

# Superannuation Competitiveness and Efficiency

## Individual Submission to Australian Government Productivity Commission

I refer to the invitation to provide comments on the recently released paper: Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, Canberra. I congratulate the Productivity Commission on the production of this comprehensive document. The set of principles and specific measures reflected in the document are expansive.

### General Comment

The proposed list of measures will provide interesting information. However there is a risk of getting lost in the detail if all measures are launched simultaneously. Indeed, clients of superannuation funds will not be better informed at all by being provided too much data. Furthermore, in a sea of data, funds in a competitive environment will be able to cherry-pick data in a way that adds to confusion.

RSEs have a fiduciary relationship with their clients. In the first instance it makes sense for the Productivity Commission to concentrate on areas in which:

- Impediments to RSEs acting in their clients' best interest are mitigated or removed
- Evidence of RSEs not acting in their clients' best interest are identified
- Systemic risks to the superannuation system and the Australian economy are identified and mitigated
- The potential of the superannuation system to help the economy grow is maximised

Lack of meaningful transparency in terms of fee disclosure is the main way in which the current superannuation system impedes RSEs and potentially increases systemic risk to the economy. And there is a possibility that the measures currently proposed for implementation in February 2017 may make this worse, as I recently discussed separately with ASIC Commissioner Mr Greg Tanzer.

RSEs have a fiduciary relationship with their clients. It is highly inappropriate that, under current fee disclosure requirements, clients are not told the fee that is being extracted by the RSE to act in its fiduciary capacity. As a result, there is a lack of transparency at this fundamental fiduciary level and no clear competitive pressure for RSEs to become more efficient.

Impediments to RSEs acting in their clients' best interest will be diminished by requiring fees to be disclosed at three different levels: fees that the RSE charges to act as a fiduciary agent, fees that are paid to related third parties and fees that are paid to unrelated third parties. Such fees should be readily identifiable as part of the preparation of Business Activity Statements for GST calculations.

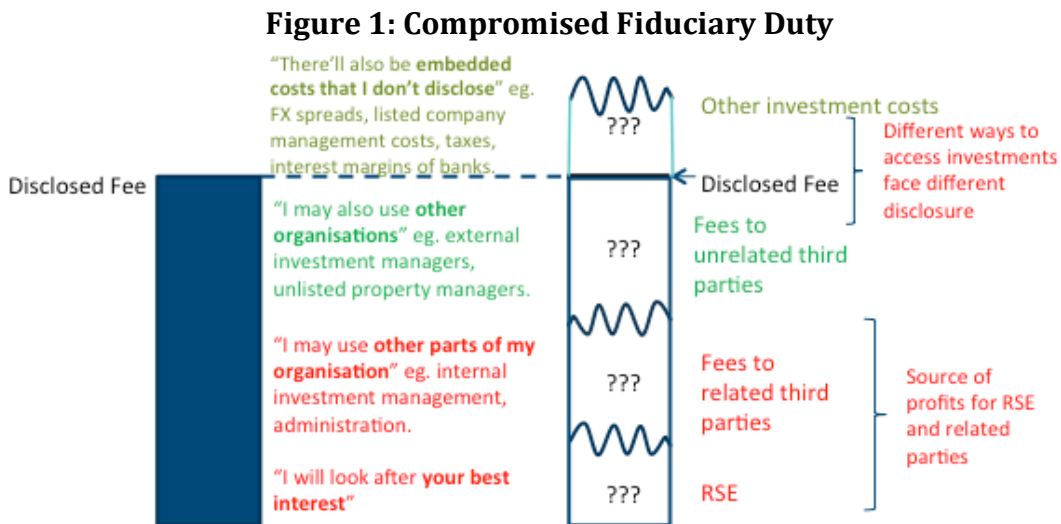
Once this is done there will be a clear demarcation between what an RSE is charging and what is being paid to other parties on behalf of clients.

For example, there will be no undisclosed financial benefit that an RSE will gain from replacing a high-fee external investment manager with a low-fee external manager – all

the benefits from such action will accrue to clients. By the same token, RSEs will not be financially penalised if they decide to invest with a higher-fee manager if they genuinely believe that is justified by higher net returns.

Importantly, RSEs will not be impeded from investing in a broad range of investments in the pursuit of higher net returns. Over time the superannuation system as a whole will utilise a broader opportunity set and this will reduce the systemic risk that will occur if investment strategies otherwise become more concentrated.

More detail on this issue was provided in the original submission that I made to the Productivity Commission, in which I included the following diagram to illustrate the source of the current compromise within the system.



