASIC's definition of an enforceable code of conduct.

The code owners should be given two years to strengthen the code and make it binding and enforceable on signatories before further regulatory intervention is considered.

The taskforce should annually report findings on industry progress on the code.

Both ASIC and APRA should be members of the taskforce, with ASIC taking the lead.

DRAFT RECOMMENDATION 19 INDEPENDENT REVIEW OF INSURANCE IN SUPER

The Australian Government should commission a formal independent review of insurance in superannuation. This review should evaluate the effectiveness of initiatives to date, examine the costs and benefits of retaining current insurance arrangements on an opt-out (as opposed to an opt-in) basis, and consider if further regulatory intervention or policy change is required. The review should be initiated within four years from the completion of this inquiry report, or earlier if the strengthened code of practice is not made enforceable within two years.

The (mis)selling of insurance to members for whom it is inappropriate needs fixing quickly. \$8.5 billion-plus annually is a large amount to be taken from members in premiums. Similar problems have emerged in other jurisdictions, such as UK, and rapid actions have been taken. The above recommendations seem quite leisurely, with the review, for example, taking more than four years.

DRAFT RECOMMENDATION 20 AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

APRA should (in addition to draft recommendations 4 and 16):

- require all APRA-regulated superannuation funds to conduct formal due diligence of their outsourcing arrangements, at least every three years, to ensure the arrangements provide value for money. Each fund should provide a copy of the assessment to APRA (including the fees paid and the comparator fees)
- report annually to the Council of Financial Regulators on the progress stemming from the application of the MySuper scale test (and then the outcomes test, once legislated) in bringing about fund mergers
- undertake a systematic assessment of the costs to funds of the thousands of legacy products in the superannuation system. If the evidence demonstrates that they represent a significant cost in accumulation, APRA should further refine trustees' obligations for member transfers so these products can be rationalised
- embed product-level reporting within its reporting framework as soon as practicable (no later than 18 months) to enhance visibility of actual member outcomes across all APRA-regulated funds and to bring reporting for the choice segment into line with the MySuper segment. APRA should also expedite efforts to address inconsistencies in reporting practices.

Improving APRA's scrutiny of fund performance is to be welcomed. Simpler to give APRA (or another agency) statutory responsibility for the overall performance of the industry and hold APRA/this agency Directors/Officials to account for doing this?

DRAFT RECOMMENDATION 21 AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

ASIC should (in addition to draft recommendation 9):

- ² proactively set and enforce standards for the meaningful disclosure of information to members on superannuation products and insurance policies (in addition to product dashboards). Information should be simple, comparable and easy for members to understand
- ² require all superannuation funds to publicly disclose to current and prospective members the proportion of costs paid to service providers that are associated with related-party outsourcing arrangements
- ² proactively investigate (questionable) cases where mergers between superannuation funds stalled or did not proceed
- ² review exit and switching fees faced by existing members, with a focus on whether these fees are related to the underlying performance of the product, and whether they unreasonably impede members moving to products that better meet their needs.

Improving disclosure is to be welcomed. But this still doesn't focus on the hidden costs of outsourced activities (where costs incurred by fund managers, for example, lead to lower net-of-costs returns but are not required to be reported directly). See Morris and Nicholls (2017) on RG97 etc.

DRAFT RECOMMENDATION 22 SUPERANNUATION DATA WORKING GROUP

The Australian Government should establish a superannuation data working group, comprised of APRA, ASIC, the ATO, the ABS and the Commonwealth Treasury (with Treasury taking the lead). This group should:

- ² identify ways to improve the consistency and scope of data collection and release across the system, with a focus on member outcomes
- ² evaluate the costs and benefits of reporting changes, including strategies for implementation
- ² identify areas where legislative or regulatory change may be necessary to support better data collection
- ² report annually to the Council of Financial Regulators on its progress, and on the data analytics capabilities of each regulator.

Useful and long overdue! But is the PC confident that setting up a taskforce will in fact get the various regulators to work together effectively? Or perhaps recommend a unified regulator for superannuation?

