Efficiency and Competiveness of the Superannuation System – Issues Paper/March 2016

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1 Summary of this submission

The thrust of this personal submission is that overall composite measures of efficiency will hide more than they reveal. There is however merit in a detailed examination of the institutional elements of the superannuation system, and their underlying processes, for their cost effectiveness in achieving the objectives of the system.

The main failings of the system are its regulatory complexity, which is in part, and perhaps arguably, a function of regulatory capture. Regulatory complexity inhibits the development of more appropriate products and services, spawns additional costs, and creates opportunities for the extraction of economic rents. It also distracts from efforts to address a number of conflicts of interest.

In evaluating administrative efficiency it is suggested that the Commission should investigate the data used by CEM benchmarking to evaluate the micro-efficiency of Australian funds.

The impact of the system on the allocation of capital needs to be assessed by considering the efficiency of investment markets. It is also suggested that the Commission consider measures of the efficiency of Australia's investment markets and cost of fund management as a whole. In doing this, it will need to make efforts to uncover a number of unreported costs, that potentially create secret and unreasonable profits.

The following measures are suggested as worthy of investigation in order to promote efficiency and competition:

- Consider ways of directing expertise in the SMSF sector back into the market for larger funds. One way is to require directors to have all their personal superannuation assets in the funds they serve.
- Thoroughly simplify the governing legislation.
- Enforce the common law by eliminating conflicts of interest by requiring banks to divest their control of superannuation funds, and financial advisors to charge their clients directly.
- Foster the development of mutual organizations as competition to proprietary companies. Allow SPSFs also to expand to perhaps 20 family members. Empower members by giving them the right to elect trustees, and institute AGMs.
- Introduce short term intellectual property protection to encourage innovation.

The effectiveness of the system in facilitating the smoothing of income over the lifetime and ensuring inter-generational equity needs to be measured by means of surveys and modelling.

SIS regulations 1.05 and 1.06 continue to prevent the introduction of annuity products that are dominant in some overseas markets – in spite of the gap in longevity protection being, perhaps, the major failing of the system.

2 Question on System Efficiency Objectives

Within the current policy settings, what are the objectives against which the efficiency and competitiveness of the superannuation system should be assessed? How prescriptively should the objectives be expressed?

I have previously made a submission to Treasury on the objectives of the Superannuation system – attached as submissions have not yet been made publically available.

In summary:

- Defining the objectives too tightly is inappropriate as it will inhibit future changes that need to be debated on their merits. Systems such as superannuation are complex and are necessarily in a state of flux. Potential changes may have too many intended and unintended consequences to be subject to the straitjacket of tight definitions.
- If we must have definitions, essential elements should be broadly defined:

i. Facilitate consumption smoothing for families/households over the course of life.

ii. Integrate with other government programs to address special needs, and to achieve intergenerational equity.

iii. Contribute to economic democracy and an efficient investment market.

3 Questions on the Commission's approach to assessment

3.1 Broad approach

Do you agree with the broad approach of combining performance benchmarks with a test of barriers to efficient or competitive outcomes in the superannuation system?

Yes.

3.2 Unique features

How should the unique features of the superannuation system (identified in section 2) be taken into account in developing criteria and indicators for assessing its competitiveness and efficiency? Are there other possible approaches?

Figure 3 should be extended by adding the self-employed, who are not compelled to contribute, and who are more expensive to recruit. Failing to consider them separately can distort comparisons with other countries.

The characterization of the industry on page 6, leaves out some important considerations covered below.

3.2.1 Investment uncertainty

Most importantly, the investments outcomes have and, in all likelihood, will continue to vary dramatically over time. The chart overleaf, taken from US Congress testimony by Gary Burtless[1] shows the best outcomes can be as much as four times the worst – and that after taking no post retirement investment risks.

This has a number of consequences that are perhaps not fully appreciated:

1. The lowest outcomes from investing in shares are comparable if not higher than the best outcomes from fixed interest investment in government stock. This means that it makes sense to take the risks, and that government provided pensions would always be lower if they were determined on a fair basis – with the return equal to that available to other investors in government stocks.
2. The outcome is uncertain and largely unmanageable. Much academic effort has gone into developing investment strategies to reduce risk. There remains considerable uncertainty as to the appropriate determination of the objective, let alone the implications for investment. (See for instance, Haberman and Vigna (2001), Kingston and Fisher (2014) and Butt and Khemka (2015)). Asher et al (2015) identify the dire state of financial advice as a pressing issue, and suggest ways in which it can be addressed. The project described in that paper is, we believe, making some progress.
3. The additional return is almost all undeserved as well as unpredictable. No one chooses their data of birth so the great outcomes of the sixties and late nineties (on this chart) are all windfall. One implication is that the taxation of superannuation

[1] http://www.brookings.edu/research/testimony/1999/05/11saving-burtless

should be[2] progressive and could be related either to the investment returns or the final drawings, i.e. ETT rather than TEE which is the current approach.