## Specific Issues

In the Draft Report, the Productivity Commission requested information in a number of specific areas for which I provide the following comments:

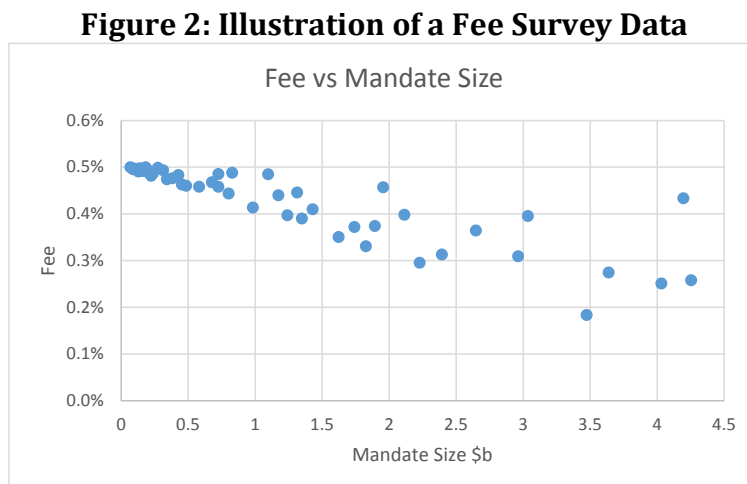
1. What is the best way to measure differences in the costs and member fees from funds outsourcing services to related versus unrelated providers? What is the best source of data for such analysis?

What is the most robust and feasible way of assessing system-level trends in the costs and margins of wholesale providers of administrative and investment superannuation services? What are the best sources of data for such analysis?

APRA is well-placed to survey fee arrangements for material outsourcing arrangements such as administration, custody and investment management. As the regulator, APRA can do this in a way that does not compromise confidentiality agreements to which RSEs may be committed.

Summary information can be provided to RSEs who can then compare the fees that they have negotiated with those in the market. This will also provide a basis for benchmarking relationships with related parties and, over time, be used for trend analysis.

To illustrate, data for a specific type of investment mandate might be reflected in the following chart.



Similar like-for-like comparisons could be completed for brokerage, administration, custody and other material activities.

For example, brokerage rates might be compared against market impact, the volume of trading and nature of the mandates. Administration costs could be compared to the number of members, assets under management or average account balance. Custody costs are likely to vary by the size of assets, complexity of investment arrangements and range of services.

2. What reference portfolio should be used to benchmark long-term net returns in the system and particular segments of the market?

Superficially it is attractive to adopt a standard simple reference portfolio as a benchmark against which to compare investment returns. However, there is no guarantee that any static reference portfolio will be relevant in meeting objectives that are relevant for superannuation clients. It will also be difficult to determine a single reference portfolio that will remain relevant across an industry that is aiming to invest to meet a range of different client profiles. It will be even more difficult for this reference portfolio to remain relevant as the underlying mix of superannuation clients changes over time.

Furthermore, there is a danger that any such reference portfolio will become the default investment strategy for the entire industry. If this occurs, money will flow into this naïve strategy and the short to medium term performance of the naïve strategy will be very strong. Funds that choose not to invest in this strategy will suffer in terms of performance as a bubble inflates and will be discouraged from looking outside the reference portfolio. In time, assets represented by the reference portfolio will become highly priced relative to other assets but there will be no incentive for RSEs to seek the better-value assets. The overall effect that will emerge will represent a serious institutionalised systemic risk for the superannuation system as well as the whole economy.

Nevertheless, a reference portfolio might be useful at a whole system level. Instead of setting such a portfolio by an *a priori* asset class allocation it may be better to determine

the reference portfolio asset allocation *ex post* as one that matches the overall volatility of returns that have been generated by the industry. By matching the volatility there could be an assessment of the efficiency with which the industry had generated investment returns.

3. How do funds do their internal performance attribution analysis (for example, to what extent is performance attributed to strategic asset allocation, dynamic asset allocation or the individual asset manager)? Are the results consistently reported and made public? What implications can be drawn from performance attribution for the measurement of system-wide efficiency in this study?

A major shortcoming of traditional performance attribution is that it starts with a reference portfolio as a benchmark as opposed to objectives that are meaningful for a superannuation fund client. In effect, for an investment team the reference portfolio becomes the risk-free return and the link to client objectives gets lost.

Superior attribution analysis starts with an objective of, for example, CPI +x and then attributes performance to the separate components:

Objective

- + Contribution from Reference Portfolio
- + Contribution from Strategic Asset Allocation
- + Contribution from Tactical Asset Allocation
- + Contribution from Stock Selection

Using this approach, the efficacy of the reference portfolio itself is assessed. There may be superannuation funds that implement a strategy that systematically underperforms a reference portfolio when that reference portfolio is expected to perform very strongly against the underlying objective but outperforms when the reference portfolio does not deliver the required levels of return. Such hedging may be very valuable but would get lost in traditional performance attribution.

4. Are there any other indicators of systemic risks in the superannuation system that should be incorporated into the assessment of this criterion? Are there any useful indicators that capture the impact of regulation and regulators on systemic risk?

One indicator of systemic risk would be a measure of the homogeneity of investment strategies.

### **Final Comment**

I would be very pleased to provide additional input on any issues relevant to this review.