IA **Investment Analytics Research**

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By email: super@pc.gov.au

Ms Karen Chester
Deputy Chair
Productivity Commission
Canberra ACT 2600

Dear Ms Chester

Re: Inquiry into the Assessment of the Efficiency and Competitiveness of the Superannuation System

Congratulations for making substantial progress in the Commission's inquiry into the competitiveness and efficiency of the Australian superannuation system, as published in the draft report dated 29 May 2018.

I was formerly a Principal Researcher at APRA and was a senior advisor to the Super System Review in 2009. My 23 years of research into Australian superannuation has intensified in recent years. My comments on your draft reports are appended below. These comments are backed by an attachment summarizing substantial research over the years.

The most important conclusions which the PC should reach are:

- APRA has hindered an informed market and has prevented market competition.
- The beneficiaries of Australian superannuation funds have been adversely affected by profit-seeking *Retail* funds. Their trustee directors have failed to manage their conflicts of interest and have broken the fiduciary law (SIS Act).
- Instead of enforcing the fiduciary law, APRA has sought to change the law thus facilitating looting within the superannuation system. The system cannot become efficient or competitive unless the rigging is stopped.

Yours sincerely

Dr Wilson Sy

Comments on Productivity Commission Draft Report on Assessing Efficiency and Competitiveness of Superannuation

The Productivity Commission (PC) has made considerable progress in getting to the truth about the Australian superannuation system. However, the PC is still on a journey, climbing a steep learning curve, not yet at its destination. It is a journey with blind alleys and false turns. The Productivity Commission Draft Report (PCDR) needs to record these in order to build a solid foundation for its recommendations and to provide signposts for future inquiries.

My comments on the PCDR have been limited to recommending the PC:

- focuses on the truths and some significant propositions
- uses the right data and methods to arrive at robust conclusions
- understands the impact of regulators on the superannuation system

Focus on the Truth

The PC should focus on new and significant truths supported by accurate data and solid evidence to create an informed market.

- The PCDR should note that economics and finance are not sciences because their theories do not match the facts. This may explain why there are few recognised significant facts or truths about the economy in general, and about the superannuation system in particular.
- The noise and confusion of half-truths from erroneous research and media reporting have caused the public to be ill-informed and unable to recognise useful facts. In this environment, market competition cannot be effective, resulting in an inefficient superannuation system.
- The PCDR contains far too many "key points", which the PC must know either have variable truth-values of minor significance or low information content, e.g. "*Overall, the system has delivered mixed investment performance for members*."
- Like those from previous inquiries, the voluminous PCDR (with 549 pages) adds to the existing noise, producing more heat than light. This observation would explain why numerous inquiries in the past have similarly been ineffective in making substantial improvements to the superannuation system.

The PC needs to focus on new and significant truths about the system rather than be distracted by peripheral issues.

Significant Propositions

The PC needs to establish incontrovertible truths about the Australian superannuation system, which are significant propositions with wide consensus. Over a decade of research using decades of official data, we have made some significant findings which are summarised in the attached paper (with references). The PC needs to verify those findings and establish them as significant facts or propositions important for its recommendations.

- The superannuation system has performed poorly, returning less than one percent per annum above cash equivalents over twenty years. The poor performance has been masked by substantial contribution flows totalling $1.9 trillion from 1997 to 2017.
- The *Retail* sector has captured the most contribution flows and held the most assets of any sector; yet it has performed the worst, by significant margins. Many extraneous, unproven or peripheral explanations have been proposed for this poor performance to divert attention from the main cause.
- The poor performance of *Retail* sector is caused mainly by wealth transfer from beneficiaries to the financial industry through indirect costs which occur in unnecessarily complex investment processes involving many intermediaries. The unnecessary wealth transfer is now around $15 billion per year.
- *Retail* funds are managed to make profits for shareholders. For trustees and trustee directors, this profit motive has created conflicts of interest which have adversely affected their beneficiaries in contravention of the fiduciary duty required by *Section 52 of the Superannuation Industry (Supervision) Act 1993 (SIS Act).*
- The poor performance of *Retail* sector is consistent, persistent and highly predictable, because the reasons are structural and permanent, unless there is appropriate reform to change the structure. That this and other glaring facts have not been widely recognised demonstrates that the industry is highly inefficient and uncompetitive.

The PC has not stated or established clearly all of these significant propositions in the PCDR potentially for various reasons discussed below. These are significant propositions with serious implications for Australian superannuation. The PC should be obliged to accept or deny the propositions stated here as facts.