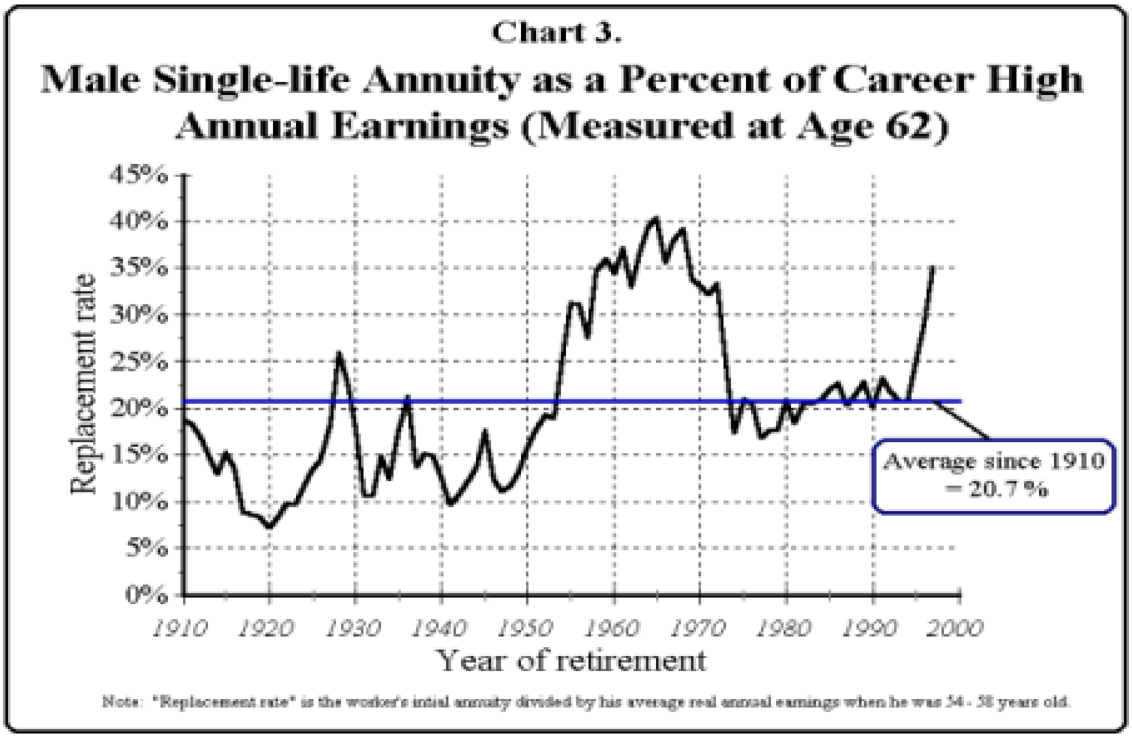

Figure 3-1 Relative replacement rates

3.2.2 Engagement

Recent research[3] has indicated that people are more engaged in their superannuation than previously thought – with the number in the SMSFs (unique to Australia) providing further demonstration that most people are engaged.

3.2.3 Principal agent relationships

The Commission may find the diagram from Asher (2006), overleaf, of use. Each of them need to be addressed. In the first place, fund accounts should ensure that they are reported to trustees and members to ensure that no secret profits are made. Secondly, conflicts of interest should be prohibited as in the common law.

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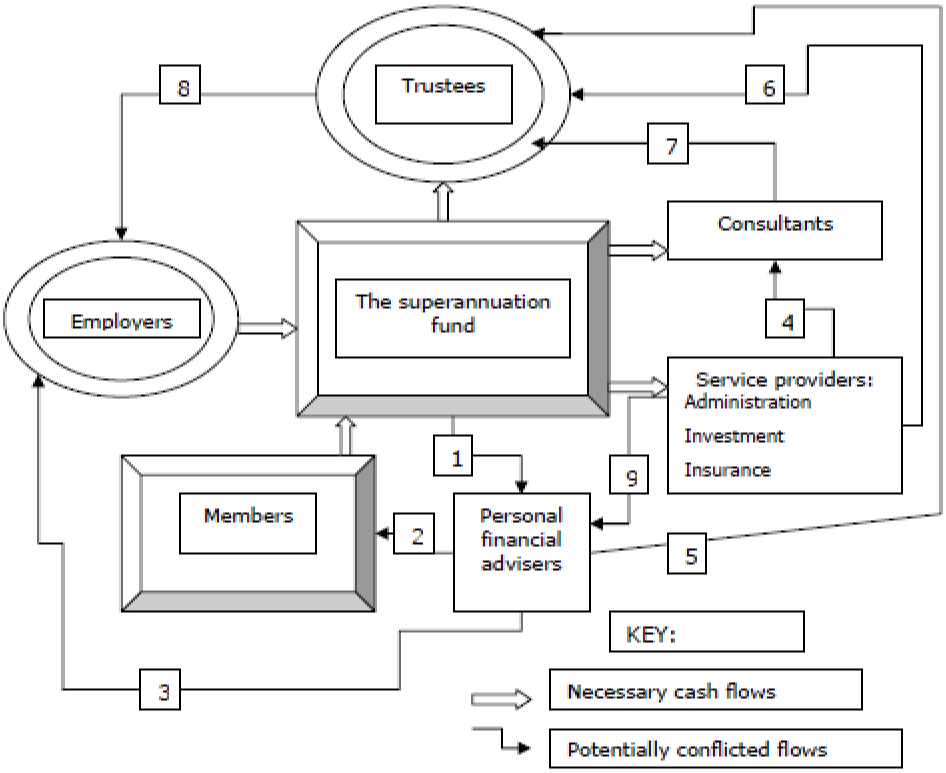
[2] I set out the criteria for this judgement in Asher (2011a), although have only recently seen the implications for taxation.

[3] See for instance, http://www.cifr.edu.au/assets/document/CIFR%20Superannuation%20Showcase%20D%20Foster.pdf



Flows causing potential conflicts of interest or duty

1	Adviser owes principal duty to member, but paid by fund, trustee or life company - sometimes also with soft dollars.
2	Adviser rebates commission, so reducing superannuation account.
3 & 8	Adviser, trustee or group rebates or provides other benefits to employer.
4	Service providers make secret, discretionary or soft dollar payments to consultants.
5, 6 & 7	Trustee or group makes, possibly, secret profit from holdings in adviser groups, service providers and consultants, or exercises discretions to make a greater disclosed profit at the expense of the members.
9	Financial advisers receive, possibly, secret profits from service providers.

Figure 3-2 Sources of Conflicts

3.2.4 Data reporting

To what extent do different data reporting formats make it difficult to compare SMSFs and APRA-regulated funds, and hence to assess the performance of the superannuation system as a whole?

It is not so much the data reporting format, but the fact that a significant proportion of the underlying costs are incurred in life insurance companies and various managed investment schemes. Returns are often reported net of expenses and sometimes even of tax – as traced in Asher (2004). Other costs are incurred by stockbrokers and various banks and dealers and are capitalised in the cost of shares or foreign exchange, or deducted from interest rates. The following diagram is sourced from South African experience, but is confirmed by other research discussed in section 3.4 of Asher (2007).

