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

Written Submission by Anthony Asher in response to policy-related issues raised in the MODULE 5: SUPERANNUATION CLOSING SUBMISSIONS

Executive summary

Misconduct in the superannuation industry has occurred partly because much of it is in thrall to service providers that have developed a culture that panders particularly to greed. The sector has grown by over-servicing and over-charging, extracting economic rents made possible by various forms of regulatory capture, and of which the law breaking reported to the Royal Commission (RC) are symptoms. Community expectations, of compulsory superannuation particularly, are that services and charges are fair, and that the organizations are primarily focussed on their social purpose.

The suggestions in this submission are the RC recommend:

- The Parliamentary Office of Best Practice Regulation require Regulation Impact Statements to document consideration and adopted solutions to potential issues of *rent seeking* – and political parties be less ready to make superannuation promises at elections.
- The Gordian knot of regulatory complexity be cut by replacing much of the Superannuation and Corporations legislation with the General Law's proscription of conflicts of interest.
- Trustees be made more accountable to members by being democratically elected, and remuneration be limited, to address arrogance at the top.
- The creation of an appropriately resourced public advocate with a remit to address rent seeking, and which can represent the public in overseeing regulation, advise trustees in their oversight of service providers, and take over ASIC's role in the development of financial literacy.
- The development of the MyGov system to automatically provide individuals with the fact find information that they or their financial advisors would need to develop a financial plan. This could increase the likelihood of obtaining reasonably priced and competent financial advice.

1 Introduction

I welcome the RC's incisive and disinterested approach to the sector, and the opportunity it offers to address *economic rent seeking* and *regulatory capture* – especially as there appears to be bipartisan support for meaningful change.

If press reports are indicative, the RC is likely to get a few submissions along similar lines[1], although there may silence from the sector itself. Reference to the possibility of regulatory capture and rent-seeking is absent from the recent Financial Services Inquiry and the Productivity Commissions reports into Superannuation[2], nor is it considered by APRA, ASIC or the Treasury paper on the RC website. The questions may be too uncomfortable to address and would require a level of public self-reflection not available to agencies and civil service.

My forty years' actuarial experience - divided equally between business and academia – with an ongoing interest in ethical and policy issues,[3] may mean that my approach questions from a different angle to other submissions. In what follows, I focus particularly on greed and economic rents in the culture of the finance sector; the response of regulation and why it fails; and then on more detailed discussion of how the financial sector extracts unacceptable levels of economic rent from superannuation. The ideas are hardly new – perhaps most eloquently expressed by Adam Smith:

> *The interest of the dealers, however, ..., is always in some respect different from, and even opposite to, that of the public. To widen the market and to narrow the competition is always in the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public, but to narrow the competition must always be against it, and can only serve to enable the dealers, by raising their profits above that which they would naturally be, to levy, or their own benefit, an absurd tax upon the rest of their fellow-citizens. 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.*[4]

The table below sets out my responses to the questions in the Closing Submissions.

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[1] Melbourne Economic Forum (Allan Fells, Ross Garnaux, John Daley) http://www.abc.net.au/news/2018-09-04/banking-royal-commission-embarassing-apra/10200028 and Ross Gittins https://www.smh.com.au/business/banking-and-finance/economists-do-little-to-promote-bank-competition-20180210-h0vvku html

[2] http://fsi.gov.au/ and https://www.pc.gov.au/inquiries/current/superannuation

[3] More details can be found at https://research.unsw.edu.au/people/associate-professor-anthony-asher

[4] Smith, Adam (1804) An Inquiry into the Nature and Causes of the Wealth of Nations, Volume 1, https://play.google.com/books/reader?id=n1FHAAAAYAAJ&hl=en_GB&pg=GBS.PP16, p207

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825.1 and 2	29
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825.24	22,35,39
825.25	17

The boxes in the text are quotations from my own research to clearly distinguish them from quotations from others more expert. References and footnotes have been reformatted for clarity – so the quotations are not exact.

2 The standards to apply

In his opening remarks, the Commissioner mentioned (p8) the ideas and links between the ideas of purpose, fairness and expectations. These are worth unpacking. Alisdair McIntyre's modern revival of Aristotelian virtue theory[5] highlights the link of ethics with purpose: the financial system will be good if it fulfils its purpose. Fairness requires justice, one of the main cardinal virtues and a cornerstone of ethics, without which the purpose will be missed.[6] Justice is served if a proper process is followed by those with power; that recognises people's needs and just deserts; is reluctant to interfere in their lives; and strives to achieve equality. Overcharging and overserving leads to enrichment at the expense of others is unjust: it cannot be justified by desert or need, and undermines equality and efficiency. This is aggravated where people's freedom has been circumscribed by compulsory contributions. I think it follows that in the financial sector, injustice is most evident in overcharging and over-servicing which offend each of these criteria.

Within compulsory superannuation particularly, members might reasonably expect the trustees to both treat them fairly and do their best to serve their needs for financial security – particularly in old age. The law already includes provisions that "obligations implied by the

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[5] MacIntyre, Alasdair (1981). *After Virtue: A Study in Moral Philosophy.* University of Notre Dame Press.

[6] My book, Asher A, (2015) *Working ethically in finance: Clarifying our vocation (Business Expert Press, NY),* explores these themes in more detail. Also see Asher A, (1998) "Effective and Ethical Institutional Investment", British Actuarial Journal 4.V: 969-1027.

promotional material of the company, and policy owners' *reasonable benefit expectations* based on past company practice"[7] will need to be met (by insurers at least.)

There are other legal concepts where overcharging and over-servicing – depending on circumstances – can be regarded as the unacceptable exploitation of weaker parties. One is "unconscionable conduct"[8] which will depend on the extent of the over-charging and the relative weakness of the exploited members, and can lead to restitution. A third possibility is that the terms of a contract that give too much unfettered discretion to a stronger party can be "void for vagueness", or at least reset to reasonable levels.[9] Fourthly, "secret profits" may have to be disgorged – particularly if a fiduciary duty is involved.[10] Finally, failure to observe the proscription of conflicts of interest should lead to the disgorgement of profits.[11]

3 Culture

The cultural crisis in finance, recognised in the RC's terms of reference as a cause of misconduct, is captured by some of the quotes in Box 1.

Box 1[12]

Cultures play a role in promoting harmful practices, through for example, socialization of new members (of boards of directors, executive teams, trading teams) into value sets that place 'winning at all costs', 'fleecing the customer' or 'covering up' at the centre of a firm's culture[13]. The US Financial Crisis Inquiry Commission[14], for example, found that "the captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public. Theirs was a big miss, not a stumble." Moreover, in many finance organizations, mistakes are hidden and those who admitted to them are 'punished' in some way. These cultures did not come into being through some chance set of circumstances or at the other extreme as the inevitable outcome of 'natural laws' of economics.

[7] APRA Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital. (My italics)

[8] Defined in Section 12BG of the ASIC Act as causing a "significant imbalance in the parties' rights and obligations."

[9] Lucke, H.K., 1977. Illusory, vague and uncertain contractual terms. Adelaide Law Review, 6:1-25.

[10] Justice James Edelman (2012) *Fiduciaries and Profit Disgorgement for Breach of Contract* Speech Given To The Journal Of Equity And Commercial Law Association Conference, Sydney, 30 March.

[11] Edelman J, (2012) "Fiduciaries and profit disgorgement for breach of contract" Speech given to *The Journal Of Equity And Commercial Law* Association Conference, Sydney, 30 March.

[12] This section is taken largely from a draft paper, likely to be entitled Asher, A and Wilcox T, Virtue and Risk Culture in Finance. An early version can be found at https://www.actuaries.asn.au/Library/Events/ASTINAFIRERMColloquium/2015/AsherWilcoxVirtuePaper.pdf

[13] Darley, J.M. 2005. How Organizations Socialize Individuals into Evildoing. In Collins-Chobanian S. (Ed.) *Ethical Challenges to Business as Usual*, Pearson Prentice Hall, Upper Saddle River NJ, 211-223.

[14] Financial Crisis Inquiry Commission, 2011. *The financial crisis inquiry report.* US Government Printing Office. http://fcic.law.stanford.edu/report/ p xvii.

… Economist Jeffrey Sachs has expressed this concern stridently, claiming:

> *I regard the moral environment as pathological. And I am talking about the human interactions that I have…They have no responsibility to pay taxes; they have no responsibility to their clients; they have no responsibility to people, to counterparties in transactions…They are tough, greedy, aggressive and feel absolutely out of control in a quite literal sense, and they have gamed the system to a remarkable extent.*[15]

The 'dominant' logics and sense-making practices in the finance sector have their roots in neoclassical economics[16] ... Agency theory, for example, is premised on a "normative theory of practical rationality" that categorizes moral rules and cooperation as "irrational", and opportunistic self-interested behavior as "rational" [17]. These "rudimentary assumptions" of self-interest and profit maximization are, Enderle notes, "not only taken as explanatory variables, but also as normative demands indicating how economic actors should behave."[18]

It is difficult to find hard evidence that these flaws are worse in finance,[19] although it is widely agreed that failure to manage them contributed to the recent financial crisis – and the misconduct already identified by the RC. As a UK report has it in respect of the financial crisis: "First, to pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis." [20]

3.1 Greed

These mortal flaws do however need to be addressed. As Donaldson puts it: "Greed … a persistent feature of the human condition … rather depends on opportunity and rationalization.[21] Most commentators and regulators accept the inevitability of greed (rational self-interest), focussing on "perverse incentives"[22]. They seem unconscious of the possibility that agency theory may have limitations and create normative perversions as raised in the last

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[15] https://www nakedcapitalism.com/2013/04/jeffrey-sachs-calls-out-wall-street-criminality-and-pathological-greed.html#Gi77xWO2eYLE1jTD.99

[16] Lounsbury, M. and Hirsch, P.M., 2010. Markets on trial: Toward a policy-oriented economic sociology. In *Markets on Trial: The Economic Sociology of the US Financial Crisis: Part A* (pp. 5-26). Emerald Group Publishing Limited.

[17] Heath, J., 2010. Agency theory. In Boatright (ed). *Finance ethics: Critical issues in theory, practice*, 125-142, p. 136

[18] Enderle G., 2000. Whose ethos for public goods in the global economy? An exploration in international business ethics. *Business Ethics Quarterly*. 10(1), 131-144.

[19] Some research has found that bankers' professional social identity, when salient, predisposes them to more greed and dishonesty, even when it leads to relatively small personal gain. (Cohn, A., Fehr, E., & Maréchal, M. A. 2014. Business culture and dishonesty in the banking industry. *Nature*. doi:10.1038/nature13977). Others have questioned the interpretation which they have had difficulty replicating. (Vranka, M.A. and Houdek, P., 2015. Many faces of bankers' identity: how (not) to study dishonesty. *Frontiers in psychology*, *6*, p.302.)