Management and Regulation of Pension Schemes

Australia a Cautionary Tale

By Nicholas Morris, published in April 2018 by Routledge



Introduction and Overview

In the early 1990's, Australia took important decisions to require its population to save for retirement, introducing a *Superannuation Guarantee Charge* which is currently 9.5% of earnings. As a result, superannuation funds today comprise a significant proportion of Australian personal wealth.¹ Their effective management and regulation, the subject of this book, is vital for the well-being of Australian retirees. Unfortunately, the Australian superannuation system exhibits numerous problems including that it currently delivers an income replacement rate for retirees that is among the lowest in the OECD, that it forces fund members to bear risks they are ill-equipped to manage, and that it provides significantly poorer returns on investment than could reasonably have been expected.

In Section 2.1, we consider the design of the Australian system that has led to these outcomes. This begins by evaluating three fundamental policy choices: whether to use a pay-as-you-go (PAYG) or a funded system; whether to allocate pensions on a defined benefit (DB) or a defined contribution (DC) basis; and whether the public or the private sector should manage the funds. For historical and ideological reasons set out in Chapter 3, Australia chose the latter option in each case (funded, DC and privately managed). The outcomes we describe in this book, and much of the relevant literature, suggest that the former would have been a better choice (PAYG, DB and publicly managed).

Empirical estimates presented in Chapter 4 show that, over the last twenty years, the Australian superannuation industry has delivered some A\$700-900 billion less return for its members than it could have if different policy choices had been made.² The result is that Australia's superannuation funds, instead of potentially being worth around A\$3 trillion, are now only worth around A\$2.2 trillion³ (a cumulative shortfall equivalent to about 45% of Australia's annual Gross Domestic

¹ In 2013-14, superannuation comprised 17% of household assets, figures based on the latest Survey of Income and Housing (SIH). Australian Bureau of Statistics, 'Household Income and Wealth, Australia, 2013-14' (6523.0, 4 September 2015).

² The calculations leading to these estimates of shortfall are described in detail in Chapter 4.

³ Australian Prudential Regulation Authority (2017) 'Quarterly Superannuation Performance June 2017' (APRA, 22 August 2017) 8, available at <http://www.apra.gov.au/Super/Publications/Documents/2017QSP201706.pdf>. Note: A\$= Australian dollar. In all subsequent Sections, '\$' refers to the Australian dollar, except where specified otherwise, for example 'US\$'.

Product (GDP)).⁴ This shortfall is, in large part, a reflection of the high costs of the superannuation industry which has been created to manage the funds.

The industry that has emerged in Australia is complex, to an extent that it is imperfectly understood by policymakers, and by most members. As Section 2.2 explores, this facilitates rent extraction and works against policy reform. Complexity strengthens the hand of those who seek to manipulate the system for their own benefit, while making it difficult or impossible for regulators and representatives of fund members to ensure that returns are maximised and costs minimised. The more complex the industry, the less likely are members (and trustees on their behalf) to be able to negotiate an acceptable outcome.

International literature highlights how principal-agent and conflict of interest problems abound in financial services, and demonstrates that a high proportion of the potential return to investors from managed funds is routinely extracted by fund managers (and associated intermediaries) through excessive fees and charges. In Australia competitive pressures, governance systems, and legal and regulatory constraints, appear to have been inadequate to curtail *rent-seeking behaviour* by advisers and managers.⁵ Competition and choice do not seem to work well enough in this industry to impose the necessary constraints, partly because of a lack of transparency over costs. The high degree of separation between members and those who manage their funds, a result of extensive outsourcing, both increases costs (because all the intermediaries charge a margin) and reduces focus. In addition, individuals in DC schemes face severe longevity and market risks, the management of which (including the provision of fairly priced products) has so far received insufficient attention. In Section 2.3, the reasons why stronger and more effective regulation is therefore needed are discussed.