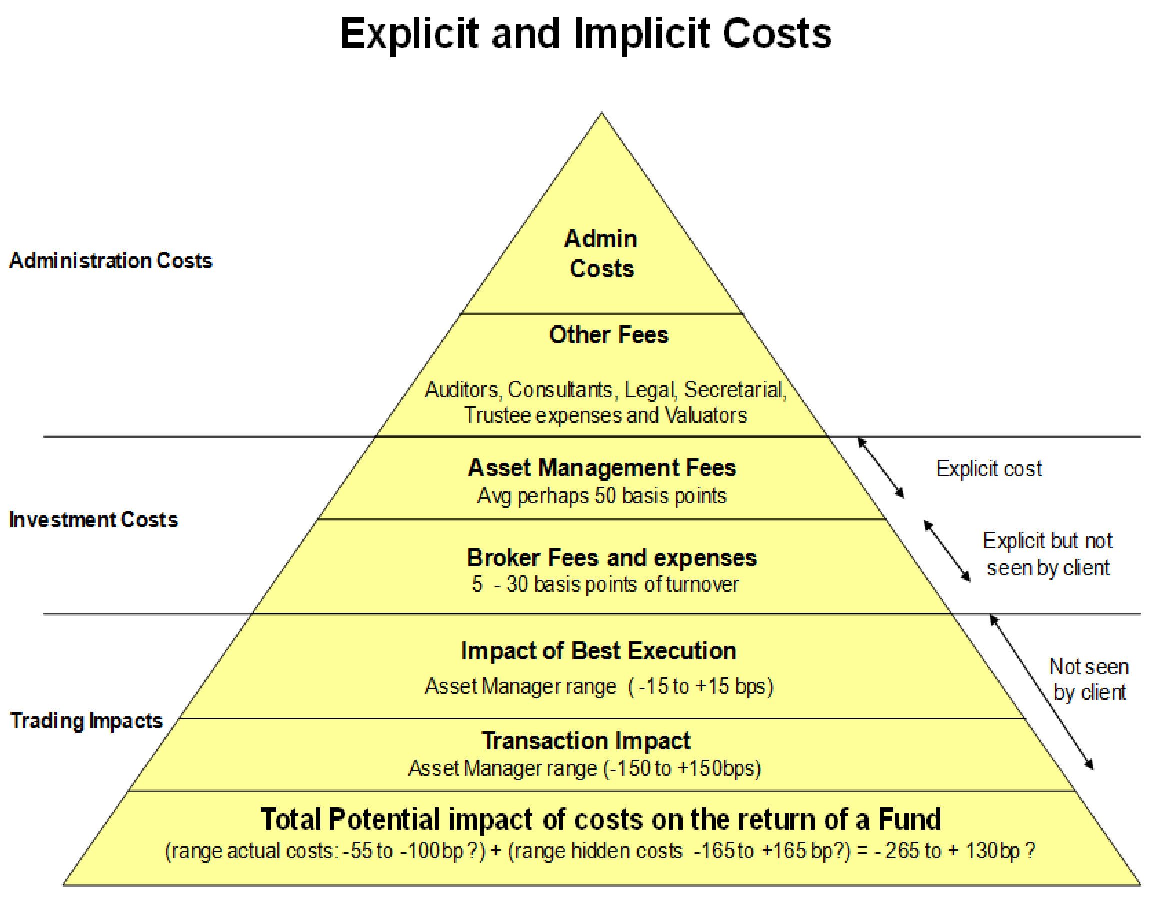


Figure 3-3 Investment costs *Source: Deloitte/Telemetron*

Which of the existing cross-country composite measures of pension system performance would be most relevant to this study and why? What are the challenges in using those measures to assess the efficiency and competitiveness of Australia's superannuation system?

The difficulties of cross-country comparisons are covered in Deloitte (2009), which makes a variety of such comparisons. As an author of that report, my experience suggests that composite measures invariably distort more than they reveal. In my view cross country comparisons are only useful in the investigation of the drivers of expenses, which require a detailed evaluation of the functions performed and the costs of doing so.

CEM benchmarking[4] can be strongly recommended as a source and for their research. There is no substitute for the insights developed from the in-depth analysis of micro-data.

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[4] http://www.cembenchmarking.com/

3.3 International comparisons

What measures and criteria are comparable across different countries?

Which of the existing composite measures of Australian superannuation fund and/or product performance would be relevant to this study and why?

No composite measures are helpful: they all mislead by failing to balance costs and benefits. Costs must be divided into administration, investments and advice as they are fundamentally different.

Administrative costs are best described in dollar rather than percentage terms. The graph below is from Rice Warner (2014) and show that they vary between some $100 and $250 pa. The Deloitte report showed that they were higher than internationally, largely because of a large number of manual transactions. The automation of Superstream is a long overdue intervention that will reduce these costs. Costs are also clearly reduced by scale, although increasing computer power is likely to reduce this as smaller funds should be able to access more computing power, while fintech developments mean that they will also have access to cost effective outsourcing.

Graph 5. Superannuation fund expenses

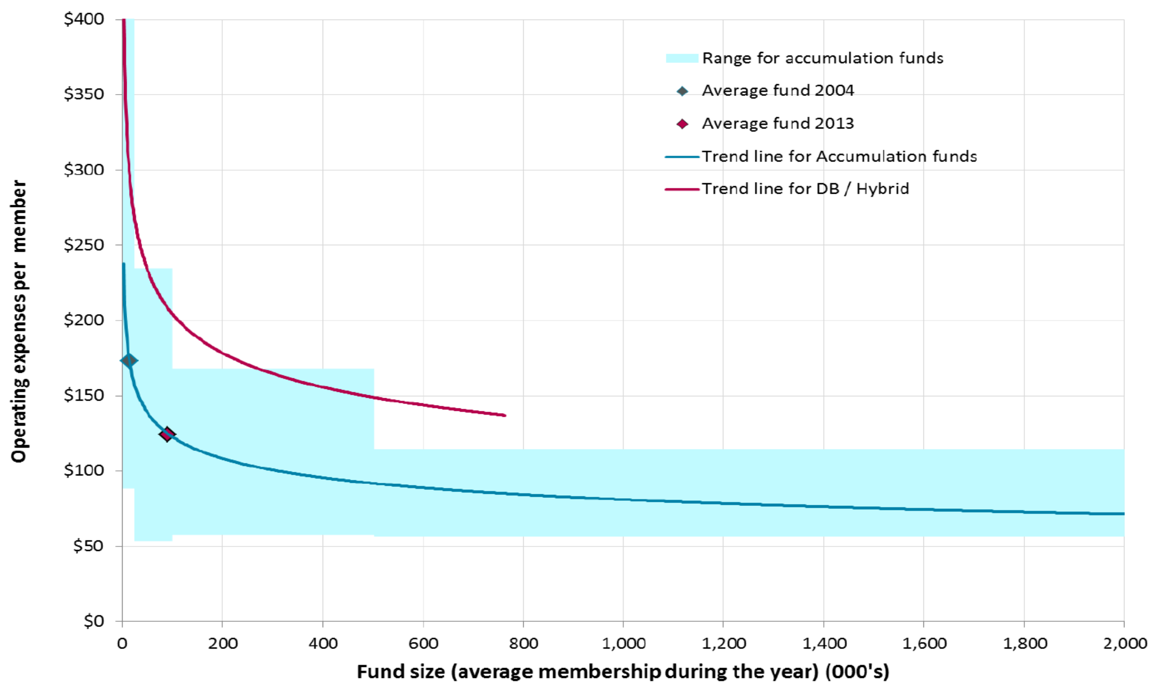

Figure 3-4 Economies of scale

I suggest that, from a policy perspective, the costs of administration savings are too small to warrant much effort.