[20] Financial Crisis Inquiry Commission, 2011. *The financial crisis inquiry report.* US Government Printing Office. http://fcic.law.stanford.edu/report/. Conclusion, xxii.

[21] Donaldson, T., 2012. Three ethical roots of the economic crisis. *Journal of Business Ethics*, *106*(1), pp.5-8.

[22] See UK Parliamentary Commission on Banking Standards, (2013) note 73

paragraph of Box 1on page 4. At risk therefore of belabouring the point, Box 2 spells out the argument in more detail.

Box 2[23]

Legal academics, such as Jaap Winter[24], and philosophers, such as Joseph Heath[25], are prominent amongst the critics of classical, or positive, economics.

They identify the major issue as the misuse of the assumptions made about people's motivation and rationality. As you would have been taught, all other things being equal, we can assume that people want to make economic decisions rationally. This will mean that they want to maximise some *utility*, which is often their personal material wellbeing. Difficulties arise, however, when other things are irrelevant rather than equal, when people are assumed to make entirely rational decisions, and when *utility* is seen purely in private material terms.

Heath shows that many economists make these irrational jumps in the development of their theory and practical recommendations. The errors are not merely theoretical and easily undone. He looks particularly at agency theory, which has been used to justify the granting of the excessive remuneration discussed above. The problematic assumption is that executives need material incentives to perform their jobs diligently not only flies in the face of the evidence, but:

> *... even a well-designed system of external incentives has the potential to undermine moral motivation, and thus to create agency costs where previously none existed ... People may be active cooperatively merely because they consider it the right thing to do. When they are subsequently offered an external incentive, it may have the effect of changing their perspective, so that they no longer consider the question from a moral point of view, but rather examine it from the standpoint of their self-interest. ...Sophisticated practitioners of agency theory are familiar with these limitations, but a large number of enthusiast are not. Because of this agency theory can serve as a source of considerable inadvertant mischief when treated as an accurate representation of reality.*[26]

He then goes on to suggest that management begin to work on the view that people are only interested in their own material interests, and:

[23] See note *Working ethically in finance, p72-73*

[24] Winter, J. (2010). Corporate governance going astray: Executive remuneration built to fail. *DSF Policy Paper*, *5*.

[25] See note 17

[26] Ibid.

> *... it would be no surprise to discover that a social environment in which the dominant assumption is that "it's every man for himself" is one that would not only encourage unethical behavior, but could become positively criminogenic.*[27]

> Aggravating the problem is failure to incorporate the desirability of personal and social virtues into our thinking. This is illustrated in a popular recent book, *Animal Spirits* by two well-known economists, George Akerlof and Robert Shiller[28]. They appear to have written the book in haste and can be criticised at a number of levels – as by Richard Posner, a US judge, in a review: *Shorting Reason.* What I find interesting is that even the legally trained do not find it strange that they describe the concept of "fairness" as irrational. People can of course behave irrationally when their interests are threatened – as employees when their jobs are at stake, as discussed in the book. People may also use arguments involving fairness that are not rational. The need to create a fair society is however entirely rational … The more we are certain of fair treatment, the more we are free to concentrate our efforts on mutually beneficial production.

It can also be pointed out that giving prominence to the power of greed – to tempt and to create injustice – is common in religion. Greed is one of the three poisons of Buddhist teaching, the tenth commandment is against it, St Paul identifies it with idolatry and the King James translators saw it as "the root of all evil."

Apart from setting out moral codes and ethical reflection, the time-honoured approaches to removing ethical temptations to greed are by the prohibition of conflicts of interest addressed in section 4.1 below, and ensuring the appropriate accountability of those in power, which are covered in section 4.2 and 4.3 below).

3.2 Hubris

The complacency and recklessness issuing from hubris can perhaps be mentioned at this point. The hubris associated with corporate failure and misconduct can be linked to directly to overconfident CEO's and their excess remuneration.[29] While excesses of remuneration are less of an issue in Superannuation than in other parts of the financial sector, there is a risk that they will overpay internal investment managers for the same reason that they have failed to control the costs of outsourced management. More important for the overall economy, as major shareholders they have a critical role in ensuring directors have the courage to stand up to over-confident CEOs.

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[27] Ibid.

[28] Akerlof, George A. & Robert J. Shiller (2010) *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism, Princeton University Press*

[29] Paredes, Troy A., 2014, Too Much Pay, Too Much Deference: Is CEO Overconfidence the Product of Corporate Governance? Washington U. School of Law Working Paper No. 04-08-02. https://ssrn.com/abstract=587162 and Plöckinger, M., Aschauer, E., Hiebl, M.R. and Rohatschek, R., 2016. The influence of individual executives on corporate financial reporting: A review and outlook from the perspective of upper echelons theory. *Journal of Accounting Literature*, *37*, pp.55-75

3.3 Economic rent

The economist's term for overcharging and over-servicing that may be the consequence of greed is economic rent.

> *"Economic rent" is a term that defines an amount of money earned that exceeds that which is economically or socially necessary. This can occur, for example, when a buyer working to attain a good or service that is considered exclusive makes an offer prior to hearing what a seller considers an acceptable price. Market imperfections thus lead to the rise of economic rents; it would not exist if markets were perfect, since competitive pressures would drive down prices. Economic rents should not be confused with normal profits or surpluses that arise in the course of competitive capitalist production. This term also differs from the traditional use of the word "rent," which applies to payments received in exchange for temporary use of a particular good or property, such as land or housing.*[30]

The definition goes on to say that "economic rents are considered to be unearned." When applied to superannuation, economic rent arises if providers were to charge greater fees for services than they would strictly need to provide the services, or to profit by providing more services than are necessary: i.e. overcharging or over-servicing. This is the "absurd tax" referred to by Adam Smith above. In a compulsory superannuation system, the community might reasonably expect not to be subjected to such a tax.

3.4 Financial sector rent-seeking

Box 3[31]

A number of observers see the increased funding of social security systems as contributing artificially to the growth of the finance industry – both ideologically and in its share of GNP.
…
Adair Turner, then head of the UK Financial Services Authority and with a much closer link to the sector, takes a similar view:

> *And, indeed, there are good reasons for believing that the financial industry, more than any other sector of the economy, has an ability to generate unnecessary demand for its own services – that more trading and more financial innovation can under some circumstances create harmful volatility against which customers have to hedge, creating more demand for trading liquidity and innovative products; that parts of the financial*

[30] https://www.investopedia.com/terms/e/economicrent.asp

[31] Taken from Asher A (2014) "Redistribution and capital market impacts of social security retirement systems: principles and scope for actuarial involvement" *The Australian Journal of Actuarial Practice* 2:13-20

services industry have a unique ability to attract to themselves unnecessarily high returns and create instability which harms the rest of society. [32]

There are other reasons for the growth of the financial sector, and evidence that it contributes to economic development. ... Rajan and Zingales[33] document the contribution to economic development, but note the role of private interest groups in obstructing development in various countries of the world during the twentieth century. They suggest that one way of limiting the power of such interest groups is "public awareness of the hidden costs of policies that ostensibly promote economic stability."

Figure 1 provides further evidence of the growing share of the financial sector, and perhaps more importantly – shows that it does not have to be this way.

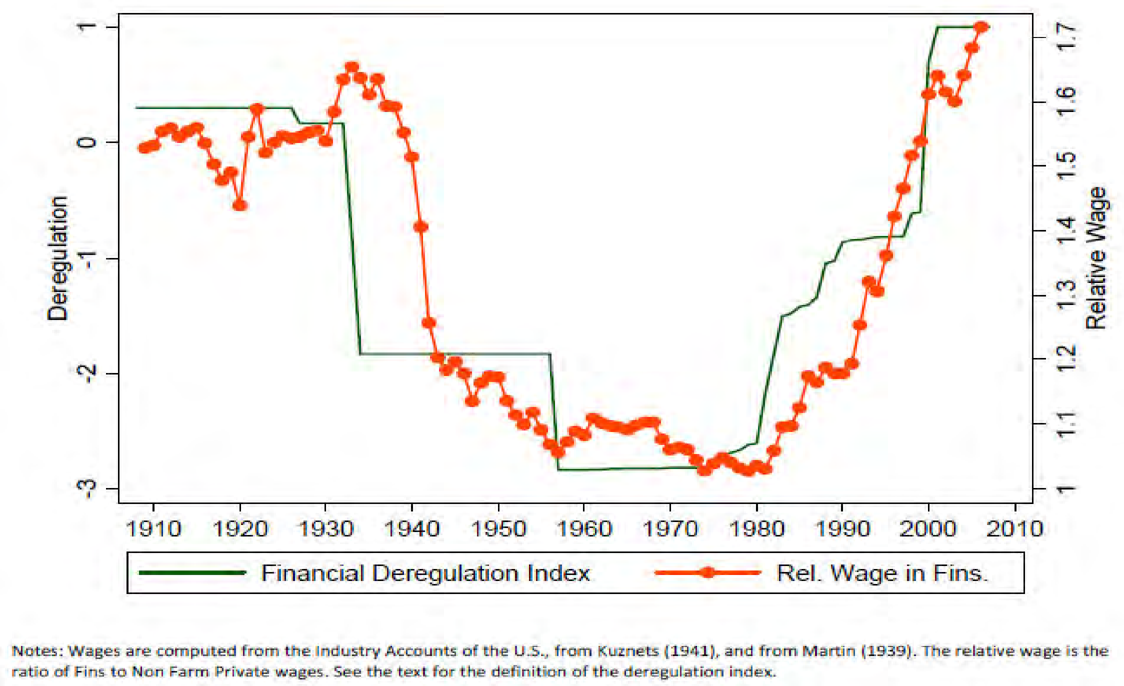

Figure 1 Finance sector wages[34]

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[32] Adair Turner, 'Speech by Chairman, FSA' (Speech delivered at the City Banquet, The Mansion House, London', September 22 2009, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0922_at.shtml.

[33] Rajan, R. G., & Zingales, L. (2003). The great reversals: the politics of financial development in the twentieth century. *Journal of Financial Economics*, 69(1): 5-50.

[34] Taken from Philippon, T. and Reshef, A. (2009) *Wages and Human Capital in the U.S. Financial Industry:* 1909-2006 NBER Working Paper No. 14644. http://www.nber.org/papers/w14644 accessed: July 2013, Figure 6.

4 Regulation

This section looks at how regulation should perhaps respond to the temptations of greed, on the one hand circumscribing the ability of those with power to exploit others, and on the other responding to misconduct so as to create disincentives and to compensate those who have been exploited.

