

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

SUBMISSION ON POLICY ISSUES RAISED IN ROUND 5

Superannuation is an important component of Australians' retirement plans and an important sector of the economy. I have been involved in superannuation and financial services, in both executive and non-executive roles, over a period of almost
5 40 years. Many of the elements in the superannuation system work well but I congratulate the Commission on identifying a number of areas of misconduct. Through such periodic analysis it is possible to achieve meaningful improvements in policies and behaviours.

10 RSEs have a fiduciary relationship with their members. The main areas in which improvements can be achieved include:

- Removing or mitigating impediments to RSEs acting in the best interest of their members
- Identifying and correcting aberrant behaviours
- Controlling systemic risks to the superannuation system and the Australian
15 economy
- Recognising and realising the ancillary benefits that can flow to and from the Australian economy from a well-functioning superannuation system.

20 Closing submissions for Round 5 raised a number of policy questions, many of which have some relatively obvious and simple answers that I expect the Commission will identify.

I would be pleased to provide additional input on any issues relevant to this review but, in this submission, I comment on what is probably the most critical issue:

Managing Conflicts

25 Counsel Assisting asked whether there are structures that raise inherent problems for a superannuation trustee being able to comply with its fiduciary duties. This question was raised specifically in relation to the obvious conflicts that exist for dual-regulated entities.

30 However, there is a more fundamental structural issue that currently impacts on all
superannuation funds. This relates to fee disclosure. Fixing this one issue in the
way that I describe below would mitigate many of the inherent conflicts and lead to
a more effective superannuation system.

1. Fee Disclosure

35 Current fee disclosure in the Australian superannuation industry is not transparent
and acts as a barrier to RSEs acting in the best interests of their members. Tacitly it is
also encouraging investment strategies that will become increasingly concentrated in
a narrow range of strategies, such as passive investment in publicly traded
40 securities. The concentration of strategies introduces systemic risks to Australians'
retirement savings as well as the economy. At the same time, other investment
opportunities that could enhance retirement outcomes and the broader economy will
be starved of capital

As part of its fiduciary role, an RSE is responsible for a number of tasks. In return
45 for taking on this fiduciary role, the RSE is entitled to extract payment for its
services. However, the current fee disclosure rules, which bundle fees together,
mean that members are not told the fee that is being extracted by the RSE to act in
this fiduciary capacity. As a result, there is a lack of transparency at this
fundamental fiduciary level. There is also no clear pressure for RSEs to become
50 more efficient.

In exercising their fiduciary responsibilities, it is important for RSEs to spend
members' money wisely in the search for investment returns. However, current fee
disclosure means that RSEs face a number of potential issues that can compromise
55 their ability to act in the best interest of their members.

To take one example, an important role of an RSE is to identify and exploit
investment opportunities. An RSE may take a view that there is an opportunity to
extract returns by lending money to households or businesses. This could be
60 implemented in a number of ways, some of which may include investment
management costs and some others that may involve a third-party guarantee by a
bank or other highly rated organisation.

Faced with the complexity of direct lending, the RSE might simply lend money to a
65 bank which then on-lends the money to underlying borrowers. The superannuation
fund would then receive an interest rate after the bank on-lends the money and
extracts an interest margin.

Now suppose that the RSE determines that a direct lending program can be
70 implemented, with appropriate guarantees, at an average interest rate of 6% pa

before costs and 5% pa after deducting costs. At the same time, the RSE sees that the interest rate being offered by a bank is 3% pa; with the “fee” that is represented by the bank’s interest rate margin being unknown.

75 The direct lending program has an expected net return of 5% pa after a 1% explicit fee; the lending to the bank has an expected net return of 3% pa after an unknown implicit fee. However, by pursuing the higher net return, the RSE risks being seen as uncompetitive in terms of fees even though the RSE itself may not be receiving any additional fee for its own account. The RSE is discouraged from even considering
80 such disintermediation.

An issue raised in the Royal Commission’s public hearings was the extent to which RSEs do or do not invest in unlisted assets, which typically incur higher management fees.

85 Acting in the best interests of its members, one RSE could take a view that unlisted assets are a good investment opportunity.