- Many Australians have more than one fund and, although they could save the annual administrative costs, have not bothered to do so. If they did, the costs of the system would be lower.

- While some of the costs can no doubt be eliminated by more diligent management, there is no evidence of systematic corruption or exploitation to justify intervention.
- Technical advances may well make economies of scale available to smaller funds, and action at this time would be premature.

Investment costs are however much greater, particularly if the full range in figure 3.3 (the pyramid) are taken into account. They are material and cause for policy consideration:

- They are much larger in the long run than administrative costs
- They can be reduced significantly[5] but there is little price competition in the market.
- Many of the costs are hidden representing a specie of corruption and exploitation.

It will be difficult for the Commission to undertake an international comparison of costs, because the items in the pyramid are not collected and reported. Some of the custodians have the capacity to produce the data, but are not active sellers of the reports as they themselves make profits from deposits, the purchase of derivative contracts and foreign exchange. Asher (2007) suggests that performance and cost measures should be routinely required by trustees. My experience as trustee and consultant over some years is that trustees lack the confidence to request the information, and my recommendation would be for this information to be required by regulation.

[5] http://www.superreview.com.au/news/superannuation/super-funds-embracing-insourcing

4 Questions on the role of competition in superannuation

4.1 Competition

What are the key ways in which competition can improve efficiency in the superannuation system?

Is there sufficient emphasis on competition in the regulation of superannuation?

Are there any current circumstances where competition is not delivering efficient outcomes and why?

4.1.1 Reintegrating informed consumers

Competitive markets work when there are sufficient numbers of informed consumers. 10% of the best informed customers have fled the APRA superannuation fund for SMSFs. Many of these are managers of the APRA funds.

Some of the flight to SMSFs cannot be addressed, but some of the reasons relate to a failure of the larger funds to provide appropriate tax management, or to give reasonable volume discounts. Tax management involves tax aware investment (which is now being addressed) and saving capital gains when transferring to the decumulation phase.

A quick way of ensuring that these and future issues are addressed is to require directors managers of superannuation funds to have all their superannuation in the funds they manage. This will bring the most acute consumers right back into the market. It is hardly a surprise that Liu and Arnold (2013) find superior performance in those funds where the directors are invested. To facilitate this switch, the barriers created by capital gains tax should be removed when people switch funds.

4.1.2 Barriers to entry

Taylor *et al* (2016) is an exploration of regulatory capture in the Australian superannuation industry. In it we identify regulatory complexity as a main barrier to entry.

The SIS Act and the FSRA changes to the Corporations Act have long been recognised as appallingly complex and cumbersome legislation. As set out in the extracts from our paper in appendix 2, complexity is recognised as a source of inefficiency in itself, and a barrier to competition with large and well-resourced incumbents and their consultants.

This is aggravated by the manner in which both regulators have not always stuck to material issues. That Paskin and Turner (2008) found it necessary to argue for the application of the *de minimis* speaks volumes about overenthusiastic enforcement at times. While APRA argues, legitimately, that its own standards are principle based, its supervisors can be seen to require hugely piles of documentation, often obtained at significant legal cost.

Capital is not a major barrier, although the utterly pointless operational risk reserve[6] again illustrates a failure to adequately distinguish the immaterial.

The greatest possible contribution to innovation and competition would be a thorough review and simplification of the SIS Act and the FSRA sections of Corporations Act.[7]

Unrealised capital gains tax is a particular obstacle to changing fund and to the product rationalisation that has been identified as a potential source of administrative savings. It is subject to numerous exceptions, which are complicated and require considerable regulatory attention. The simplest solution that did not involve a loss of revenue, would be to tax unrealised gains. Although a somewhat novel idea it is feasible and would lead to greater market efficiency. It is feasible in that that superannuation funds already need to be liquid. It would have the additional advantage of increasing the liquidity of investment markets and reducing the costs of making investment decisions. It would reduce investment market bubbles by forcing sales when the market is high.

4.1.3 Conflicts of interest

Figure 3.2 above identifies a wide range of conflicts of interest, discussed in greater detail in Asher (2004). The main issues to my mind arises from the vertical integration of a large proportion of the industry in the big four or five banks.

- Bank managers can put collateral pressure on employers to encourage staff to join a bank fund, and other customers to do so as well.
- To the extent that the management of the superannuation fund is contracted to them banks can make hidden margins from investment fees, custodial services, foreign exchange, life insurance and deposits.

I believe that these conflicts have contributed to the cultural problems currently facing the banks, and that they should be forced to dispose of all their interests in the management of superannuation funds.

The issue with personal financial advice has already been widely debated, but it should be characterised by the same type of professional relationship as with doctors and lawyers. There is a need for to regulate trustworthiness. Many personal financial advisors would hover have begun their careers as high pressure life insurance sales persons, and still face significant conflicts of interest. The conflicts and pressures on the advisors are discussed in Asher (2004) section 4.1 and the references there. The impact of industry lobbying on the legislative process is documented in section 3.2 of Taylor et al (2016). While politically fraught, there is no alternative but to requiring financial advisors to charge directly for their services.

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[6] Section 1 of Asher and Gale (2006) gives the reasons why it is unnecessary and the chart on page 8 graph show its immateriality.

[7] While not a lawyer, but as a practitioner and academic who has read and worked with both, my personal opinion is that they could be abolished in their entirety (except to the extent that other primary legislation relies on them.) Competition would be enhanced, and members would enjoy greater protection, under the common law.

4.1.4 Choice and voice

Most Australian employees were given choice of superannuation fund in 2005. This was ostensibly intended to create freedom and competition, but can also be understood as an ideological choice to reduce the union's power over industry funds. Gallery and Gallery (2005) characterise the resultant system as "paternalistic libertarianism". It does appear to be modelled on the Chilean system developed under Pinochet and the "Chicago boys". It proved to be very expensive and failed to provide for lower income people, and has subsequently been reformed to cut costs by giving administrators a two year monopoly on administration [8].

Choice replaces emphasis on the members' voice in the running of the fund, with the right of exit. As the Commission has noticed, Rice Warner has reported that there has been an increase in marketing costs as a consequence. They would have reported direct marketing costs, but the indirect costs of having to improve and extend services are probably greater. Some of these changes are likely to benefit members; others such as the proliferation of investment options are unlikely to have been worthwhile. Another possible negative consequence has been that funds are required to focus on short term investment returns when it would be better if they took a longer term perspective on their investments.[9]

For many funds the horse has bolted, but it would be worthwhile to maintain those funds where members do not have choice as a natural experiment as to the benefits of competition.