4.1 Conflicts of interest

The RC has identified this as an issue, Box 4 showing how the prohibition of conflicts of interest has been attenuated. While Australian industry funds are not entirely free of conflicts of interest, their success makes it obvious that it is possible to avoid most of them in practice. It can moreover be noted that the "Pension Trustee Code of Conduct" [35] developed by the CFA Institute together with trustee bodies from the USA, UK, Switzerland, Netherlands and Hong Kong specifically calls on trustee to avoid conflicts of interest.

As can be expected, the empirical literature is mixed: those faced with conflicts will not always exploit them.[36] This goes to show that greed is not inevitable, and reinforces the need for appropriate bulwarks against the temptation to greed.

Box 4[37]

The prohibition should provide a bulwark against abuse of power, which can be used by those with courage to maintain integrity. The Act does not appear to be adequately cognizant of the failings of human nature, particularly when faced with the temptations of power and greed.

Conflicts of interest are specifically permitted in the Act, although they are prohibited in the general law. There, it is an "inflexible rule … that a … fiduciary … is not … allowed ... in a position where … interest and duty conflict. Human nature being what it is, there is danger, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect …" (Bray vs Ford). But section 58B specifically permits them. …

There is more. In the general law, "… a contract made in breach of … fiduciary duty, will be voidable … unless" [38]… it is specifically permitted. But S55 (2) allows such contracts to

[35] https://www.cfainstitute.org/ethics/codes/pension/Pages/index.aspx

[36] Mehran, H. and Stulz, R.M., 2007. The economics of conflicts of interest in financial institutions. *Journal of Financial Economics*, *85*(2), pp.267-296.

[37] From Asher, A and E Rajadurai (2018) Investing Superannuation for the Public Good: Creating new markets to benefit members & fund necessary investments, The McKell Institute. https://mckellinstitute.org.au/app/uploads/FINAL_Superannuation_2018_WEB.pdf

[38] Allco vs Trust, NSW

stand regardless: "A contravention … is not an offence and … does not result in the invalidity of a transaction."

Similarly, in the general law:"… disgorgement of *profits* is a common, and unremarkable, remedy for breach of fiduciary duty."[39] An example is the requirement of lawyers to disgorge their fees where a conflict is shown to exist. But S52 (3) limits the claim to any losses that have been suffered.: "… may recover the amount of the *loss or damage* by action" … and moreover S52 (5) reduces even this right. "It is a defence … if the defendant establishes that the defendant has complied with all of the covenants."

These failures of the SIS Act were known at the time. The Australian Law Reform Commission and the Companies and Securities Advisory Committee[40] recommended, inter alia that prohibition of conflict of interest should be central to the new legislation.

It appears that the legislature felt at the time that the requirement for equal representation of employers and members would be sufficient to combat the conflicts of interest, but the decline of corporate funds and the rise of retail and industry funds with limited effective member representation have removed this protection.

Question 825.17 to 19 – managing conflicts

The RC has obtained enough evidence from trustee's own evidence to make it clear that the SIS Act's dilution of the general law has not been effective. I think the total prohibition of the general law is far to be preferred.

Allowing trustees to have their own superannuation in their fund is one exception to a total prohibition of conflicts that I believe is worth making. This is because there is, in most cases, an alignment between the interests of all members. It is therefore not surprising that Liu and Arnold[41] find superior performance in those funds where the trustees are invested.

Trustees would face potential conflicts where the allocation of benefits, tax or administrative costs to different classes of members is a subjective matter. Under such circumstances, there should be rules for them to recuse themselves from the discussion and not just the vote. Where a majority of trustees are conflicted, then the decision can be delegated to a consultant, who ideally should not be aware of the personal circumstances of the trustees. Such decisions can be far from trivial matters,[42] and I believe the rules should be specified by regulation.

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[39] See note 11.

[40] ALRC and CSAC, *Collective Investment Schemes: Superannuation*, Report No 59 (March 1992).

[41] Liu, K. & Arnold, B. (2013), Superannuation and Insurance: Related Parties and Member Cost. *The Journal of Superannuation Management*, vol. 5, no. 1, pp. 44 - 52

[42] I have personally seen many situations where member trustees have made self-serving decisions as to the allocation of surpluses particularly, but also in the allocation of tax and insurance subsidies.

The remuneration of trustees creates an unavoidable conflict that should similarly be delegated to a disinterested party. I think much would be gained by the regulator setting caps on such remuneration – noting the tendency for such caps to become the norm.

4.2 Accountable to members

Good governance also reduces temptations to greed by making those with power accountable to others with the power and interest to ensure they perform their duties diligently and fairly.

Peter Drucker, doyen of management writers of the last century wrote extensively on pension governance and how it was necessary for trustees to represent the interest of members.

> *Drucker believed that is was wrong for banking institutions to manage pension funds since it involved them in conflicts of interest. He did not believe that it was either desirable or possible for banks to construct so-called 'Chinese Walls' between their business loan departments and their money management departments. In his view, pension funds anyway needs trustees who were independent of banks and employers and who truly represented the interests of employees whose savings they managed. Only trustees of this sort would have the legitimacy and autonomy needed to act in the long-term interests of pension fund beneficiaries, persuading them, when necessary, to raise contribution rates to ward off inflation and to ensure investment-led growth sufficient to anticipate the rising proportion of the retired and the consequent dis-savings problem.*[43]

4.2.1 Independence of mind more important than expertise

Box 5[44]

Not many trustees will be expert in superannuation and they are, therefore, largely reliant on expert help for the administration of their funds and the investment of assets. There may be a temptation to abdicate and yield power to the professionals. Being represented by lay (non-expert) trustees who control the professional service providers does however gives more power to members than alternatives that vest greater power in experts. It does need to be emphasized that the system requires some diligence on the part of lay trustees if they are to preserve the balance of power. Professional service providers will always face temptations to usurp power - for reasons of efficiency and of commercial interest.

These temptations can be seen in two of the trends currently observable in the retirement fund industry. The first is investment choice that devolves power of investment choice from trustees to members. Members are, however, in a weaker position when it comes to

[43] Blackburn, R., 2003. *Banking on Death, or, Investing in Life: The History and Future of Pensions*. Verso, p12.

[44] Taken from Anthony Asher, 'Conflicted Super Structures: Are Australian Investors Being Short-changed?' in John Evans, Michael Orszag and John Piggott (eds), *Pension Fund Governance* (Edward Elgar Publishing, 2008) 61, 53–89.*Conflicted superstructures.*

monitoring the value of investment management services. This surely explains some of the increase in costs that inexorably accompanies the introduction of choice. The second is the suggestion of paid professional trustees as recommended, for instance, in Myners[45]. This again has apparent advantages, but clearly weakens the position of the lay trustees in board meetings. If trustees want independent advice, they would be advised to contract for it rather than to surrender some of their powers.

If they are representative they may well face conflicts and lack appropriate expertise. He highlights, however, that the undoubted expertise of the trustees of Australian retail funds has not prevented them from obtaining lower net returns for the funds they control than those run by less expert, but representative, trustees. The difference can be explained by conflicts between the interests of the trustees' employer and their members. Avoiding such conflicts may however not help as even independent experts may be intellectually captured by service providers, and not be as motivated to achieve the best results for members. On the other hand, lay trustees can be trained ...

4.2.2 Democratization

The SIS Act requires equal member and employer representation on either the governing body or a "Policy Committee". Member representation is however limited in both cases. In Box 6, I suggest that the government's proposal that funds should hold annual meetings should be extended to the right to elect trustees. While it is true that mutual companies (which is what they would become) have a patchy governance record (see Box 15), the large balances involved may often sharpen accountability.

Box 6[46]

But the logical conclusion of having annual meetings for superannuation funds is that members - like shareholders of public companies - should be given a vote. By doing so, both independent trustees and members will have real power over the funds. … trustees hold assets for beneficiaries, who are effectively regarded as not competent to handle the assets themselves. Such a top-down approach was probably never appropriate in this context, and is now clearly outdated. … by calling the beneficiaries of superannuation funds "members", we already acknowledge implicitly their right to vote for trustees and hold them accountable at meetings. Let's give it to them.

Independent directors with their own constituencies could be more likely to stand against rent seeking by the financial sector. That case has been made in a recent paper[47] by Scott Donald and Suzanne Le Mire. They argue that reforms to introduce independent directors have the potential to deal with some of the governance shortfalls, but only if they deal with issues related to director nomination, selection, tenure and remuneration. In interviews with board directors, they found concrete examples of a lack of independence influencing decisions

[45] Myners, P. (2001) Institutional investment in the United Kingdom: a review, Her Majesty's Treasury, London

[46] https://theconversation.com/democratising-super-would-bring-more-independent-voices-to-the-negotiating-table-84690

[47] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2758451

around "fund mergers and related party transactions" where members' funds were at risk. They argue that "an appointment nomination process that includes member elections promotes the accountability of the board and improves transparency. Both can be expected to inspire legitimacy."

Democracy is the least worst system
Of course, by itself, democratising boards will not change anything on its own because, similarly to everyday voters, board members may not choose to avail themselves of their powers. … Democracy provides a channel to voice discontent, to criticise power from a position of power, and ultimately to replace incumbents. It is the "worst form of government except all others that have been tried". People will still be able to choose what super fund they wish to use, but they can be more empowered as members of that fund.

There are good reasons for thinking that members will be more engaged than shareholders if they have voting rights. Many members will already interact with each other at work, and meetings held in the workplace are likely to be better attended and lead to more engagement. Those most interested in their superannuation – not least because of their larger balances – are those approaching retirement and in early retirement, who may have more time and capacity to contribute to fund governance.

My experience as an elected trustee and on various regulatory bodies has been that the boards functioned well and the election processes create a relatively high level of engagement. Such engagement also seemed to include greater financial literacy, which should have a positive spin-off in financial preparations for retirement.

There may well be wider social benefits of democratization. In the first place, it provides the structure for greater accountability of the economic order. Long term superannuation savings contribute almost half of our business capital. If funds were democratically controlled, then one would potentially have a virtuous circle of mutual accountability, as in *Figure 2*.

Figure 2: A circle of accountability

4.3 Accountable to the law

Confucius: "If people be led by laws, and uniformity is sought to be given them by punishments, they will try to avoid punishments but have no sense of shame.[48]"

Misconduct often calls for harsher retribution, but this can be an overreaction without consideration of the implications. Tatum[49] suggests that punishment of financial crimes should be seen as much more than deterrence, but rather as in the (Canadian) Criminal Code in having broader and more humane aims: "denounce unlawful conduct, deter the offender and community from committing offences, assist in rehabilitating offenders, provide reparation for harm done to victims, and promote a sense of responsibility in offenders."

4.3.1 Restorative justice and responsive regulation

These broader aims are addressed by the holistic response briefly described in Box 7.

Box 7[50]

One of the perverse results of a mechanistic approach to management is the idea of "zero tolerance" for mistakes. Human error or mistakes and unfavourable outcomes from business risks are often difficult to distinguish – and often require the same type of response. Neither can be entirely avoided, both should be acknowledged and taken seriously.