Profit-driven *Retail* funds have failed to manage conflicts of interests which have adversely affected their beneficiaries against the fiduciary law. *Retail* funds which have broken the law should be banned.

Recently, having had their management problems exposed publicly, some banks have voluntarily taken steps to divest their wealth management operations. Previous inquiries and the PC have not reached these clear and significant conclusions because their data and methods have been flawed. Their researchers have not diagnosed the main cause because they did not understand well enough many facets of the industry.

Perhaps understandably, due to compromised industry funding, there has been very little published research on how much money financial institutions can siphon off without any hard data available to prove it. Differences in reported fees and costs are merely the tip of the iceberg. Insiders who have had broad experience of financial market trading and investing might call the mechanism of wealth transfer: “indirect costs”.

Indirect Costs

There are many examples of indirect costs which are often hard to trace, let alone report on. Significant issues of cost have not received adequate attention in assessing the efficiency of the system. Some obvious examples are:

- If the PC did not know about the fraud and misconduct in superannuation before, it surely should know by now given the revelations of the Hayne Royal Commission. The costs to superannuation beneficiaries may be significant, but where are they recorded in the data on costs?
- Superannuation supports a multi-billion dollar industry in financial planning and financial advice, which is riddled with scandals. It is well-known that financial advice services (whether delivered or not) may be imbedded in the costs of superannuation products. How do these costs affect the disclosed fees and costs? Where are they recorded in the databases?
- Many large *Retail* funds belong to large ASX-listed financial companies which publish annual reports on their operations. Their superannuation funds are connected significantly with their wealth management operations which generate substantial revenues and profits. How do these numbers tally with the fees and costs they disclose to the regulator and how much is reflected in the official databases?

The issue of indirect cost shows that regulators do not understand how the financial industry actually works when they attempt to make investment managers declare all their fees and costs. For example, in a misguided attempt to enhance disclosure of fees and costs, the Australian Securities and Investments Commission (ASIC, 2017) issued a requirement under Regulatory Guide No.97 (RG 97) for superannuation products to enhance their fee disclosure.

As mentioned above, many costs in superannuation and financial transactions in general, are indirect and cannot easily be quantified. As another important and common example, in proprietary trading or principal trading, a service provider can trade simultaneously on the house account and on the accounts of its clients, creating a conflict of interest. Wealth transfer can take place between the house account and clients' accounts without any fees being formally registered.

Indeed, stockbrokers undertaking principal trading may trade notionally for clients at zero commission, while recouping their service costs through rigging their transactions. Some investment managers, particularly hedge fund managers, may declare zero fees for superannuation funds because they declare only net returns to the funds and recoup their costs by wealth transfer through notional trades from clients' accounts to their house accounts without explicitly declaring a fee.

For this reason, one of the most dramatic and controversial aspects of the 2010 US Dodd-Frank reform is to ban proprietary trading – the Volcker rule. Yet ASIC appears to be totally oblivious to this equally important aspect of the Australian industry, where propriety trading is common and many of the investment costs of superannuation coming from proprietary trading cannot be quantified in vertically integrated financial conglomerates. It is one thing to understand the importance of cost, but quite another to fool yourself that you have measured it.

Therefore the enhanced fee disclosure of RG 97 enforced by ASIC is potentially misleading to investors, because the regulation favours vertically integrated financial conglomerates which could extract fees silently through proprietary trading without having to declare them formally as fees. Entities, such as *Industry* funds, are at a disadvantage, because they do no proprietary trading and have no such means of hiding indirect costs. Hence, all other funds may be forced to report higher costs relative to *Retail* funds run by financial conglomerates – creating a totally false and misleading impression for investors.

Australian financial regulators have confused and misled investors. Australian financial markets are not informationally efficient, with the Australian Prudential Regulation Authority (APRA) inappropriately withholding useful information from investors. Poorly informed investors (buyers) suffer from information asymmetry which is exploited by banks and other financial institutions (sellers) to loot their clients' wealth in superannuation.

> **Indirect costs are a significant cause of inefficiency in the superannuation system, yet they have not been understood or adequately investigated.**

Generally, the more complex the superannuation operation the higher the indirect costs, which are sometimes referred to as "leakages". As parts of complex corporate structures, *Retail* funds have the highest indirect costs.

Methodological Issues

The reason that the PC has not reached clear and significant conclusions is that it itself is a victim of market noise. The PC needs to be more critical of published research based on data and methods which are deficient or defective. Much of the academic and consultant research also lacks real understanding of all facets of the industry and is motivated by publication for publication's sake.