Care would have to be taken that members were not disadvantaged as a consequence of such as experiment. The idea of compulsory tenders for that administration of such funds would be worthwhile. The other idea worth pursuing is that of the election of independent directors as suggested by Donald and Le Mire (2016), and of annual general meetings. This should apply to all funds, with the possibility that the number of elected directors could increase in future.

Asher and Gale (2006) argued in section 2 that the existence of mutual companies in the Australian market place would contribute to competition. To the extent that they are controlled, and can be subject to greater control by members, large Australian superannuation funds can function as mutuals and could act as a counterweight to with profit companies. At a smaller level, SMSFs could be allowed to admit more trustee members. There would be a ceiling above which it would not be practical for all members to remain engaged, but if they are all closely related, one cannot see objections to numbers up to perhaps 20.

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[8] Chant West (2014) Chilean Pension System: Relevance for Australia. http://www.fsc.org.au/downloads/uploaded/2014_0911_Chile%20Report%20FINAL%2029Aug14%20v2%20(3)_316a.pdf

[9] Haldane and Davies, R. (2011) summarise the debate and provide new evidence

4.1.5 Lack of intellectual property protection

Innovation may also be constrained by the lack of intellectual property (IP) protection. Neither patents nor copyright offer protection to innovators, making it more difficult to justify an investment in a new product or method of doing business. I have personal experience of this difficulty in developing the product set out in Asher (2011b).

It seems generally agreed that IP encourages innovation. Some type of IP for financial products might do the same. My thoughts are that such an instrument might dispense with the patenting requirement that an invention be non-obvious and novel by a measure of whether the product was currently available in the market. A potential supplier might apply for a short term (say 5 year) exclusive licence.

4.2 Economies of scale

What are the key sources of economies of scale? What are the ways of realising economies of scale, in addition to fund mergers? Are there any parts of the system that may be operating with diseconomies of scale? What are the best indicators for measuring the current realisation of scale economies, and the scope for future increases?

As above. The economies of scale in administration are not sufficient to concern the Productivity Commission.

On investment fees, there are economies of scale that are obtainable by very large funds particularly if they are prepared to bring investment management in-house. As discussed by Warren and Gallagher (2016), this also allows funds to benefit from paying more reasonable salaries to investment managers. Section 7 of the Deloitte report suggests that Australian funds are not uncompetitive internationally when taking size and other factors into account.

While fewer and larger funds will produce economies of scale, they will also significantly reduce diversity in investment markets – placing a majority of the country's assets under the control of a few teams. This concentration of power might have doleful impacts on investment market efficiency, and on democracy generally. Some additional costs would be justified therefore.

5 Questions on assessing competition in the superannuation system

What are the key outcome-based indicators of competition in the superannuation system?

5.1 Market definition

For each of the levels in the vertical supply chain (figure 3), who are the relevant consumers, and which market participants within or outside of the superannuation system are the most likely source of competitive pressure?

As discussed in 4.1.1 above, it is necessary to reintroduce at least some informed consumers who have fled to the SMSF sector.

Ensuring that fund administrators were independent of the banks particularly would lead to greater competition.

For each of the levels in the vertical supply chain, is there evidence of competition on factors other than price, and if so what are they (for example, performance, investment options, any additional features)? What drives this choice?

Investment performance is clearly a huge issue, and poorly understood. In Asher (2004), I characterise it as bordering on superstition (see section 3.3.2), and in Asher (2007) note that behavioural economists use credulity (section 1.2.1). As one of the better known Australian investment manager, Jack Gray, has it: “No one can identify a good investment manager, we do not know ourselves.” As mentioned in 3.2.1 above, Asher (2007) makes a variety of recommendations to address some of the irrationality of the investment management market.

On what factors and features do default funds compete in corporate tenders? What factors are relevant for the assessment and selection of platform service providers by funds?

I would be surprised if this was not competitive to all intents and purposes.

What is the degree of substitutability between different types of superannuation funds and products? How can this be evaluated or measured?

Members can effectively move between funds, although there are obstacles:

- Administrative obstacles.
- Inability to obtain similar life or disability insurance – sometimes for health reasons.

The number of people who move each year could be measured.

What is the relative contribution to member fees from the various participants through the vertical value chain?

For the fees that are known, I believe that the Rice Warner report provides an adequate overall view. CEM benchmarking could provide more detailed and useful information. For the hidden fees in mentioned in 3.2.4 above, I think new regulations are required. These could come from the APRA Reporting Standards, but I would prefer them to be included in the Accounting Standard AASB 1056.

5.2 Criteria and indicators

What are the most reliable and relevant assessment criteria and indicators for measuring the competitiveness of the superannuation system?

I do not believe that there are simple indicators. It requires an analysis of the type the Commission is performing. I think it ultimately will be more qualitative than quantitative.

What are the barriers to efficiency-enhancing competition in the superannuation system? In particular, what are the policy impediments to competition? How can the impacts of these barriers be measured?

Complexity has been discussed in 4.1.2 above.

The unspeakable SIS regulations 1.05 and 1.06 prevent the development of suitable annuity products, (Asher, 2012). What are dominant annuity products in some annuity markets internationally are not permitted in Australia, in spite of the development of longevity products being identified as the major shortfall in the system. The failure of successive governments over 20 years to remove these obstacle, in spite of numerous submissions, endorsement from all the relevant enquiries and absence of opposition are inexplicable. The Commission might use this as a case study to assess the dead hand of regulation.

How would you measure the effectiveness of regulation in promoting competition within the superannuation system?

One would want to measure the extent to which regulation protects incumbents. I think this would also be more qualitative than quantitative.

How would you measure the extent of competitive pressure from the SMSF segment on the rest of the superannuation system?

One can obviously see the introduction of individual shares into the large fund choice menu, but as long as the SMSF sector has lower fees than the rest of the system, the pressure is clearly minimal in this respect.

Can levels of transparency on aspects such as conflicts of interest and details of reporting to members (for example, as income stream equivalents) be used as a measure of competition?

Absolutely – both clarity and quality. Perhaps the Commission could develop a puffery index for annual reports and other communication. The ratio of pictures to tables would be a good start! Much greater detail of costs, and of the investment performance measures suggested in Asher (2007), would obviously help to focus minds on relevant issues.

Providing income stream equivalents, as with investment returns, are not likely to provide much useful information as they are almost entirely due to chance. As discussed in 3.2.1, there are pressing reasons for better illustrations for better financial planning.

6 Questions on assessing operational efficiency of the system

Do you agree with the proposed objectives for operational efficiency? If not, what should they be?

6.1 Benchmarking

What are the most reliable and relevant assessment criteria and indicators for benchmarking operational efficiency of the superannuation system? What are the evidence requirements and current gaps in using your proposed criteria and indicators?