Risk cultures must go beyond awareness, to being quick to acknowledge and correct errors. This entails an admission to being prone to making mistakes, a quickness to admit when they are wrong, and correct and often to forgive them. Many huge losses can be blamed on failure to ensure that there are sufficient checks and balances – because people do not admit they are prone to failure. This is more obvious in health and safety matters: protective clothing and safety mechanisms being unused. In finance, it is back offices disempowered and auditors belittled.

Mistakes and failures will occur. In order to be addressed and addressed quickly, the perpetrators must have no need or incentive to protect themselves or hush up the error. In many organizations, those who admit to mistakes are routinely punished for them, in some way. Too often, the boss's response to being told of an error is: "bring me a body". ...

Braithwaite advocates a responsive regulation involves a variety of strategies. It builds on those moral standards that are demonstrated by meaningful internal codes of ethics and industry standards. These provide the basis not for punishment, but for "re-integrative

48 Analects II/3

49 Tatum, Jeremy (2012) Enhancing Corporate Accountability under the Criminal Code through Enforcing Corporate Social Responsibility. https://ssrn.com/abstract=2143940

50 Taken from Asher, A and Wilcox T, Virtue and Risk Culture in Finance. Presented to the IAA Colloquia, Sydney 23-27 August 2015. http://www.actuaries.asn.au/Library/Events/ASTINAFIRERMColloquium/2015/AsherWilcoxVirtuePaper.pdf

shaming", where peer pressure is positively brought to bear on excessive risk takers and those that make mistakes. It can be contrasted with "stigmatising shaming", which drives offenders into a counter-culture of passive resistance and mechanistic compliance.

One of the points made by Braithwaite[51] is that one cannot have a hierarchical view of regulators, as "if the n+1th order guardian is corrupt, the whole edifice of assurance can collapse". The regulators themselves need active monitoring – not just by politicians.

Box 8 highlights the problem with criminalising many white collar crimes. While it may achieve some general deterrence, failure to obtain a conviction fails all the other objectives of the criminal code.

ASIC is on record as wanting to criminally charge institutions for poor culture,[52] and when questioned did not seem aware of the South African experience in Box 8. I think this is to face the wrong way.

Box 8[53]

One of the debates in regulation is the extent to which unsocial behaviour should be punished. This is partly a matter of desert; it would be unfair that bankers who steal should get lesser sentences than burglars do. There are also considerations of liberty and efficiency: whether it is necessary to take the dishonest banker off the street when society can be made safe if they are kept away from financial institutions. Both desert and efficiency come into play with the difficulty in obtaining criminal convictions. The standard of proof is that the matter must be beyond reasonable doubt, and wealthy individuals can employ good lawyers to sow such doubt. The South African experience is described in the Johannesburg Stock Exchange:

> *South Africa was the first country to initiate civil prosecution of insider trading with the added advantage of compensation for those prejudiced by insider trading. ... The civil provisions of the Act have been the main tool utilised by the FSB, resulting in settlements since 1999 totalling more than R93 million. In all cases, the persons involved were named in press releases.* [54]

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[51] Braithwaite, J. 1999. Accountability and governance under the new regulatory state. *Australian Journal of Public Administration*, *58*(1), 90-94

[52] http://www.abc.net.au/news/2015-06-03/asic-considers-criminal-sanctions-for-poor-company-culture/6517684

[53] See note *Working Ethically in Finance, p133ff*

[54] Johannesburg Stock Exchange (2013) Insider trading and other market abuses (including the effective management of price sensitive information)

They go on to report on a survey of market participants, where over three quarters felt that the new approach had reduced insider trading. Dennis Davis[55] reports that South African company law has followed this approach more widely in decriminalising many offences that can be dealt with more efficiently otherwise.

Questions 825.25 - Encouraging regulators

I do not think the overall regulatory architecture is particularly relevant. The regulators do need powers to force the disgorgement of unfairly earned profits. Willingness to do so will depend on their attitudes and courage, and oversight which I think is a parliamentary responsibility. More recommendations are made in section 4.8 below.

John Braithwaite suggests the use of *Qui tam:*[56]

> *Qui tam had a long history in British and US law, but was characterised by much abuse until put on a more principled footing with 1986 amendments to the False Claims Act in the US. These allowed whistleblowers in cases of fraud against the government to take their evidence of fraud to the Justice Department. If Justice found their evidence new and meritorious, it could take over the whistleblower's False Claims suit. When successful, a hefty percentage of the recoveries from the lawbreaker as a result of the suit are paid to the whistleblower*

4.4 Codes of ethics

In addition to removing temptations, we can reinforce private consciences by encouraging the adoption of professional codes of conduct, as in Box 9.

Box 9[57]

I have found that the ethical codes of the actuarial profession do make it easier to challenge unethical behaviour in other actuaries. I have therefore invested many hours in attempting to refine them so that they can be used in this way. The codes have, however, recently have tended to grow into depressingly detailed lists of what not to do. While this makes it easier to convict an offender, the aim should be to reform poor – and reinforce better – behaviour. It is easier to phone a fellow professional and suggest that he or she is close to a rather vague line, than to point out that they have infringed a clear boundary that must be enforced.

On the other hand, I have not been enthusiastic about company codes of ethics, because they seem to feed hypocrisy. I seem to have been wrong. The research does indicate that affirming

[55] Davis, D. M. (2010). Dealing with corporate defaulters: curbing the unfettered exercise of criminal law: enforcement and regulatory regime: part IV. *Acta Juridica: Modern company law for a competitive South African economy*, 411-432.

[56] Braithwaite, J. (2012). Flipping markets to virtue with qui tam and restorative justice. *Accounting, Organizations and Society*.

[57] Taken from *Working ethically in finance,* note 6, p182

the virtues, even in such ways as signing a code of ethics, does help make people more honest[58]. The risk of hypocrisy is however just another manifestation of vice, and should not prevent us from acting. François de la Rochefoucauld puts it nicely: "Hypocrisy is the homage which vice pays to virtue".

Ethical codes should however be simple. Ten Commandments are more than enough! Focussing on meeting the needs of clients is a good start. Peter Drucker regards the most important ethical principle for businesses as the same as found in the doctors' Hippocratic Oath, "primum non nocere – 'Above all, not knowingly, to do harm.'" This involves avoiding unintended consequences, and is often a high standard.

My bias is obvious, but I do see advantages in requiring trustees to obtain a regular financial condition report from an actuary – as I have previously suggested to APRA, the relevant sections copied in the Appendix to this submission.

4.5 Regulatory Capture

The power of greed can pervert not only private organizations but regulators. Box 10 explains, but Adam Smith is more colourful:

> *The member of parliament who supports every proposal for strengthening this monopoly, is sure to acquire not only the reputation for understanding trade, but great popularity and influence with an order to men whose numbers and wealth render them of great importance. If he opposes them, on the contrary, and still more if he has authority enough to thwart them, neither the most acknowledged probity, nor the highest rank, nor the greatest public service, can protect him from the most infamous abuse and detraction, from personal insults, nor sometimes from real danger, arising from the insolent outrage of furious and disappointed monopolists.*

Box 10[59]

Public interest theory is built on the fundamental assumptions that economic markets are subject to market failures and, as a result, can operate inefficiently. … Thus, the public interest paradigm is based on the assumption that the government will act on behalf of the public to improve welfare in situations where the market has failed to do so.[60] …

[58] Shu, L. L., Gino, F., & Bazerman, M. H. (2009). *Dishonest deed, clear conscience: Self-preservation through moral disengagement and motivated forgetting*. Harvard Business School.

[59] From Taylor, Sue, Anthony Asher, and Julie Anne Tarr (2017). "Accountability in Regulatory Reform: Australia's Superannuation Industry Paradox." *Federal Law Review*. 45(2), 257-289.

[60] Refer to the seminal publications: Barry M Mitnick, *The Political Economy of Regulation* (Columbia University Press, 1980); Douglas Needham, *The Economics and Politics of Regulation: A Behavioural Approach*, (Little, Brown and Company, 1983); Richard A Posner, 'Theories of Economic Regulation'(1974) 4 *The Bell Journal of Economics and Management Science* 335.

In contrast to this public interest theory, the 1980's 'Stiglerian'[61] version of *private interest theory* was developed by economists, building off Adam Smith and Mancur Olson.[62] Findings in this respect have highlighted outcomes wherein government regulations appeared, in many cases, to have primarily served the interests of small, powerful interest groups rather than the public interest. Within this framework, government regulation is seen as a market for wealth transfers, with politicians having the power to coerce to affect wealth transfers, which product is then 'sold'. ... The sale price takes the form of explicit payments to Governments (eg bribes, campaign contributions, etc) or subtler forms of payment (eg assurances of factional voting support).[63]

Producers within this original formulation of the private interest model will generally seek to maximise their wealth by lobbying for regulation involving less competitive market dynamics (e.g. price fixing, restriction of entry, subsidies, and suppression of substitutes). As producer groups are generally small relative to consumer groups, and where profits are potentially large, producer groups are easier to organise and strongly incentivised to seek self-benefitting regulation. Consumers, conversely, face an insignificant incentive per person to oppose regulation. The 'protective' regulatory shield sought by incumbent producers is to ensure that these benefits are 'delivered' by government in an opaque manner, such as in the form of highly technical and complex supervisory regulations, which allow little scope for fund member/consumer recognition of the 'hidden' benefits/subsidies to producers and, therefore, see no reason to mount any form of counter lobbying campaign.[64] …

Regulatory capture theory provides another perspective that aligns with the regulatory outcomes described. Harvard's Tobin Project[65] has generated a range of studies around industry-based capture deriving from barriers to entry and which can be argued to characterise current superannuation regulation. Tobin research reconsiders Stiglerian concepts of regulatory capture which predominantly focused on rent seeking activities designed to generate *more regulation:* for example, creating barriers to entry to new firms. …

Our research[66] finds that the changes to Australian law and regulation over the past two decades has persistently failed to meet its own standards of Regulatory Impact Assessment.

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[61] George J Stigler, 'The Theory of Economic Regulation'(1971) 2 *Bell Journal of Economics and Management Science* 3.

[62] Mancur Olson, *The Logic of Collective Action* (Harvard University Press, 1965).

[63] See, more broadly, Eric A Posner, 'Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective' (2001) *University of Chicago Law Review* 1137; Sam Peltzman, 'Towards a More General Theory of Regulation' (1976) 19 *Journal of Law and Economics*, 211, 109–48; Gary S Becker, 'A Theory of Competition among Pressure Groups for Political Influence' (1983) 98 *Quarterly Journal of Economics* 371.