Other countries, notably the UK, are now following Australia down the path of introducing more individually funded, defined contribution pensions, and reducing reliance on both publicly funded and defined benefit provision while increasing the proportion of funds outsourced to private sector managers. This book highlights the dangers of these changes, and how such moves impose greater risks and welfare losses on retirees, current and future. Although Australia is our primary focus, Section 2.4 includes brief summaries of the policy choices made by a number of other countries. This is partly to inform analysis of the Australian situation, and partly to draw out the lessons that can be learned from the Australian case that may be relevant to other countries as they develop their own pension systems.

Section 2.5 summarises the challenges Australia now faces. These include that those about to retire will do so with inadequate pensions; high administration and fund management costs; a lack of trust

⁴ 2015-6 GDP was A\$1.66 trillion, Australian Bureau of Statistics (2017) '1345.0 - Key Economic Indicators, 2017' available at <http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/1345.0Main%20Features12017?opendocument&tabname=Summary&prodno=1345.0&issue=2017&num=&view=>.

⁵ Economists use the term 'rent' to capture the idea of excess payments, over and above what would normally be considered necessary, an idea which dates back to the work of Gordon Tullock: Tullock, Gordon (1967) 'The welfare costs of tariffs, monopolies and theft' 5 *Western Economic Journal* 3, 224-332. See Congleton, Roger D., Arye L. Hillman and Kai A. Konrad (eds.) (2008) *Forty Years of Research on Rent Seeking I - Theory of Rent Seeking* (Springer, Heidelberg), 45-53; Hillman, Arye L. and Heinrich W. Ursprung (2015) 'Rent seeking: The idea, the reality, and the ideological resistance' (paper presented at the Department of Economics, International Trade and Development Seminar, University of Pittsburgh, October 7, 2015), available at <http://www.econ.pitt.edu/sites/default/files/Hillman.Rent%20seeking.2015.pdf>.

in the industry and its advisers; and the transfer of risks to individuals who are poorly equipped to manage them. Legal and regulatory constraints and guidance provided by a combination of trust law, the *Superannuation Industry (Supervision) Act* (SIS Act), and the various regulatory agencies in Australia need rationalising and strengthening. Organisation and governance of the system also needs overhaul, and action is required to assist members with the risk management that has been imposed on them. Although large tax concessions have been provided to encourage contributions to superannuation funds, these have been disproportionately available to the rich, while the poorest individuals suffer from paying contributions they cannot afford, while receiving little or no tax benefit. As a result of all these issues, the Australian system can best be described, after twenty-five years, as still a work-in-progress.

Chapter 3 describes how the Australian system, and the financial industry which supports it, evolved. Australia developed a 'three pillar' system, with a means-tested old-age pension enhanced by charitable giving, occupational and public sector schemes, and voluntary savings encouraged by tax incentives. This history is presented in four epochs, with the final one starting with the introduction of the *Superannuation Guarantee Charge* in 1992. The situation today is that Australia has the highest incidence of poverty, among the old, in the OECD.

Superannuation policy in Australia has suffered from the 'stop-go' effects of a short electoral cycle and the tendency of incoming governments to overturn policies initiated by their predecessors. In the post-war period, the influence of the union movement and its interface with Labor administrations also had a crucial impact. Australian superannuation policy also reflected developments in Europe, the UK and the US, and in particular ideological struggles between those who believed in public control and administration, and those who believed in the primacy and efficiency of markets. Section 3.8 describes the reasons why strategy for, and management of, superannuation funds was to a large extent handed over to the private sector, Section 3.9 discusses how the modern legal and regulatory framework evolved, and Section 3.10 sets out how the modern superannuation industry emerged. A timeline of key legislation and events from 1849 to the present is provided in Annex A.