What are the appropriate benchmarks against which the operational efficiency of Australia's superannuation system should be measured? Are there countries that have superannuation systems that could provide an appropriate benchmark?

What types of fees are relevant to assessing the competitiveness and efficiency of the superannuation system? How should these fees be measured? What data sources are available and to what extent are these comparable with one another?

What are the best measure(s) of (post-fee) risk adjusted rates of return? How comparable are these measures?

What aspects of operational efficiency cannot be reliably measured using a benchmarking approach? How could this assessment incorporate aspects such as service quality?

What are the advantages and disadvantages of using techniques such as data envelopment analysis over conventional approaches such as simple benchmarking of a single criterion?

6.1.1 Composite and granular measures

In my view, composite measures distort reality.

Treatment of the self-employed provide an example. If superannuation contributions were mandated for the self-employed and included in the tax collection process, then they would involve an electronic transfer from the tax office to the superannuation fund at a cost of a few cents. As they are not compulsory in Australia, the self-employed either have to set up their own fund or contribute using a financial advisor – in both cases costs amounting to thousands of dollars a year. It is a policy decision as to whether the costs are worth it, but not strictly an efficiency issue.

The high level insights obtained from the research mentioned in box 5 are of little practical value in measuring the effectiveness of policy settings or suggesting changes. The micro data of the Rice Warner report, which separately identifies investment, administration and advice does however provide a basis for the more granular investigations that would be needed. The even more detailed CEM benchmarking studies are essentially what is necessary to home in on processes where greater efficiency can be obtained.

For investment efficiency, it will be necessary to collect the data discussed in section 3.3 above.

I agree that operational efficiency is measured by cost effectiveness, as suggested in the last line of table 2 of the Issues Paper, but not that effectiveness can be measured by maximum returns or "income efficiency" as suggested in the first two lines. As discussed earlier, risk adjusted investment returns are barely within the control of the industry, while "income efficiency" of a retirement product will similarly depend on investment returns not in the control of the industry, or mortality selection that cross subsidises some members at the expense of others. Therefore, in each case – for each process – cost effectiveness means balancing the costs against the benefits, and then benchmarking the process against similar funds in different countries.

6.2 Measuring success against objectives

I do think it important to evaluate the success of the system against the general objectives I suggested in section 1 above.

6.2.1 Facilitate consumption smoothing for families/households over the course of life.

6.2.2 Integrate with other government programs to address special needs, and to achieve intergenerational equity.

These two questions can be answered together. Success here should be measured both cross-sectionally and longitudinally. Are there significant differences in standard of living between generations? Are households supported by the superannuation system and welfare systems in maintaining a relatively level standard of living over their lifetimes? Both questions can be measured by surveys such as HILDA and the ABS Household Income and Wealth surveys. Such surveys would need to be supplemented by modelling (Asher et al, 2015; Asher, 2011b) that would identify the liquidity constraints of the young, and the old locked into excessive housing by means tests.

Operational efficiency is measured by the administrative costs of the superannuation system, which I have suggested are relatively small in any event.

6.2.3 Contribute to economic democracy and an efficient investment market

The first requires funds to be active participants in company governance – apparently a legal requirement in the US ERISA legislation – also discussed in Haldane and Davies.

Determining the contribution of the system to efficient investment markets is difficult to measure. On a macro level, a more efficient market should allocate capital more effectively, increasing returns. On the other hand, international capital flows might neutralise any local advantages, and indeed a well-functioning investment market might crowd in international investments, so ultimately reducing returns.

Comparisons of the cost of active and passive management should be made with caution, as the passive managers are free riders on the analysis of the active managers. While some free riding will reduce costs, large investors that dominate the market cannot use passive management without endangering the efficiency of the capital market as a whole.

There are measures of market efficiency that can be made:

- Measuring the way in which share prices respond to relevant news, based on assumption that efficient markets will show little sign of insider trading and respond quickly to news.

- Compare the investment performance of active vs passive investment managers, and those of institutions (presumably informed) and individuals (presumably ill-informed)

On both these measures, the Australian market appears reasonably effective. Managed funds specialising in the smaller capitalised shares do however appear to outperform the market, which prima facie suggests some inefficiency, but I am unaware of detailed research in this area.

Arguments are made from time to time that superannuation funds, being long term investors, should be investing in long term unlisted assets. As discussed earlier, fund choice makes this a risky enterprise. There are however good arguments for suggesting that the listed market provide both liquidity and an independent pricing method. The Australian investment markets do not appear to create much of an expense overload, but this is a question that might be investigated by the Commission.

On measures of operational efficiency, one would need the data described in 3.2.4 above.

6.3 Barriers to operational efficiency

What elements of regulation have the greatest effect on the operational efficiency of the system and which aspects of operations are affected? How could those impacts be measured?

I think the effects of complexity on operational efficiency might be measured using the methods of CEM benchmarking.

7 Questions on assessing allocative efficiency

Do you agree with the proposed objectives for allocative efficiency? If not, what should they be?

7.1 Benchmarking

What are the advantages and disadvantages of using benchmarking to assess the allocative efficiency of the superannuation system? Which aspects of the system most lend themselves to such assessment?

Which criteria and measures are most relevant to assessing the allocative efficiency of the system, and how should they be interpreted? What are the evidence requirements and current gaps in using your proposed criteria and indicators?

This has been covered above.

Barriers to allocative efficiency

How can the magnitude and cost of principal–agent problems be assessed?

Should the criteria and indicators for assessing the extent and magnitude of principal–agent and governance problems focus on outcomes or inputs and process, such as best practice governance principles, or a combination of both? What existing measures of governance could the Commission draw on, and what are their strengths and weaknesses?

Glover (2002) is quoted in Asher (2004):

> *"Investors, and more particularly members of superannuation funds enjoy significant protection from the common (or general) law. Corporate officers and advisers with whom we are concerned are disciplined at general law as 'fiduciaries'. The term refers to the law's code for the maintenance of the honesty and integrity of persons in positions of ascendancy and trust. Its centrepiece is an 'inflexible rule' which prohibits fiduciaries, such as corporate officers and advisers, from putting themselves in positions where their interest and duty conflict.16"as Its centrepiece is an 'inflexible rule' which prohibits fiduciaries, such as corporate officers and advisers, from putting themselves in positions where their interest and duty conflict"[10]*

Failure to enforce this "inflexible rule" is a measure of regulatory capture, and an obvious failure in the system.