[64] Sue Taylor, 'Captured Legislators and Their Twenty Billion Dollar Annual Superannuation Cost Legacy' (2011) 58 (3) *Australian Accounting Review* 268.

[65] Daniel Carpenter and David A Moss ,*Preventing Regulatory Capture: Special interest influence and how to limit it* (The Tobin Project, Cambridge University Press, 2014).

[66] Note 59, and Tarr, Julie-Anne, Taylor, Sue and Asher, Anthony (2016). "Australia's flawed Regulatory Impact Statement (RIS) process" *Australian Business Law Review* 44: 361-376.

4.6 Intellectual capture

The victory of vested interests over regulation is described by academic John Kay as:

> *...regulation that is at once extensive and intrusive, yet ineffective and largely captured by financial sector interests. Such capture is sometimes crudely corrupt, as in the US where politics is in thrall to Wall Street money. The European position is better described as intellectual capture. Regulators come to see the industry through the eyes of market participants rather than the end users they exist to serve, because market participants are the only source of the detailed information and expertise this type of regulation requires.*[67]

There is a widespread view that this is related to neo-classical economics as raised in Box 2:

> *ascendancy within the academic community and many regulatory authorities of ideas highlighting the efficiency of financial markets at understanding and allocating risks, their self-stabilizing nature, and the benefits of financial innovations for the economy...* [68]

In a similar vein, in a book on the place of trust law in superannuation[69], Scott Donald questions Australia's legislative program of the past decades as favouring a view of the member as a "consumer of financial products" and thereby losing some of the "valuable protections" (55) that stem from Equity. In another chapter, Pamela Hanrahan suggests, in particular, that market conduct regulations "default" to the investor perspective, expressing disquiet at the process, which appears opaque, overly complex and prescriptive: "there is no need to use all regulatory interventions on all people". (32)

4.7 Complexity

This leads to perhaps the most insidious channel through which regulatory capture works:

> *the complexity inherent in financial regulatory policies and the built-in advantage that the financial firms targeted by specific regulation have in terms of knowledge and information vis-à-vis other stakeholders are factors that increase the dependence on industry for expertise. Moreover, many analysts have lamented the lack of engagement with financial regulatory debates from stakeholders such as deposit holders, investors, and consumers of financial services. Besides being disadvantaged vis-à-vis financial industry groups in terms of financial resources and technical*

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[67] http://www.johnkay.com/2012/07/22/finance-needs-stewards-not-toll-collectors

[68] Stefano Pagliari, Making good financial regulation: Towards a policy response to regulatory capture (Grosvenor House Publishing, 2012, p15–16.

[69] M Scott Donald and Lisa Butler Beatty, *The Evolving Role of Trust in Superannuation*, The Superannuation Committee of the Law Council of Australia, The Federation Press, 2017.

> *expertise, these groups' voices remain hindered by their diffuse nature and the resulting 'collective action problems'.*[70]

And again from John Kay: "This complexity has created a financial regulation industry – an army of compliance officers, regulators, consultants and advisers – with a vested interest in the regulation industry's expansion."[71] Justice Stephen Rares has raised other issues with complexity:

> *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.* [72]

The UK Parliamentary Counsel Cabinet Office makes further points:

> *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 hinders economic activity, creating burdens for individuals, businesses and communities. It obstructs good government. It undermines the rule of law.* [73]

In the context of Australian superannuation, I suggest that "… the tsunami of financial regulation over the past few decades has swept aside much of the sense of personal accountability."[74] My views were captured in an Actuaries Institute submission to ASIC:[75]

> *We believe that this area is too complicated and fluid at this point to benefit from detailed regulations, but rather suggest that the area will develop best if providers of robo-advice are required to obtain appropriate professional advice. We suggest that members of the Actuaries Institute, the CFA Institute, and professionally qualified accountants can fulfil these roles. The advantage of professional oversight is that members of these professions have:*
>
> - *Appropriate in-depth training as to the subtleties of the various issues involved*
> - *Have access to the combined wisdom of the profession (reflected in standards and guidance notes)*

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[70] See note 68, p10.

[71] See note 67.

[72] Steven Rares J, 'Competition, Fairness and the Courts' (2014) 28(3) Commercial Law Quarterly: The Journal of the Commercial Law Association of Australia 17.

[73] UK Office of the Parliamentary Counsel, *When laws become too complex* (16 April 2013) Cabinet Office https://www.gov.uk/government/publications/when-laws-become-too-complex/when-laws-become-too-complex.

[74] https://theconversation.com/why-we-cant-just-throw-more-regulation-at-the-ethical-issues-raised-by-the-banking-royal-commission-96646

[75] https://www.actuaries.asn.au/Library/Submissions/2016/20152016SubmissionASIC.pdf

- *Must limit themselves to areas of advice where they have appropriate knowledge*
- *Are subject to professional discipline in order to limit commercial excesses*

> *Detailed rules shift the locus of responsibility from industry to the regulator. It therefore stifles innovation and deflects energy into unnecessary compliance costs – for the industry and the Regulator. The rules in any event, might focus on process not outcomes. The paper in the appendix[76], suggests that many existing robo advice calculators are not fit for purpose. While the opinions are debatable, the proposed regulations will do nothing to address the problems. Professional bodies so however provide the necessary institutional framework to address these debates and create generally acceptable principles.*

Interestingly, the first draft of this submission did engage with the detail of the ASIC consultation paper. My suggested changes to oppose detailed regulation by ASIC was welcomed by members of the ad hoc committee debating the wording. The voluntary resources of the profession, which was fairly successful for maintaining life insurance solvency for over a century before modern risk regulation, are normally too stretched by complexity to function as well as it might.

It may be objected that neither the entities, nor regulators, will always have the time or the intellectual and moral capacity[77] to understand the problem in sufficient depth to develop their own rules. Many people prefer detailed prescriptions that can be followed more easily. The apparent certainty of prescriptions, however, offers a false sense of comfort and reinforces immature thinking. It fosters uniformity and has the potential to create greater systemic risks.

Question 825.24 – Other system changes

The superannuation industry labours under three unnecessarily complex legislative frameworks: superannuation, the financial services elements of the Corporations Act and tax and means tests issues. Unscrambling the first two will be horrendously complicated, but it is suggested that the introduction of a strict prohibition of conflicts of interests from the general law would provide the solution to untying the Gordian knot.

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[76] Same as that referred to in note 108

[77] It is somewhat disconcerting that researchers using the models of Jean Piaget and Lawrence Kohlberg have found that a *minority* of adults consistently use the "formal operational" thinking and "post-conventional" morality that would characterise a principled approach to risk management.

SIS Act

When the 1993 Act was eventually reviewed by the Productivity Commission[78], it identified that the legislation was 'voluminous, complex and in some respects, overly prescriptive'. Some suggestions for reform were made in Box 11.

Box 11[79]

The SIS Act and Regulations, which ought to be read with Superannuation Guarantees (Administration) Act 1992 and the Retirement Savings Account Act 1997 and their regulations, make up well over a thousand pages. They are particularly repetitive[80] and clumsy, contain a number of alternative and counter-intuitive definitions and compare unfavourably with other Acts administered by APRA as well as some international legislation such as the Canadian Pension Benefits Standards Act, 1985.

Specific suggestions for simplification would be:

- Transfer those parts and sections administered by the ATO and ASIC to legislation that they administer.
- The current plan to simplify taxation already requires a substantial re-writing. This could be put into another Act. (The opportunity should be taken to remove part 8, which is particularly convoluted and permits "in-house assets" that the common law would prohibit.)
- The terms of reference are somewhat confusing as APRA does not legally have the power to issue standards for superannuation funds and trustees. Issuing standards not already in the SIS Act is the prerogative of Treasury[81], which must incorporate them into the SIS regulations. We suggest that APRA's powers under the licensing regime allow for a rationalization of powers, and for some of these other sections of the Act to be removed. It would be better for APRA to be able to regulate superannuation funds in the same way as it manages its other industries. APRA should therefore be allowed to issue prudential standards that should specifically cover operating risks and fiduciary standards.
- Remove the distinction between superannuation funds and approved deposit funds, pooled superannuation trusts and retirement savings accounts. This would facilitate the removal of many of the repetitive passages that make the Acts so complex.

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[78] Productivity Commission, Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Similar Legislation, Inquiry Report No 18 (10 November 2001).

[79] Andrew Gale and Anthony Asher from what was then Trowbridge Deloitte, in a submission to the Joint Committee Inquiry into the structure and operation of the superannuation industry in September 2006.

[80] We note that the drafters of the Acts seem to approve repetition of provisions when they are applied to different circumstances. The counter argument is that this makes it necessary to read much more material when one wants to know the difference between each of the circumstances. It is suggested that there would be much greater clarity if identical provisions were not repeated, and that the distinctions were separately identified

[81] In terms of section 31

Given the extended powers of APRA since, a fresh start with a total proscription of conflicts might be easiest and produce a much shorter replacement.

Financial Advice

The *Financial Sector Reform Act (2001)* led to the licensing of financial advisors, together with various other requirements. They were to harmonise financial services sector products and distribution to 'facilitate innovation and promote business, while at the same time ensuring adequate levels of consumer protection and market integrity.'[82] As is evident from evidence to the RC, they have proved impossible to administer and ineffective. Moreover the arguments, made in Box 18 below, are that the science underlying much of the advice would not have helped its recipients even if they had been effective.

Repealing the legislation and proscribing the payments of commission and all but very limited advice fees would offer considerably more protection to members.

Taxation and means tests

This is not the place to make suggestions for specific changes to the tax and means test rules.[83] One can however note that much of the need for financial advice is the current complexity of the system. A significant cause of this is the way in which political parties make election promises that are exempt from regulatory impact assessments and are therefore not appropriately considered (let alone costed). My personal experience was a minor involvement in the changes to introduce the $1.6 million cap on retirement accounts. The fact that decisions had been handed down from on high meant that there were no possibilities for of using much simpler methods for obtaining much the same result.

4.8 Recommendations to address capture

Box 12 gives all the recommendations from joint work with Sue Taylor and Julie Anne Tarr.

Box 12[84]

First, that both political parties, as a social imperative, pursue regulatory capture as a systemic risk across all agencies and legislative processes. As suggested by Whitehouse and Leach, consideration should be given to establishing an official public advocate, with

[82] Explanatory Memorandum, *Financial Services Reform Bill* (Cth) 2001 <https://www.comlaw.gov.au/Details/C2004A00891/Download>.

[83] See however Asher, A (2011) "Equity in Retirement: Are All Australians Getting a Fair Deal?", *The Economic and Labour Relations Review* 22.3: 65-84 and Asher, Anthony & John De Ravin "The Age Pension means tests: contorting Australian retirement" presented to the Actuaries Institute Financial Services Forum https://www.actuaries.asn.au/microsites/financial-services-forum-2018/program/papers-and-pre-reading.