- The PC should be concerned with systemic issues of macroeconomic significance. Instead, it has been distracted into comparing individual products and options in a game played by research firms for individual clients. The PC is a victim of the false claim that "like-for-like" comparison is possible or even desirable for its work.
- Not only are product comparisons not really "like-for-like", they suffer from serious problems of sampling biases such as from self-selection of best products in surveys and from survivorship[1] of only viable funds and products in the databases.
- The attached report shows that survivorship bias can overestimate population returns significantly at around two percent per annum, even for the fullest samples. With potentially substantial distortions to investment performance, comparisons of samples of products could lead to misleading conclusions about the system as a whole.

[1] Survivorship bias in finance is the logical error of focussing on businesses, funds, shares or other assets which have survived past a certain point in time, while overlooking those that did not. This bias could lead to falsely optimistic conclusions about a group.

The PC should understand that to investigate systemic issues it needs to avoid sampling biases and focus on aggregated APRA data of system and sectors.

APRA needs to understand its own data and do quality peer-reviewed research to enhance its own understanding of the industry, in order to better supervise, to better inform the public and to better promote competition. However, APRA has now abandoned research altogether, having closed down its small research unit.

Information and Regulation

For competition to be viable there needs to be clarity of purpose of competition and rules to be enforced to ensure free and fair competition. It has been stated often enough and with wide consensus that the purpose of competition in Australian superannuation is to achieve investment efficiency. The PC stated (PC, 2016, p.7):

> *Maximising net returns (after fees and taxes) is the most important way in which the superannuation system contributes to adequate and sustainable retirement incomes.*

The rules for trustees are clear and adequate, as they are already set down in the *SIS Act*. As glimpses from the Hayne Royal Commission have shown, the regulators have not enforced the rules competently. Instead they have prevented competition by not informing the public adequately and by protecting financial oligopolies.

Empowered by the *Financial Sector (Collection of Data) Act 2001*, APRA is able to collect high quality data and makes them readily available to the public. Moreover, APRA should communicate its own understanding of the significance of the data to inform the market.

- The PC has found inadequacies with APRA data and complained about them in many places in the PCDR. For example (PC, 2018, p.6), "*Data held by regulators contain many gaps and inconsistencies, especially in relation to funds' investment expenses and related-party relationships."*
- APRA data are not available as standard database tables like those from other data agencies. Users have to extract the data manually from Excel spreadsheet reports with variable formatting. The standard of APRA data provision and usability falls well short of that set by the Australian Bureau of Statistics.
- APRA deprecates (APRA, 2017) the data it collects because it does not understand their significance (Sy, 2018). Instead of getting more information out of high quality, audited data through research, APRA has closed down its research unit and started to collect and publish unaudited data which are considered more "relevant". This shift in data policy is potentially very damaging to superannuation through misinformation.
- In the midst of the PC inquiry, the Hayne Royal Commission and other inquiries, APRA has seen fit to launch a completely new website which requires users to expend substantial effort to navigate. Metadata to indicate data availability is not provided to help new users. Even if some data are known by experienced users to exist, they are now hard to find. Some older data, reports and speeches are no longer available.

The evidence suggests APRA puts a low priority on informing the public, leaving it "in the dark" and hindering market competition. ASIC has also collected large amounts of data on complaints against financial services, including superannuation. ASIC does little or no statistical research to inform the public proactively, with hard facts rather than motherhood statements, on potential problems to protect consumers. Australian regulators operate essentially data black holes which suck in information at great public expense, but with little escaping to help consumers.

It is all very well for APRA Chair, Wayne Byres to say "It is important that the concept of caveat emptor remains in the system" (*The Australian*, 16 July 2018). However, because of secrecy and data traps, the Australian financial markets are racked with information asymmetry where buyers in transactions know much less than sellers. How could buyers beware when they are kept "in the dark"? It is hypocritical for APRA to disclose information only reluctantly by hiding improperly behind secrecy provisions of the *APRA Act 1998*.

> **Australian financial regulators have not helped, but have hindered, the creation of well-informed markets.**

Since the 1979 Campbell inquiry and the 1996 Wallis inquiry, the fundamental assumption of market-based financial regulation is that investors are well-informed. This assumption is seriously wrong when regulators trap most useful information in data black holes. While the PC recognizes problems with data collection and dissemination, it needs to know the problems originate with the nature of the regulators.