Another RSE might take a view that unlisted assets are currently valued too highly
90 and will not deliver an acceptable future return. This RSE might assess that passively managed listed shares, which incur lower investment management fees, offer better prospective returns. For such an RSE, this would be a legitimate basis on which to prefer listed investments over unlisted. Under current fee disclosure practice, an ancillary benefit for such an RSE would be an improvement in its profit
95 margin or what appears to be more competitive fees. This raises an obvious conflict.

Members of a fund should want their RSE to be making investment decisions on the basis of outcomes that are relevant for the members; not the profit margin that the RSE is able to extract or the third-party costs that the RSE expects will add value for
100 its members. Fees that an RSE pays to unrelated third-parties are effectively a cost of doing business.

In fact, the ability of an RSE to access unlisted investments and negotiate terms is likely to be much better than members can do as individuals and, in some cases,
105 such opportunities would not be available at all to an individual. Classing amounts paid to unrelated third parties to manage these investments as “fees” masks and distorts what might actually represent a saving for members compared to what they could do themselves.

110 Similarly, spending money on external tax or legal advice might add significantly to net returns but the additional cost could increase reported costs.

There are many more examples in which fee disclosure can discourage activity that

would both improve retirement outcomes and make the economy more efficient.

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The following diagram, which I have previously provided to the Productivity Commission, illustrates the sources of the compromised fiduciary duty.

Figure 1: Compromised Fiduciary Duty



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Specifically:

- Vertical integration may bring undue pressure to use related party service providers.
- Choice of investment implementation can be compromised by different disclosure treatments of costs – for example remuneration to those who operate a listed company typically is not classed as a fee whereas remuneration to those who operate an unlisted hedge fund would be regarded as a fee.
- Superannuation fund members have fiduciary agents but are not informed what their agents are charging to provide the fiduciary services.

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These compromises apply to both profit-for-members industry funds and commercial funds. Indeed, as industry funds become more and more vertically integrated they are likely, eventually, to face some of the same conflicts that are faced currently by the commercial funds.

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One potential response to this issue of fee disclosure is to “look through all costs”, a concept that is embodied to some extent by the RG97 fee disclosure rules.

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However, whenever money flows in the economy there is a potential for a proportion of that flow to be extracted as a payment. Such payments can take a

145 variety of names including profit share, margin, brokerage, surcharge, bonus, wage,
 salary, tax, commission, rent, interest, carry, rebate, loading, disbursement, duty,
 royalty, rates and probably many more. They all are effectively some type of fee and
 are an implicit cost of doing business; but trying to identify every single one is
 impossible. With apologies to Augustus de Morgan, *“Investment flows have little fees
 upon their backs to bite ‘em. And little fees have lesser fees and so ad infinitum”*.

150 Fortunately, such an extreme approach is also irrelevant if fee disclosure is modified
 in a way so that it emphasises the fiduciary relationship that RSEs have with their
 members.

155 In order to make the industry more competitive and to allow RSEs to concentrate
 more fully on net returns to members, fee disclosure should take the following form.
 These costs should be readily identifiable as part of the preparation of Business
 Activity Statements for GST calculations:

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- Identify the costs being added and charged by the RSE to undertake its role as a fiduciary agent
 - Identify fees and other payments from the RSE to related third parties and require the RSE to ensure that these are fair and reasonable, with assistance of the survey to which reference is made in the following Point 2.
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- Payments to unrelated third parties should be competitive but should NOT be the primary focus for fee disclosure, as the only reason for an RSE to employ such third parties should be to pursue higher net returns for members. Such “fees” may represent the replacement of an implicit fee with a lower explicit fee and, in the interests of efficiency, RSEs should be
- 170 encouraged to seek such opportunities.

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 as a cost of doing business.

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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 members. 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 an expectation of higher net returns.

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185 Importantly, under this approach, RSEs will not be impeded from investing in a broad range of investments in the pursuit of higher net returns. RSEs will be encouraged to identify a greater range of potential investment opportunities and

will be free to pursue the most efficient method of exploiting each of those opportunities. This will improve retirement outcomes, enhance competition and make the economy more efficient.

190 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 increasingly concentrated

195 At the same time, members will be able to see exactly what they are being charged by their fiduciary agent and this will allow competition to be more effective at this basic level.