[84] Taken from Taylor et al, note 59

expertise in highly technical financial regulation, who is charged with representing the public interest during the regulatory process.[85]

Second, integrated with the creation of an official, expert, public advocate, to allow for an informed debate among different stakeholders, steps need to be taken to address the informational advantage of all industry insiders participating in any RIS-related consultations. For example, both the APRA and the ASIC need to be empowered to generate and disseminate information to remedy the informational disadvantage vis-à-vis the industry and any lobbyists. This release of data: 'will help energize the public to overcome collective action problems and rally behind the agency … so that they can engage in the issues, possibly against the deep pockets of the incumbents'.[86]

Third, that political parties and the OBPR require RISs to document consideration and adopted solutions to any potential issues that may be perceived as arising around rent seeking. In the case of the Australian superannuation industry, given the size and power of the Financial Services Sector, consideration of this variable should be included in RIS processes particularly around potential rent seeking activities that impose costs on fund members.

Included within this point should be the prioritisation of the completion of outstanding Post Implementation Reviews (PIR).[87] Ensuring reviews conducted around superannuation revisit legislation that may have previously been exempted through grants of exemption 'carve outs' would be meritorious and, going forward, should align with standards arising out of recommendation four below.

Fourth, there is a need for the ongoing development of more rigorous statistical parameters for both the related costs and benefits of any proposed regulations, as suggested by Posner and Weyl.[88]

Fifth, there is the desirability of significantly restricting the carve-out and exemption provisions that are included within the Australian Government Regulation Impact Assessment process, as flagged in the 2012 Borthwick and Milliner Review. Specifically, 'Prime Ministerial exemptions from the need to undertake a RIS should be provided only in genuinely "exceptional circumstances"'[89]

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[85] Carpenter and Moss, above n 65, 473.

[86] Pagliari (ed), 2012, above n 70, 24.

[87] As detailed on the OBPR site, <https://ris.govspace.gov.au/files/2012/04/03-PIR-Table-Required-2014-15_22072015.pdf> as 30th June 2015, there were a total of 90 post-implementation reviews (PIR) required. Of the 90 PIRs, in 57 cases the regulation has been implemented, whilst in 4 instances the regulation has not been implemented and 29 PIRs were completed and published. Eight PIRs were non-compliant for not having been completed in the required timeframe.

[88] Eric Posner and E Glenn Weyl, 'Speculation, Insurance and Financial Regulation: Benefit-Cost Analysis for Financial Regulation' (2013) 103 American Economic Review: Paper and Proceedings 393

[89] avid Borthwick and Robert Milliner, Independent Review of the Australian Government's Regulatory Impact Statement Process, Review for the Minister for Finance and Deregulation (2012)., 11.

Finally, it is suggested that the Federal government seek contribution more actively and formally from Australia's highly experienced fund licensees in the early stages of the RIS process to ensure a 'voice' is given to them and, through their expertise, to those of the millions of fund members whose life savings are the subject matter of their fiduciary investment care.

5 Further application to superannuation

This section addressed the elements of the industry from the approach developed above: marketing, administration, advice and investment management.

Box 13[90]

The extent of the charges is not easy to gauge. The larger financial services industry has a turnover of $146 billion annually or 9.5% of the GDP.[91] …

It can be calculated that the 1.9% per annum that Industry funds outperform Retail funds could more or less double spending in retirement; the difference is too persistent and the numbers too large for this to be a statistical anomaly. [92] A variety of research ascribes the difference to agency costs, which arise from the objectives of the largely bank-operated commercial retail funds against the trade-union dominated non-profit industry funds.[93] Asher

[90] Taken from Taylor, Sue, Anthony Asher, and Julie Anne Tarr (2017). "Accountability in Regulatory Reform: Australia's Superannuation Industry Paradox." *Federal Law Review*. 45(2), 257-289.

[91] Australian Bureau of Statistics, *5204.0 Australian System of National Accounts, Table 5. Gross Value Added (GVA) by Industry* <http://www.ausstats.abs.gov.au/ausstats/ABS@Archive.nsf/0/11C6681E4D26E070CA258059000EE9D4/$File/5204005_gva_by_industry xls> Sheet 'Data1', cell AI67 and cell DY67 respectively.

[92] See APRA, *Annual Superannuation Bulletin* (June 2016) <http://www.apra.gov.au/Super/Publications/Documents/2017ASBEXCEL201606%20-%20PDF.pdf, 17 (Table 9) for the difference, which is the average over the past five years. The calculations are the authors', and assume 45 years of contribution to a superannuation fund, and 22 years of drawdown—with real investment returns of 3.1% and 5% respectively. Table 9 also reports a difference between the 25th and 75th quartiles as about 2% in 2016. If this is typical, and the distributions are normal, there is a more than 99% probability that the underlying difference between the funds exceeds 1.3% per annum.

[93] See Anthony D F Coleman, Neil Esho and Michelle Wong, 'The impact of agency costs on the investment performance of Australian pension funds' (2006) 5 *Journal of Pension Economics and Finance* 299; Adam Clements, Gemma Dale and Michael E Drew, 'Australia's retail superannuation fund industry: structure, conduct and performance' (2006) 12 *Accounting, Accountability & Performance* 1; Thi Thuy Chi Nguyen, Monica Tan and Marie-Anne Cam, 'Fund Governance, Fees and Performance in Australian Corporate Superannuation Funds: A Non-Parametric Analysis (2012) 11 *Journal of Law and Financial Management* 2; and Kevin Liu and Bruce R Arnold, A*ustralian Superannuation Outsourcing: Fees, Related Parties and Concentrated Markets* (12 July 2010) <http://www.apra.gov.au/AboutAPRA/Documents/SA_WP_ASOFRP_072010_complete.pdf>. There is, however, limited evidence elsewhere. See Krzysztof Jackowicz and Oskar Kowalewski, 'Crisis, Internal Governance Mechanisms and Pension Fund Performance: Evidence from Poland' (2012) 13 *Emerging Markets Review*, 493; and Manuel Ammann and Christian Ehmann, 'Is Governance Related to Investment Performance and Asset Allocation? Empirical Evidence from Swiss Pension Funds' (Working Papers on Finance No 2016/23, Swiss Institute of Banking and Finance, University of St. Gallen, September 2016) .

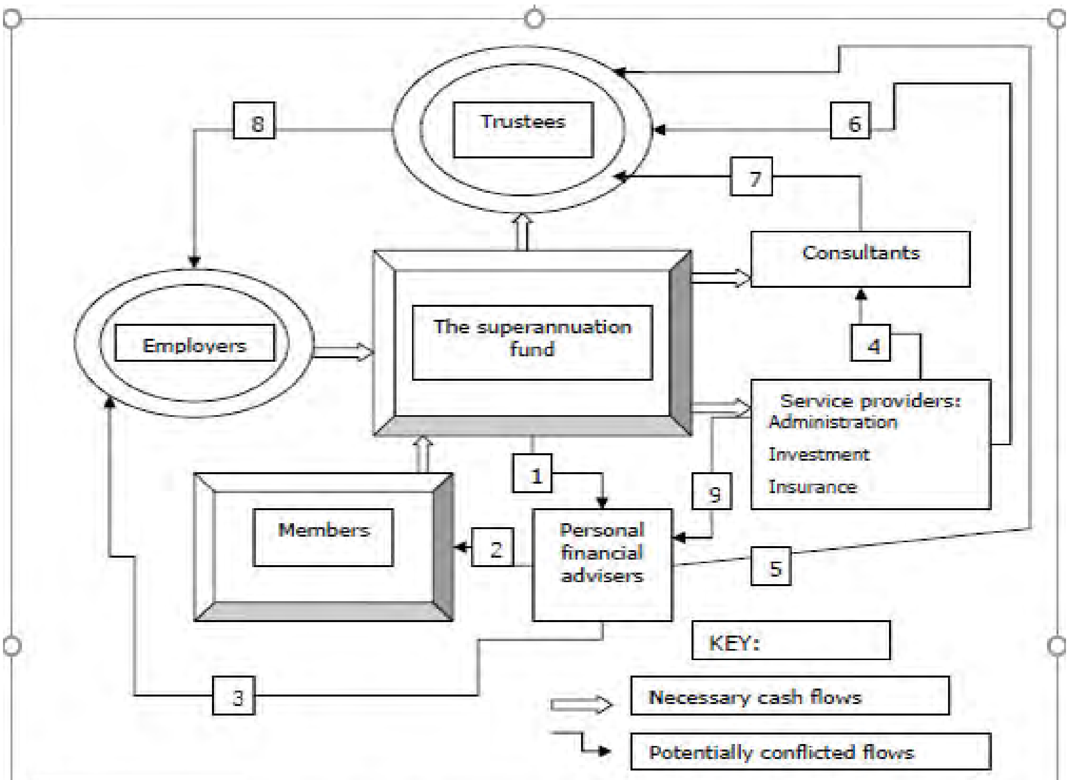
explains most of the difference to commissions for advice and distribution costs[94], although these too can at least partly be ascribed to agency issues...

*Figure 3: Sources of Conflict*shows both the necessary cash flows and indicates where conflicted and secret payments may be made. It is, obviously, not easy to obtain confirmation that such payments are being made, but the evidence given to the RC makes it relatively easy to believe that they exist. Identifying them would involve a forensic investigation of accounts, which is not really practical for the RC. Braithwaite's *Qui Tam* suggestion in 4.3 above has merit.

Question 825.6 Trustee retaining payments from 3rd parties

I am not sure I understand the subtleties of this question, as it appears entirely inappropriate.

[94] Anthony Asher, 'Conflicted Super Structures: Are Australian Investors Being Short-changed?' in John Evans, Michael Orszag and John Piggott (eds), *Pension Fund Governance* (Edward Elgar Publishing, 2008) 61, 53–89.



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: Sources of Conflict

5.1 Marketing

This heading can include the costs of promotion and the choice and remuneration of sales channels.

Question 825.2 – Advertising in general

If members have choice of fund, Trustees must spend money on marketing or ultimately to cease operating. Box 14, where we refer to the industry funds as mutual organizations, expands.

Box 14[95]

Advertising costs are part of the general cost of distribution, which includes marketing and sales. No business can survive without marketing in some way.

Proprietary companies theoretically determine their marketing costs by judging what level will lead to the maximization of profits. Greater advertising, for instance, is expected to bring in new business that will more than cover the costs of the advertising. One necessary assumption is that the marginal revenue from the new business will be greater than the marginal costs of administering the business.

The same considerations apply to mutual organizations. Existing members will be charged less if the marginal revenue from new business is greater than the marginal costs of administration and the cost of the advertising. Advertising that works is therefore in the interests of existing members.

Question 825.1 – political advertising

It is perhaps helpful, if uncomfortable to see this as healthy competition, encouraging efficiency and innovation as in Box 15.

