03 August 2018

Angela MacRae, Commissioner
Productivity Commission
Level 12, 530 Collins Street, Melbourne VIC 3000/
Locked Bag 2 Collins Street East,
MELBOURNE VIC 8003

Re: Productivity Commission - Superannuation: Assessing Efficiency and Competitiveness

Dear Commissioner MacRae,

I would like to lodge this submission for the draft report of the inquiry into Superannuation: Assessing Efficiency and Competitiveness.

I am Professor of Economics at Catholic University of Chile, Santiago, Chile, Faculty of Economics and Business Administration. I have a Ph.D. in Economics from the Massachusetts Institute of Technology (1987). I also served as Senior Advisor to the Minister of Finance of Chile in 2010-2014. I attach a CV in English with my publications in international journals and professional activities.

Through this letter, I wish to contribute to the Productivity Commission's inquiry into Australian superannuation policy, by linking the recent evidence uncovered in Australia about a large difference in average risk-adjusted rates of return for pension funds managed by for-profit and not-for-profit.

The recent paper by Dr. Kevin Liu and Elisabeth Ooi published by the Journal *Accounting and Finance (2018)* provides the empirical result that the annual difference in rates of return is about 100 basis points (1% per year). Over the lifetime of a worker this difference accumulates into a difference in old-age contributory pension of the order of 25%. I am sure this very substantial gap is going to get first priority in this inquiry.

A useful question to frame the issues is whether the difference in performance (in investment management) between Industry Funds and Retails Funds in Australia is due (a) solely to lax regulation, (b) solely to an intrinsic difference between non-profit and for-profit pension management organizations, or (c) to both.

Chile may provide considerable evidence on this. By law, all of our pension management organizations (PMOs, AFPs in Spanish) must be for-profit, although there have been some owned by unions and one is still owned by an employers' association. Still, a large share has been owned by large financial conglomerates (historically, i.e. since 1981, and up to the present). In the last few years two global financial conglomerates, Metlife and Principal have taken control of two large PMO's that provide active life services. Prudential has entered into a joint venture with the PMO controlled by an employers' association. In the

passive-life area, there are at least 15 active life insurance companies providing semi-mandatory CPI-indexed life annuities (single and joint with partner), of which at least 5 are controlled for global life insurance companies.

However, the practices that Drs. Liu and Ooi report prevail in Retail Funds owned by large vertically integrated financial conglomerates in Australia, regarding hiring of related parties *are rare in Chile, or if they exist, are definitely muted and more indirect*.

Apparently, a major reason for this is strong regulation, quite different from Australia's. It is similar in aims to the one proposed by Drs. Liu and Ooi to the Productivity Commission in their submission this 12 July, but the instruments used are a bit different and much wider ranging. The purpose of my submission it to point out these facts, which may be revealing.

The following regulations are written into the Chilean pension law (Decree Law No. 3.500, available in https://www.spensiones.cl/portal/institucional/594/w3-article-3832.html).

This a long body of law, so this is only a selection, non-exhaustive:

1. ***TITULO XIV, "De la Regulación de Conflictos de Intereses",*** articles # 147 to 159. Specially pertinent are the following:
    - Art. 153, paragraph 3: The CEO, the CFO and the marketing chief, all executives from the commercial (marketing) and portfolio management areas, may not perform simultaneously similar duties in any entity that is the member of the same Business Group as the PMO (Another Chilean law defines Business Group with a lot of detail: see law No. 18.046).
    - Art. 153, par. 1: It is incompatible for anybody to participate in activities related to portfolio management decisions for both the pension funds and the PMO, with management of any other portfolio owned by third parties (including the personal portfolio owned by an employee)
    - Art. 156 par. 1: In addition to the prohibition contained in the Companies Law (No. 18.046), the following persons shall not be members of the board of a PMO: (a) executives of banks, stock exchanges, securities brokers, managers of investment fund companies, insurance companies and PMOs; and (b) board members of any of the institutions identified in (a) plus board members of any entity, Chilean or foreign, that is a member of the same Business Group as the PMO.
    - Art. 156 par. 3: Regarding persons prohibited in art. 36, numbers 1 and 2 of the Companies law (members of parliament, mayors, Ministers and high ranking officers of the Executive Power), the prohibition established here will remain for 12 months after the person leaves office at the PMO.

2. **"Autonomous" Directors are required by law.**
   Art. 156 bis: The Board of a PMO must have at least 2 directors that are autonomous. These are directors who do not have other links with:
   - the PMO,
   - other entities of the Business Group of the PMO,
   - the controller of the Business Group
   - the principal executive offers of both the PMO and these entities where those links may generate a potential conflict of interest or reduce their independence of judgment.
   - It is presumed that a person is not autonomous if at any time in the last 18 months (a) the person maintained any interest or dependence of economic, professional, credit-wise, in a sufficient volume according to a general rule to be issued by the Superintendency; (b) wife, husband and family members with the individuals mentioned above; (c) those that were partners or shareholders of principal executives of organizations that provided legal services, consulting services, external auditing services to the entities mentioned above, according to a general rule to be issued by the Superintendency; and (d) those that were partners or shareholders of principal executives of organizations that provided goods or services to the PMO for relevant amounts, according to a general rule to be issued by the Superintendency

3. **"Single dedication principle (*principio de giro único*)".**
   This principles prohibits PMOs from cross selling services (financial or otherwise) with other entities. Penalty: jail, in the lowest degree.

   - Example: article 23 of D.L. 3.500, paragraph 21.
   - Art. 154, 3rd par.: Emphasizes prohibition of cross-selling services provided by entities of the same financial group that owns the PMO:
   - Art. 153, par. 4: If a PMO provides a data base about its participants to any entity that is a member of the same Business Group as the PMO, important penalties apply.

Comments and Remarks:

1. Since the practices that Drs. Liu and Ooi report prevail in large Retail Funds in Australia regarding hiring of related parties are not observed in Chile, this evidence answers the useful questions posed above by discarding option (b). There remains scope for (c), but Chile provides no evidence on that because explicit not-for-profit PMOs have been implicitly prohibited, up to now, by requiring PMOs to incorporate under the Companies Law.

2. According to Chilean law, the business groups that owns the PMO still designates the majority of the board, and still selects the Autonomous Directors by voting in the

shareholders' meeting. Therefore, property rights are respected, although they have been subjected to reasonable limits.

3. Maybe Australian Industry Funds have a specific culture (linked to mutual vigilance by employers and unions) and specific regulations (linked to labor law) that are not present in certain influential classes of retail funds, who in turn have not been regulated in these matters to an appropriate extent.

4. Profit-orientation (for-profit or not) may be a necessary but not a sufficient condition for conflicts of interests and underperformance in Australia. Drs. Liu and Ooi (2018) find that not all for-profit funds are subject to the same level of underperformance. Only the vertically integrated large financial conglomerate tend to use related-parties and significantly underperform their not-for-profit peers. The other for-profit funds tend to deliver somewhat comparable performance to their not-for-profit peers in the long run. This leads them to believe that what matters is not just profit-orientation, but the combination of the inherent business model of these vertically integrated financial conglomerate and the lax regulation/supervision. I wish to add that the presence of a strong internal culture of service to participants in large Industry Funds may also be important.

5. The experience in Chile with other governance issues Dr. Liu and Ooi raise in their paper is likely to be of interest too.

If you have any queries in relation to this topic, please don't hesitate to contact me.

Yours sincerely,

Salvador Valdés-Prieto

Professor of Economics at PUC-Chile and Senior Researcher at Centro Latinoamericano de Políticas Económicas y Sociales (Clapes UC, www.clapesuc.cl)