Chapter 4 seeks to benchmark the investment performance of Australian superannuation funds against what might have been possible if different policy choices about the management of the funds had been made. Section 4.3 shows that Australia's retirees will be considerably poorer than they would have been if their contributions had been held in a single, passively-managed fund.⁶ As noted above, calculations undertaken by the author suggest that in the period from 1996 to 2016, the overall superannuation system achieved substantially less than might have been possible under alternative regimes - after reasonable costs - by between around \$700 billion and \$900 billion (34 - 44% of the 2016 funds under management). Section 4.3.8 explores the 'leakages' which have led to this shortfall, drawing on Australian and international literature. This benchmarking identifies better performance among smaller corporate funds and poorer performance among the larger Australian retail funds. Public offer (retail) fund types perform least well, while self-managed superannuation schemes (SMSFs) also exhibit below-average returns.

⁶ Of course, this abstracts from the question – beyond the scope of this book – as to whether an alternative approach would have affected investment markets more widely. Relying on passive management of funds reduces the extent to which active managers are able to influence prices, and therefore, arguably, make the market more efficient.

Section 4.4 compares Australian funds with international counterparts, using detailed cost, performance and financial data at the fund level published by APRA. These data are compared with a sample of 256 pension funds from Canada, the United States and Europe for the period 2004 to 2012. This comparison suggests that, compared to funds in those countries, Australia's funds performed badly in that period.

Detailed comparison of the Australian and international data also shows proportionately higher administrative costs among the Australian funds.⁷ Australian funds are less mature, and mostly defined contribution, whereas the international funds are more established and mostly defined benefit. Hence principal-agent problems may be expected to be more severe in the Australian case, where delegation of responsibility is widespread. There is a strong negative relationship between expenses and performance relative to benchmark. These findings are supported by Australian and international literature, as summarised in Section 4.5. This literature provides additional evidence on the high fees and charges levied by Australian funds, on the poor performance of for-profit funds, on difficulties with governance systems, and on the incidence of higher costs associated with outsourcing.

Chapter 5 draws out some lessons that may be learned from the Australian experience. Section 5.1 explores further the reasons for the relatively poor performance of Australian funds, attributing technical inefficiency to poor principal-agent relationships, weak governance, and lack of transparency. Providing greater choice to members, a major part of the policy response of successive governments, increases costs to an extent that does not seem to be outweighed by its benefits. Various tax-induced choices such as high portfolio allocations to Australian equities and use of expensive advisors may not have been to the overall benefit of members.

Section 5.2 focuses on the 'light-handed' nature of Australian legal and regulatory constraints, attributing this to the prevailing ethos that competition and choice would reduce the need for regulatory intervention. Belief, at the time the system was established, that trust law could be relied on to ensure that trustees, and others, carried out their duties effectively led to the *Superannuation Industry (Supervision) Act 1993* (SIS Act) being less prescriptive than it perhaps should have been, a matter to which we return in Chapter 6. The section also notes the division of regulatory responsibility between multiple agencies, and the lack of disclosure of significant elements of cost.

Realisation of the problems the system faces has led to numerous enquiries and attempts at reform, which are summarised in Section 5.3 and elaborated in Annex B. The recent *Super System Review* has led to the introduction of simpler, standardised products, the *Future of Financial Advice* (FOFA) reforms have sought to remove the more glaring problems over conflicted advice, and APRA has introduced a series of prudential practice guides. However, the endemic principal-agent and conflict of interest problems remain embedded in the system, consolidation of the industry has reduced competition, the disclosure regime is still imperfect, and fees and charges remain high.

⁷ The international funds mostly report investment costs while a proportion of the Australian investment costs are not reported, which makes comparison of these elements of costs difficult. For a general discussion of fee and cost disclosure practices in Australia, see ASIC (2014) *Fee and cost disclosure: Superannuation and managed investment products* (ASIC Report 398, July 2014).

Chapter 6 explores what can be done now to fix the problems outlined above. Section 6.1 sets the challenge of reducing complexity, controlling conflicts of interest and rent-seeking behaviour, and providing greater focus on outcomes for members, thus improving the efficiency of the industry. The list of what needs to be done, presented below, is long, and includes ensuring full and effective disclosure, improving regulatory and governance arrangements, and strengthening legal protections. We also explore a further policy response which has scope to make a greater difference, and suggest the creation of a publicly administered, low cost, alternative to the investment options currently available.