Competition and Regulation

The Government and APRA have given higher priority to financial system stability than to market competition or the welfare of the people. Their policies and actions have prevented market competition and protected financial oligopolies by creating barriers to entry through legislation. In relation to Australian superannuation, serious legislative attempts have been made to protect financial oligopolies and large *Retail* funds.

- In 2012, through the *Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2012*, APRA attempted to legislate that sufficient scale be a criterion to decide whether a Registrable Superannuation Entity (RSE) be allowed to operate a *MySuper* default fund. Such a law would protect financial conglomerates whose large funds consistently underperform some smaller *Retail* funds.
- In 2017, through the *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017*, APRA attempted to legislate that the board of every RSE should have a minimum number of "independent" directors. The definition of "independent" is such that it effectively means financial experts from the *Retail* sector would become some of the trustee directors in all superannuation funds. This law could make all funds perform as badly as *Retail* funds, entrenching a failed model in Australian superannuation.
- All superannuation funds have defensive allocations to cash, term deposits and other debt investments, vested generally with authorised deposit-taking institutions (ADIs). This February, the Government passed the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act Bill 2018*. This law provides APRA with the emergency power, in the event of the insolvency of a bank,

to confiscate savings deposited with banks by converting liabilities to assets ("bail-in") to shore up its balance sheet.

In the next financial crisis, Australian superannuation funds may find that their defensive assets provide no defence at all against the authorities confiscating their debt assets by converting them to depreciating common equity of banks.

This may be the case even if the *Financial Claims Scheme* were activated by the Government to protect smaller deposits of less than $250,000. One of the key points of the PCDR (p.2) is that "*Regulators need to become member champions — confidently and effectively policing trustee conduct....*" This is unlikely, as APRA is a captured regulator.

The above examples of rigging the system show that the regulator APRA has worked against market competition to protect financial oligopolies as a means to ensure financial system stability. This policy extracts wealth from ordinary people to bolster bank capital and thus create increasing wealth inequality which is socially destabilising. Instead, financial system stability needs to be achieved through structural separation (e.g. Glass-Steagall[2]) to reduce financial speculation which harms people and economies.

Competition in Australian superannuation has been hindered by APRA protecting financial oligopolies, thus harming the economy in the long-run.

The absence of market competition in Australian superannuation is partly due to APRA regulations designed to protect financial oligopolies, which have made abnormal profits, among other means, through hidden or indirect costs extracted from superannuation funds.

Other Technical Issues

Apart from the above major issues, we alert the PC to a few minor technical issues which may help in its final report.

- In using benchmarks, the PC states "What we've done that's new and novel" which is not really true and is a claim hardly worth making. Benchmarks have been used by asset consultants for many decades, though not often by academics, because benchmark construction requires the manipulation of a lot of data.
- For performance measurement, the PC uses net benchmarks, which requires many assumptions to be made about fees, costs and taxes. This approach introduced unnecessary complexity and uncertainty to the significance of the calculations, because the assumptions are open to debate.
- Net benchmarks are models, not facts, because of the added assumptions. By changing those assumptions, it is possible to raise or lower the yardsticks of comparison and thus to produce lower or higher relative performance – shifting the goalposts.
- The PCDR mostly made statements concerning the *number* of funds or products underperforming which is misleading. On this logic, it is even more important to

[2] In 1933, Carter Glass and Henry Steagall introduced in the United States a bill which legally separated commercial banking involving deposit taking and traditional lending to businesses and households, from investment banking involving securities trading and financial speculation.

count the *number* of individuals in underperforming funds. For a systemic assessment, it is more important and accurate to measure the *amount of assets* which are underperforming. Hence performance assessment needs to be asset-weighted.

- Even with its own research, the PCDR has not drawn sufficiently clearly and strongly certain important conclusions from its results. In fact, the results in the PCDR are largely consistent with the *significant propositions* which we have stated above. However, much of the significance of those propositions is lost in the PCDR among many peripheral results.

Conclusion

The PCDR is commended for making a real effort to establish facts for superannuation, even though it has often been distracted by some past research to investigate peripheral issues. The PC on its own research should have reached certain conclusions, which need to be clearly stated. While Australian superannuation has been inefficient and uncompetitive, the major reasons need to be reported.

> **The Productivity Commission should state clearly that the beneficiaries of Australian superannuation funds have been adversely affected by profit-seeking *Retail* funds. Their trustee directors have failed to manage their conflicts of interest and have broken the fiduciary law (*SIS Act*).**
>
> **Instead of enforcing the law, APRA has sought to change the law to facilitate looting in the superannuation system. The system cannot become efficient or competitive unless the rigging is stopped.**

References

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