What are the most important behavioural biases and cognitive constraints affecting the key superannuation saving, investment and withdrawal decisions of users? What are the best

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[10] See *Bray v Ford* [1896] AC 44, 51; also *Phipps v Boardman*[1967] 2 AC 46, 123, ("AC" denotes House of Lords' Appeal Cases)

assessment criteria and indicators for examining the magnitude and effect of those biases and constraints? What are the key gaps in the evidence to enable such assessment?

Apart from the credulity as to the potential success of investment management, I think users are so poorly informed by the industry that biases have minimal effects. The project outlined in Asher et at (2015) is attempting to develop a more appropriate financial planning calculator, which might provide the tools and encouragement to make better decisions.

What are the best assessment criteria and indicators for examining the extent to which the outcomes for users are optimal with respect to the current taxation settings?

Making this assessment requires plausible utility functions, and it is unclear whether it would be worthwhile. What is worth considering is the extent to which the cost of financial advice can be ascribed to complexity of tax and Age Pension legislation. If it were simple, would anyone bother to consult financial advisors?

8 Questions on assessing dynamic efficiency

Do you agree with the proposed objectives for dynamic efficiency? If not, what should they be?

8.1 Benchmarking

What are the most reliable and relevant assessment criteria and indicators for measuring the dynamic efficiency of the superannuation system? What are the evidence requirements and current gaps in using your proposed criteria and indicators?

Barriers to dynamic efficiency

What are the key impediments to dynamic efficiency and how could they be measured?

I have nothing further to add at this point.

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10 Appendix 1: Submission on objectives of superannuation

Setting the sights of the Superannuation System

I doubt the benefits of having an objective for the superannuation system, but if we must, care should be taken as to the unintended consequences – particularly where the industry is lobbying for changes that will increase the size of the system In particular, objectives be limited to facilitating consumption smoothing over the lifetime, retaining insurance within super, and have nothing to say about tax concessions.

In one of his purple and perspicacious passages, which should be prominent on every policy paper produced, Adam Smith says:

"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. … 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. It comes from an order of men, whose interest is never exactly the same as the public, who have a general interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it."

It may therefore be worthwhile to approach, with some suspicion, the Treasury proposal to enshrine the objective of superannuation in legislation. It is based on recommendations of the Financial Systems Inquiry (FSI), itself, necessarily, staffed by people with a strong financial background – Smith's dealers even if partly turned regulators. Their background, however, means that, in the words of academic, John Kay, they may see the industry "through the eyes of market participants rather than the end users they exist to serve" and are thus subject to "intellectual capture". The submissions received also tend in the same way to reflect an industry perspective. My research with Sue Taylor suggests that such capture is evident in the Australian superannuation system.

Perhaps the main question to consider suspiciously is the idea of a fundamental purpose at all. The Treasury paper says "a legislated objective will provide a way in which competing superannuation proposals can be measured". But how many Trojan horses will be included, to be brought out as arguments against proposals that otherwise have merit? Why do we not have objectives for the education and health systems?

The SIS Act already has "a sole purpose test" in section 62. Like the rest of the Act, the section is complex and clumsy. It take over 900 words to say that a superannuation fund must be set up to provide benefits on the death or disability of a member, or on or after retirement. The absence of reference to insurance benefits in the Treasury paper is possibly an oversight. It is unfortunate however, because life and disability insurance are intimately connected with retirement planning and should not be lost to superannuation:

- A significant number of people are forced to retire for health reasons, and the integration of retirement and disability benefits allows for seamless and higher benefits.
- Death benefits should decline as superannuation balances increase, and men should make provision for the mothers of their children, if they have lower superannuation benefits as a consequence of time out of the workforce.

While the case is not made vociferously, the industry would seem to resent insurance premiums being taken out of superannuation as more profits are to be made on higher balances.

The failure of most superannuation funds to provide lifelong annuity benefits received prominence in the FSI report, and seems to be the main driver of the objectives discussion. The FSI recommendation in the Treasury paper, is "to provide income in retirement to substitute or supplement the Age Pension." Set as a subsidiary objective, is to "facilitate consumption smoothing over the course of an individual's life." Three elements of the wording may be critical for future debates:

- "Facilitate" implies no compulsion; "encourage", if it were used, would suggest tax advantages; "to provide" suggests compulsion perhaps after as well as before retirement. Superannuation funds, of course, love compulsion in any form as it increases their funds under management. The majority of the public seem to agree, but majority approval does not justify interference in people's lives without good reasons. It has long been known that young families are liquidity constrained and this is aggravated by mandatory superannuation contributions. If we must have a legislated purpose, it should avoid any suggestion that compulsion should be part of it.
- "Consumption smoothing over the life time" and "an acceptable standard of living in retirement" are not the same. My research with Adam Butt, Gaurav Khemka and Ujwal Kayande on retirement planning assumes as self-evident that the aim of planning is for relatively level consumption over the lifetime – after adjusting for the costs of children and for mortgage repayments. Most calculators, however, can suggest that users reduce themselves to penury in order to meet unrealistic retirement objectives. Objectives such as 65% of pre-retirement income or the ASFA comfortable standard are seldom right. The first is almost always too high – the latter appropriate for someone slightly above middle income, but too high for some and low for others.
- "Substitute or supplement the Age Pension" seems an acceptable objective for the individual, but the question is broader and deeper. It is important that the objective does not include reducing the fiscal costs of the Age Pension, as some might have it. This could be used to justify all sorts of inappropriate means tests. The industry is, unsurprisingly, indefatigable in its pursuit of tax concessions. The Australia Institute, however, makes the point that a higher universal pension with no tax concessions for superannuation would be cheaper, easier and fairer. In my view, the means tests in their current form are unfair and represent an unwarranted interference in the lives of pensioners – and do need reform. Tax concessions, particularly the egregiously regressive no tax over 60, are all generous and perhaps unnecessary. Superannuation is a lifelong investment, and taxes on contributions and investment income barely affect consumption. Short term changes to superannuation tax rates can therefore provide a useful way of raising taxes without discouraging consumption.

The Treasury paper notes that the third of the original objectives of superannuation, increasing national savings, is currently perceived as less important than in 1992 when the basic legislation was passed. It is to be hoped that this issue will become more salient for three reasons.