If this approach is not implemented then the most likely outcome is that RSEs will remain compromised in their selection of investment strategies and investment
200 programs will become more and more concentrated in a narrow range of strategies, such as passive investment in listed shares and loans. This represents a serious systemic risk to Australians' retirement savings. At the same time, other investment opportunities that could enhance the broader economy will remain starved of
capital.

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2. Survey of Fees Paid

210 A potential problem with the fee disclosure approach described in Point 1 is that RSEs may lose focus on the payments that are made to unrelated third parties. They may also lack a solid foundation against which payments to related parties can be benchmarked.

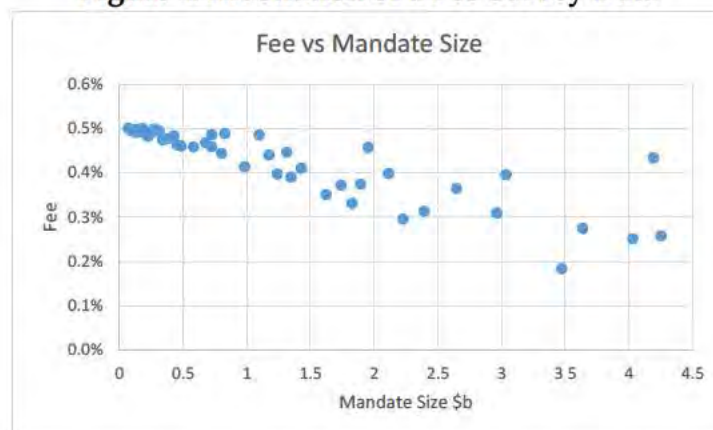
215 APRA is well placed to survey fee arrangements for material outsourcing arrangements such as administration, custody and investment management. As the regulator, APRA can do this in a way that does not compromise confidentiality agreements to which RSEs may be committed.

220 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.

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

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Figure 2: Illustration of a Fee Survey Data



230 An RSE faced with this data may identify that the fee being paid by them on a \$4.2 billion mandate is high. This outlier might be justified – for example, it may relate to a mandate with a zero base fee and the total fee reflects a share of exceptional outperformance.

235 Conversely, it is also possible that the fee had not been renegotiated for some time and had become uncompetitive. The RSE would have to make a decision as to whether or not that particular manager warranted a premium fee. If the high fee was being paid to a related party then it might be an indication that the RSE needs to

reconsider whether the arrangement, in its current form, is in the interests of its members.

240 Similar like-for-like comparisons could be completed for administration, custody, brokerage 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
245 size of assets, complexity of investment arrangements and range of services

By making fees more transparent as described in Point 1, there will be downward competitive pressure on the fees that RSEs charge for acting in their fiduciary roles. Providing information such as described in this Point 2 will provide competitive
250 pressure on the fees being paid to unrelated third parties and will also provide a solid benchmark for RSEs to assess their arrangements with related third parties.

In combination, a number of potential conflicts will be removed or mitigated. There will be downward pressure on all fees. RSEs will also have the incentive to identify
255 and exploit investment opportunities in ways that disintermediate those established players who are charging excessive fees. This will improve retirement outcomes and make the economy more efficient.

260 **3. Material Functions**

RSEs have a fiduciary responsibility to their members.

265 In considering the needs of members, an RSE might take a view that insourcing a material function is likely to provide an expected net benefit for members, for example in terms of price, value, service, sustainability, tailoring or some other aspect. Such material functions could include investment management or administration.

270 Through insourcing a material function, however, a situation may arise that will compromise the objectivity of the RSE to assess its own performance. The RSE may apply standards that are either too high or too low relative to other providers in the market. The RSE could also be compromised in its willingness or ability to act to recover losses incurred through errors and omissions.

275 Although there are mechanisms by which RSEs may be able to overcome this lack of objectivity, a much clearer demarcation of responsibilities would be achieved if RSEs were required to outsource material functions. This outsourcing could be to unrelated third parties or related third parties that have their own governance structure. The RSE would then be able to assess the ongoing suitability of the arrangements through a more objective lens.

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For a commercial fund, such structures are quite common and can be effective providing that the directors of the RSE act in a way that can view related parties on an arms-length basis. For an industry fund, this approach would indicate a need for the RSE to consider establishing a separate wholly-owned subsidiary for material functions that are insourced.

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