Box 15[96]

There is some evidence that proprietary (stock) companies are more efficient, but mutuals may offer a better deal for their customers as the shareholders gain more than the benefit of the efficiencies.

McNamara and Rhee[97] also report on views that the existence of both types of company structure – with their different advantages – increases the level of competition in a market. We agree with this assessment. Mutual organizations ought to attempt to exploit the view that all profits go to members; proprietary companies that they are more efficient and innovative.

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[95] Asher, A and Andrew C Gale (2006) "Submission to the Parliamentary Joint Committee on Corporations and Financial Services by Trowbridge Deloitte", http://www.aph.gov.au/senate/committee/corporations_ctte/superannuation/submissions/sub80.pdf

[96] Ibid

[97] M J McNamara & S G Rhee (1992) Ownership Structure and Performance: The Demutualization of Life Insurers *Journal of Risk and Insurance* 59: 2: 221-238

Questions 825. 3, 4 and 5 – role of employers

Given that employers pay the contributions, it would be impossible to create an effective barrier between them and trustees. It is therefore difficult to envisage a situation where they have no influence and trustees are not concerned with maintaining good relationships. While significant conflicts of interest are clearly not appropriate, it would be unnecessarily austere to ban reasonable entertainment expenses. The expenses should however be appropriately accounted for – to boards and in annual reports.

Question 825. 7 and 8 – sales through bank branches

Bank sales of superannuation to employers and to members contains an unacceptable conflict as explained in Box 16. Given that customers are supplicants for loans, they cannot be expected to resist suggestions from bank employees. It may be that legislation is required to confirm that this would represent a conflict of interests.

Box 16[98]

A third channel are the bank branches where employees who are paid by salary and bonus. Here it would appear to be the bank that faces the conflict. Glover[99] suggests that banks may in some circumstances owe a fiduciary duty to their customers. To the extent that the bank, and not its employees, receives the commissions paid by the retail superannuation fund, and thus makes a secret profit, there is a conflict of interest between customers and bank. Determining the profit is not easy. Australian banks report relatively small profits from superannuation business, but the estimates given in the next section suggest that superannuation and investment management charges make up perhaps a half of their consolidated fee income from all sources, or 25 per cent of total revenue. The actual contribution to profit depends on a relatively subjective allocation of overheads, so cannot easily be determined. …

I remain puzzled however by the number of accumulation funds that have been moved into retail vehicles. Is it because employers are reacting against union domination of the industry funds? Are the retail funds so very much more efficient administratively? Do the industry funds not give enough support and advice?

[98] Taken from Asher (2008) see n94, p17,18

[99] Glover, J. (1995) Banks and Fiduciary Relationships, *Bond Law Review* 7.1 50-66

Perhaps one should be more suspicious. Does the employer receive benefits from dealing with a commissioned adviser other than advice on the superannuation fund? Is it possible that employers' duties to their employees are being compromised by pressures from their bank managers? This might be suggested by the market share gained by the life insurance companies attached to the large banks. The growth in their assets over and above that of other life insurers, during the years 1998 to 2003, suggests that the large four banking groups captured over 70% of the flow out of corporate funds against their overall market share of 40%.

5.2 Administration

The Productivity Commission reports administration costs per member are approaching $200 per member annually.[100] Administration costs are probably largely driven by membership numbers so that an annual dollar amount is the best way to measure them. A major driver of increased costs have been increasingly complicated investment options offered to attract more members.

If one is open to the idea that there is both overcharging and over-servicing (and that the same would apply internationally) then neither local nor international comparisons are of much use. One can however note that many industry funds (even smaller ones) have kept fees below $100 p.a., suggesting possibilities that exploitation, by commercial providers at least, cannot be ruled out.

If the real costs of administration can be kept below $100 pa, then they amount to some $4,000 over a lifetime, compared with total contributions to superannuation of at least $80,000 for someone on the minimum wage for 35 years – which is about 5%. This seems to me to be relatively immaterial and not worth much regulatory time. [101]

Question 825.23 – stapling of accounts

Some proportion of the fees charged on duplicate accounts are contributions to overhead costs of the funds, and these will be redistributed to other accounts. I have been told informally that the marginal costs of dormant and lost accounts is as little as $10 pa, being the cost of posting an annual report.

Question 825.21 and 825.22 – MySuper outcomes

It seems to me that a dollar cap on MySuper administration fees would be simple and lead to a reduction in egregious overcharging and over-servicing. This is because the services

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[100] Productivity Commission *Superannuation: Assessing Efficiency and Competitiveness* Draft report 29 May 2018, Box 3.1 p135

[101] For a more detailed discussion on materiality in superannuation, see Asher, A and Trang Duncanson (2008), "Developing a Fair and Reasonable Unit Pricing Restitution Policy", Presented to the Institute of Actuaries of Australia 4th Financial Services Forum. https://actuaries.asn.au/Library/Events/FSF/2017/FSF085epaperAsherDuncansonFairUnitPricing.pdf

provided can be evaluated relatively easily and quickly by members. Funds would therefore trim their services so that they could meet the cap. The cap could be set by Treasury regulations, and should be at no more than $100 pa.

5.3 Advice

The RC has already identified many problems of conflicted and illegal payments for advice. One of the roots of the industry was high pressure life insurance, which placed considerable moral and financial pressures placed on them. These were investigated by Guy Oakes in a series of scholarly papers and a book, reviewed by Smith:[102]

> *The general thesis of this book is that these salesmen … are subject to two inherently conflicting principles: a commercial idiom that stresses sales at all costs and a service idiom that stresses concern and sensitivity for the needs of clients. … the author reviews the five essential steps of selling insurance: prospecting, approaching, interviewing, closing (making the sale) and providing service to clients…. After presenting both idioms, he offers a brief discussion of the major antimonies of the profession, namely, sacralization and manipulation, opportunism and professionalism, toughness and sensitivity, sincerity and dissimulation. The book ends with an analysis of the ways in which most salesmen succeed in remaining ignorant of their own conflictual situation.*

While financial advisors are not placed under quite the same financial pressures, the tensions remain. The persistence of high pressure sales is a system wide issue in that companies that do not participate are at risk of losing market share. Even leaning in the direction of less pressure is for a CEO to risk losing his job if it even appears that loss of market share is a consequence of too delicate a conscience. Box 17 suggests that the common justification for the high pressure is based on little evidence, and I would suspect that same would apply to the recipients of advice. I have seen evidence that those who have taken financial advice have more insurance and save more, but this by no means indicates that the levels are appropriate. On the contrary, it can be argued that people are able to make sensible provision without compulsion – using evidence of states in the USA where compulsory pension provision has been withdrawn.[103]

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[102] Smith, C.W. (1991) Book review: The soul of the salesman: The moral ethos of personal sales (Oakes, G Humanities Press 1990). *Social Forces*, Vol. 70.1, 287-289

[103] Miller, William and Smith, Daniel J., The Emergence, Restoration, and Resiliency of Self-Governance (November 4, 2017). Available at SSRN: https://ssrn.com/abstract=3065327

Box 17[104]

Zultowski[105] surveys research on the widespread belief that life insurance "is sold and not bought" that provides some justification for the high pressured approach. Depending on whether the agent or the policyholder is being interviewed, policyholder initiatives explain only between 10 per cent and 50 per cent of sales in the US studies reported.

In Australia, however, where superannuation contributions are compulsory, this argument cannot be said to hold. It might however be argued that the high pressure sales forces actively search out small businesses and the self-employed and contribute towards greater compliance with the law.

Question 825.15 – Banning grandfathered commissions and ongoing fees

It is appropriate to treat these together. Even if ongoing fees are ostensibly for advice, the size of the buyer of last resort[106] contracts suggest that there is a significant sales commission inherent in the profit margins. It is difficult to justify sales commissions in a compulsory system, so I agree all ongoing payments should be banned. It is perhaps noteworthy that Section 154 of the SIS Act saw fit to expressly permit them. Perhaps it was feared that they would fall foul of the general law's proscription of conflicts.

Given that they were permitted, the question is effectively whether grandfathered sales commissions are unconscionable, obtained either by deceiving or manipulating clients. While this may be well be true for some, there will be others where it is not so. Legislation is therefore inappropriate, although there may be instances where clients should be encouraged to break or be freed from onerous contracts, and in some cases to be compensated. Compensation for mis-sold financial products is common in the UK and has led to the payment of over £35 billion in compensation over the last two decades. [107]

Question 825.16 – adverse effects of a ban

I cannot see any adverse effects – only other advantages. In my view the scientific basis of many elements of current financial advice is as compromised as its ethics. There is very little agreement on a number of questions. Box 18 gives some of the evidence.

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[104] Taken from Asher (2008) see n94, p16

[105] Zultowski, W. H. (1979) The extent of buyer-initiated life insurance sales. *Journal of Risk & Insurance*, 46.4, 707-714

[106] https://www.professionalplanner.com.au/2018/05/amp-fronts-reps-over-buyer-of-last-resort/

[107] Over £12 billion for pensions mis-selling https://www.telegraph.co.uk/finance/4474114/Mis-selling-to-cost-pension-firms-13bn.html and £22 for credit insurance. https://www nao.org.uk/wp-content/uploads/2016/02/Financial-services-mis-selling-regulation-and-redress-Summary.a.pdf

Box 18[108]

There is *prima facie* evidence that the financial advice available to members of DC retirement funds is inadequate in many countries. A number of authors[109] have found huge variations in the advice given by US website calculators and personal financial advisors. A preliminary survey of different Australian websites suggests similar differences exist here. …

Numerous examples exist in the literature of what appear prima facie to be suboptimal asset allocations as a direct consequence of poor financial advice. For example, Bodie[110] reports that the advice on investment options and asset allocations provided to self-directed retirement plans in the US is logically flawed and dangerously misleading. The advice provided by financial services firms and investment advisory services leads to "a strong bias in favour of investing retirement savings in the stock market without insurance against a market decline". Mullainathan et al[111] find that financial advisors fail to undo behavioural biases and misconceptions of the clients. Instead their portfolio recommendations "reflect either biases that are in line with the financial interests of the advisers (e.g., returns-chasing portfolio) or run counter to their interests (e.g., a portfolio with company stock or very low-fee index funds)". This is not to mention the role of conflicts of interest. …

One of the consequences of inconsistent advice is underinsurance, or inappropriate insurance. Gokhale and Kotlikoff[112] investigate underinsurance in the US and suggest that "66 percent … of poverty among surviving women and 37 percent … of poverty among surviving men resulted from a failure to adequately insure survivors." They also find almost no relationship between the actual amounts of life insurance families have, and the amount of insurance that the authors believe is appropriate. They therefore find many families are over-insured. In considering the reasons for this problem, they suggest that "questionable financial advice, inertia, procrastination, and the unpleasantness of thinking carefully about one's death are the likely culprits." One relatively easy solution to this is to automatically provide life and disability insurance through retirement funds. Not only does this remove the unpleasantness of thinking about death, it is more cost effective, and provides greater coverage as much

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[108] Taken from Asher, A, Adam Butt, Gaurav Khemka and Ujwal Kayande (2015) Formulating Appropriate Utility Functions and Personal Financial Plans, Presented to the Actuaries Institute, Sydney (April); and the International Actuarial Association, Oslo (June) http://www.actuaries.org/oslo2015/papers/PBSS-Asher.pdf

[109] Ciccotello, C. S., & Wood, R. E. (2001): An investigation of the consistency of financial advice offered by web-based sources. *Financial Services Review* ***10*****(1)**, 5-18; Dorfman, M. S., & Adelman, S. W. (2002): An analysis of the quality of internet life insurance advice. *Risk Management and Insurance Review* **5(2)**, 135-154; Kotlikoff, L. J. (2006): Is Conventional Financial Planning Good for Your Financial Health?; Turner, John, (2010): Rating Retirement Advice: A Critical Assessment of Retirement Planning Software (April 9, 2010) Pension Research Council Working Paper No. 2010-03. http://ssrn.com/abstract=1706204.