- The blowout in our foreign debt over the last two decades is unsustainable, in that it cannot carry on for ever and makes us vulnerable to crises. While not a superannuation issue per se, superannuation does provide for national saving.
- What is at question is whether the funds to be invested may be too great to be absorbed either here or internationally. Paul Samuelson suggested 50 years ago that an aging population could drive interest rates negative. It is possible that current low interest rates and high assets prices reflect just this. The Treasury paper itself projects that the superannuation system be bigger than the banks in time. Where will all the investments go without pushing asset prices even higher?
- Funded superannuation does provide the potential for greater industrial democracy, as envisaged by Peter Drucker. This can occur if fund trustees are elected, but it has suited neither side of politics. Union domination has been sponsored by one side, and the other side has sponsored the fund choice that means that marketing and puffery replace democracy and shareholder responsibility. It would be good to include a reference to the democratisation of ownership.
- The suggestion here is that government should issue a short term (say 7 year) exclusive licence to any idea (be it a physical product or service) that is not available or not implemented in Australia. The originator of the idea would have to submit the terms of the licence and pay for its processing (perhaps $10,000). The licence would then be made available for public auction with the originator receiving the proceeds. Cost to government could therefore be zero but there be significant benefits for those generating ideas - and allow more experimentation with new ideas.

11 Appendix 2: More on barriers to entry

11.1 Legislative Complexity (section 2.4 from Taylor et al, 2016)

Justice Steven Rares' opinion is that:[11]

"…the policy choice of using prescriptive drafting that most Commonwealth legislation has reflected over the last two or three decades needs urgent reconsideration. It has really significant impacts on the whole community in terms of comprehensibility, compliance costs and, to use a political catch cry, access to justice.

Why is this so? … First, attempts at codification involving many permutations on a theme are inevitably complex and likely to miss something, secondly, complexity can, and often is, a handmaiden of incomprehensibility, thirdly, the unravelling of complexity requires time and effort, fourthly, the more detailed and complex that legislation is, the harder it is for the ordinary person, including the scions of the business community, to grasp the point and comply, fifthly, complexity makes litigation more complex, lengthy and expensive for the parties and, sixthly, those factors create the need for the Courts to deal with more and more in judgments or summings up to juries leading to delay, the greater likelihood of appellate challenges and, of course, error. This last aspect has affected the conduct of litigation profoundly.'

Legislative complexity has not been widely examined as a cause of regulatory failure, although the related issue of principle versus prescription is widely used. Cunningham (2007)[12] suggests that much of this use is however rhetorical, and this paper does not therefore pursue this debate. Complexity is separate issue related to the number and length of regulatory instruments, and the extent to which they interact.

While a full consideration is outside of the scope of this paper, in our view complexity has played an important role in the regulatory paradox existing within the Australian superannuation industry given that it benefits vested interests and acts as a screen for rent seekers. A recent UK surveys of trustees[13] has confirmed that the problem is not limited to Australia with the UK Office of the Parliamentary Counsel, Cabinet Office (at p. 2)[14], calling for an in depth analysis of the complexity that has been created. In the view of the Parliamentary Counsel:

"…we should regard the current degree of difficulty with law as neither inevitable nor acceptable. We should be concerned about it for several reasons. Excessive complexity

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[11] Rares, S., 2014, May. Competition, fairness and the courts. In Competition Law Conference, Sydney (Vol. 24).

[12] Cunningham, L.A., 2007. Prescription to retire the rhetoric of principles-based systems in corporate law, securities regulation, and accounting, *Vanderbilt Law Review,* 60, p.1409.

[13] Trustees warn DC governance changes have not benefited members. Accessed on 25 January 2016 at: http://www.professionalpensions.com/professional-pensions/news/2442379/trustees-warn-dc-governance-changes-have-not-benefitted-members#

[14] UK Office of the Parliamentary Counsel, Cabinet Office. (2013), When laws become too complex accessed on the 12th March, 2016 at: https://www.gov.uk/government/publications/when-laws-become-too-complex/when-laws-become-too-complex

hinders economic activity, creating burdens for individuals, businesses and communities. It obstructs good government. It undermines the rule of law.'

11.1.1 Materiality (section 3.3.2 from Taylor et al, 2016)

The regulators have had some difficulty at times in maintaining a sense of proportion, particularly about the materiality of monetary amounts. For example, until the *Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act* 2007, superannuation funds were required to report all breaches of regulation to APRA, which interpreted this as meaning that there was no concept of *de minimis* and that the most trivial of breaches should be reported.

The remediation of unit pricing errors was an issue that absorbed significant attention from the regulators from about 2003. Asher and Duncanson (2008) document remediation processes where multi-billion funds exchanged cheques of a few cents. They argue that *de minimis* rules should apply at materiality levels much higher than the 30bp in the industry and regulatory standards that had by that time been introduced to moderate excessive precision. The point is that superannuation risks are entirely dominated by the volatility of their investments, which vary on average by about 80bp every working day. The regulators, and many lawyers advising superannuation trustees, appear to have taken a particularly fastidious line, as identified by lawyers Paskin and Turner (2008).

APRA continues to attempt to impose just such a cautious line as is evidenced by its current Operational Risk Financial Requirement (ORFP), which is required to pay for operational risks. APRA suggests should the ORFP should be of the order of 25bps.[15] Not only could this be considered immaterial relative to the daily movement in the value of the fund, but in most cases, the impact on any member in a not for profit fund would be a fraction of that. All it means is that the costs of operational losses are taken out of an account before rather than after they occur.

This fussiness about the immaterial also appears to have played a role in the rationalisation of legacy products, which has been on the regulatory agenda since at least the 2006 report of the Taskforce on Reducing Regulatory Burdens on Business. In the Issues Paper produced in response, Treasury estimated that rationalization of the 6,000 legacy products would save an estimated $120 to $350 million annually – apart from reducing the risks involved in administering products with declining levels of support. While there are other reasons for the delay, there is reluctance to countenance an approach that could see all members receiving a higher expected return – even if subsequent investment movements might place them worse off under some investment scenarios.

This excess care for minutiae has effects throughout the industry. One of the authors was told that a large provider had, perhaps unnecessarily, set themselves a risk appetite of "zero tolerance" for regulatory breaches. The effect was that every marketing document was now being scrutinised by lawyers, leading to a significant increase in costs.

The obvious beneficiaries of this silly precision are the lawyers who argue, as reported in Paskin and Turner, that the courts have not ruled on the application of *de minimis* to trust

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[15] Prudential Practice Guide SPG 114 – Operational Risk Financial Requirement, July 2013 Accessed on 21/01/2016 at: http://www.apra.gov.au/Super/PrudentialFramework/Documents/Prudential-Practice-Guide-SPG-114-Operational-Risk-Financial-Requirement-July-2013.pdf

law, and that the prudent approach it to assume that it does not apply. Other consultants have also made money from unit price remediations, and the calculation of the ORFP. Companies may be reluctant to bother with legacy products if the benefits will largely accrue to the members, which is a possible outcome of public orientated regulation. The lawyers obviously influence both market participants and regulators to take a low risk approach.