Section 6.2 discusses the extent to which better and more focused regulation is likely to improve the situation. A major problem with the current arrangements is that responsibility for the efficient performance of the sector is divided up between multiple agencies. Creation of a new, or repurposed, agency with a clear responsibility for the sector would be an improvement. Such an agency would need to report directly and on a regular basis to Parliament. It would be responsible for effective development of the disclosure regime, for regular publication of benchmark indicators, and for the identification and policing of conflicts of interest. It would have a primary duty to promote effective competition. The various forms of regulation that have been made to work in other industries should be adapted to the superannuation context. These could include the introduction of a price cap, at least until effective competition has been established, and the unbundling of insurance provision from the management of superannuation funds.

Section 6.3 explores the extent to which legal constraints could be improved, perhaps through better trust law. We noted above that the SIS Act as originally drafted was less prescriptive than might have been possible in terms of setting out the required conduct of trustees and managers. It would be possible to redress this through new legislation, using precedents from other industries. The Australian telecommunications industry, for example, has developed codes of conduct which are agreed between the industry and its regulators, but which become 'mandatory on breach' and subject to penalties. We explore the extent to which this idea could be adapted to superannuation.

Section 6.4 raises the possibility that competition law could be applied more vigorously to superannuation, in order to reduce cross subsidies and anti-competitive behaviour. This is something that has received considerable attention in other countries since the GFC, and in other industries, where vertically integrated companies have been unbundled. Attention needs to be paid by the competition authorities both to the incidence of cross subsidy and about preferential access to information. A further problem in the superannuation industry is lack of consumer response to variations in cost and performance. Better disclosure and publication of benchmarks would assist in this process, but the key is to ensure that trustees both understand and take action about these issues.

A major problem with the Australian superannuation industry is lack of disclosure of all costs. Despite this being an issue which has been raised in all reviews since the industry was established, so far regulators have not succeeded in forcing the industry to disclose fully the costs of outsourced activities, especially funds management. Section 6.5 explains how the industry has argued successfully that it is sufficient to simply report net-of-costs performance, and that disclosure of the underlying cost structures of various intermediaries is unnecessary. While this might be true if (a) performance was properly measured and presented, and comparison between funds understood by

all stakeholders, and (b) competitive pressures did indeed exert discipline on those who sought to overcharge, neither condition holds in the Australian context. We argue, therefore, that attention to better disclosure and publication of relative costs is urgently needed.

In Section 6.6 we conclude by putting forward an innovative idea, that a new, publicly-administered, fund be established with a mandate to provide a low cost, passively managed investment vehicle. Migration to this fund, which is likely to easily outperform the majority of existing funds, should be encouraged, and the government should provide active and well-publicised support to its development. The new fund would then provide a clear benchmark against which the performance of other funds could be judged. In addition, it would be able to assist its members with risk management, and in particular the management of longevity risk.

How to manage pension funds effectively is one of the most important policy questions of our age. All countries, rich and poor, are struggling with questions of how to finance the retirement and healthcare costs of an increasingly long-lived population. Australia responded to this twenty-five years ago by compelling its population to save throughout their working lives. However, this is only the first part of a three-part story: once the assets have been accumulated, it is also important that they are managed well, and not dissipated in excessive fees and charges or mismanagement. And then it is crucial that individuals are assisted with the risks they face during retirement, not least uncertain longevity. So far, Australia has not done so well with these parts.

This book sets out what has gone wrong, how it happened, and the results of these mistakes. It also suggests a variety of ways of fixing the problem, including improvements to regulatory structure, legislation, market discipline and transparency. Hopefully, these will eventually lead to the development of a well-run, simpler system which meets the needs of Australia's retirees better. I also hope that other countries will take note of Australia's mistakes, and ensure their superannuation systems perform at their best to meet the needs of future retirees.