[110] Bodie, Z. (2003): An Analysis of Investment Advice to Retirement Plan Participants. In *The Pension Challenge: Risk Transfers and Retirement Income Security* ed. Olivia S. Mitchell and Kent Smetters (19-32). New York: Oxford University Press.

[111] Mullainathan, S., Noeth, M., & Schoar, A. (2012):. *The market for financial advice: An audit study* (No. w17929) National Bureau of Economic Research.

[112] Gokhale, Jagadeesh, and Laurence J. Kotlikoff. (2002): The Adequacy of Life Insurance. *Research Dialogue*, no. 72 (July): www.tiaa-crefinstitute.org.

cover can be given "free of underwriting". Hubener et al[113] show how life insurance needs can be generated relatively easily from financial lifecycle modelling, given age, income and family status. While family status is not available to Australian superannuation funds, it is available to retirement funds in many countries. The calculator envisaged in this product will also give life insurance advice, and would perhaps have an application for retirement funds.

One exception might be made. There is a case however for thinking that the bulk of the sales effort remunerated by commissions is not expended in redirecting mandated contributions but in recruiting voluntary contributions from the self-employed. Some evidence is given in Box 19, and would suggest that thought should be given to ensuring that superannuation remains salient for the self –employed. I would be reluctant to make contributions compulsory given that they are investing in their businesses and may well be liquidity constrained. An opt-out default could be tied to their personal tax returns.

Box 19[114]

Estimates of the number of self-employed range from 10% to 20% of employed Australians[115] and earn perhaps 15% to 25% of personal income[116]. The difficulties in making precise estimates relate to the 14% employed in the informal economy…

The statistics suggest that a very large proportion of these contribute voluntarily to superannuation. The HILDA survey[117] reports that 79% of the self-employed contribute to superannuation. Most of these would contribute via the retail funds or self managed funds and would be recorded as member contributions. APRA statistics show that member contributions are some 10% to 30% of employer contributions in corporate and industry funds and 100% to 150% of employer contributions in retail funds. This suggests that $12bn to $18bn in contributions is collected from the self-employed, which would suggest that they may well be paying as great a proportion of their income into superannuation as the employed…. These statistics are more impressive if one considers the fact that the self-employed are encouraged to invest in their own businesses by tax concessions that match those of superannuation.

Question 825.24 – Further system changes

Box 20 provides a suggestion as to how advice could be made considerably cheaper and more reliable. It can be noted that superannuation funds do not know their members family status for privacy reasons, which I believe are overplayed.

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[113] Hubener, Andreas; Maurer, Raimond; Mitchell, Olivia S. (2013): How family status and social security claiming options shape optimal life cycle portfolios, *CFS Working Paper, No. 2013/07*.

[114] Deloitte, 'International superannuation & pension fund fees', 2009, Prepared for IFSA.

[115] See http://www.contractworld.com.au/reloaded/ica-numbers2.php

[116] This is very speculative, but ABS report 5216 reports that only 55% of household income is earned from wages. The rest is income from investments and social security.

[117] Marion Kohler, Ellis Connolly and Kylie Smith (2004) The Composition and Distribution of Household Assets and Liabilities: Evidence from the 2002 HILDA Survey, Reserve bank of Australia Bulletin

Box 20[118]

I recommend that the Commission study the UK pension dashboard[119] as a potential prototype that would provide members with a single source for all the information that they require for a holistic financial plan. My view is that could be extended to include all financial assets, demographic and household status and income. This information is already available from different sources in MyGov (mainly in ATO databases). If this data was made available to members in a standard format, it would greatly facilitate the provision of financial advice:

- Personal financial advice is made considerably more difficult and more expensive by the need for a complex "fact find", most of which can be readily automated. If a member could access all their information though MyGov, it could be easily provided to the financial planner in one file.
- It would also encourage and facilitate the provision of robo-advice.

I note that there are a number of times in the life-cycle, other than 55, where there is a need for additional advice:

- Starting full-time work when it is helpful to consider saving for a deposit on a home. The ATO could provide a notice about the availability of the MyGov data when taxable income first exceeds a particular threshold
- Marriage and children, when cash flows become strained and saving can be reduced. Medicare is informed of the change in household composition and could provide the notice.
- Divorce and children leaving home also create the need for revising spending and saving habits and again Medicare has the necessary information to provide the notice.

5.4 Insurance

The RC (CS[365]) has already identified instances of insurance premiums to related parties being above average. The failure to ensure competitive premiums is likely to be relatively widespread in the industry, and can readily be interpreted as misconduct as suggested by CS[399]. Box 21 raises another issue that the RC might consider.

Box 21[120]

The government's changes[121] could save 5 million members up to A$3 billion of unnecessary insurance premiums. But this is an exaggeration as much of the insurance is useful and will not be cancelled.

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118 Taken from https://www.pc.gov.au/__data/assets/pdf_file/0003/230097/subdr151-superannuation-assessment.pdf

119 https://www.plsa.co.uk/Policy-and-Research/Defined-Contribution/The-pensions-dashboard

120 https://theconversation.com/changes-to-superannuation-insurance-wont-jack-up-rates-but-if-anything-they-dont-go-far-enough-96414

121 http://kmo.ministers.treasury.gov.au/media-release/050-2018/

If there is a large reduction in premiums, it may come from the 6 million accounts where members have lost contact. It is possible that many members or their families are not claiming these insurance policies. If so, premiums for those of us who are aware of our benefits will rise, although certainly not by 30%. If this number is significant it would be unconscionable and would be another matter for the Financial Services Royal Commission.

5.5 Investments

Explicit investment charges probably exceed $10bn, exceeding administration costs by a growing margin.[122] As the charges are expressed as a percentage of assets rather than an annual charge, they compound significantly over a lifetime. I calculate that 0.5% pa of assets is equivalent to 15% of lifetime superannuation savings, which I do think is material.

Also unlike administration services, investment management is extremely difficult to evaluate; institutional investment has been described as a "world characterised at best by trustee competence and at worst by amateurish confusion."[123] As Warren Buffet, the world's wealthiest investor, puts it:

> *The commission of the investment sins listed above is not limited to "the little guy." Huge institutional investors, viewed as a group, have long underperformed the unsophisticated index-fund investor who simply sits tight for decades. A major reason has been fees: Many institutions pay substantial sums to consultants who, in turn, recommend high-fee managers. And that is a fool's game.*[124]

This is not to say that investment management is not worthwhile, but that as the outcomes are so uncertain and difficult to explain, and the opportunities for overcharging and over-servicing are so high, particular efforts need to be taken to ensure that the funds are well spent. My suggestions for where trustees should require more information are included in the appendix.

There is reference there to an academic paper[125] that finds that investment banking is not overpriced, but this suffers from the ubiquity of rent seeking in finance. Insiders know differently, and many are unhappy:

> *In investment banking, I have been both adviser and been advised, and, more than anything else, the one thing I detested was the fee structure in M&A transactions. It*

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[122] The problem is that they are not all reported to APRA, and the Productivity Commission report (Note 100) makes inconsistent allowances. Rice Warner's estimates (http://fsi.gov.au/files/2014/12/Superannuation-fees.pdf) are probably more realistic but are out of date. Average charges seem quite likely to be over 50bp.

[123] Clark, G. 2008. Pension fund governance: Expertise and organization form. In (ed.) Evans J., Orszag M. and Piggott J.. *Pension fund governance: A global perspective on financial regulation*. Massachusetts: Edward Elgar Publishing.

[124] Warren Buffett (2014) "To the Shareholders of Berkshire Hathaway Inc" http://www.berkshirehathaway.com/letters/2014ltr.pdf

[125] See note133

was typical to award, to the advisory firm, a fee being a percentage of the value of the transaction only if successful. In an auction situation, the advisory firm could win millions by encouraging the client into paying more to win the asset, but it won zero if the client bid no more than true value and lost to a higher bidder. The fee structure created an Olympian hurdle for integrity in the banker's mental cabinet to leap over.[126]

Much of my recent research has been in life annuities, where there is an academic puzzle as to they are not more popular. I have increasingly been persuaded that the incentives in the structure of the financial sector are so focussed on liquidity that it fails to provide financial security to retirees, and moreover exposes the entire economy to periodic liquidity crises. It seems to me that the structure would be changed if trustees had sufficient independence to be more innovative in addressing their responsibilities. Box 22 gives a brief summary.

Box 22[127]

The ongoing problems of the financial sector must surely make us ask whether it is fit for purpose? Or, at least, how well is it fulfilling its functions[128] of allocating capital and managing risks?

We need appropriate pipes to ensure the cash generated by long-term assets flows through to fund pensioners. What we have instead is a flood of liquidity, which regularly buffets not only the financial sector but the entire economy.

The impetus to fund both long-term projects and life-long pensions must ultimately come from superannuation fund trustees. They appoint those who select assets and must set up the systems to ensure the cash flows are paid to pensioners.

To do this, they must first free themselves from the paradigm that liquidity is paramount. They then need to employ people and consultants whose loyalty is to the members and not the investment markets.

[126] Vinay Kolhatkar 'The spirit of the game applies to business, too' *Cuffelinks,* 25 January 2018. https://cuffelinks.com.au/spirit-game-applies-business/

[127] https://theconversation.com/superannuation-trustees-should-find-long-term-assets-for-their-pensioners-101370, which is in turn based on Asher, A and E Rajadurai (2018) Investing Superannuation for the Public Good: Creating new markets to benefit members & fund necessary investments, The McKell Institute. https://mckellinstitute.org.au/app/uploads/FINAL_Superannuation_2018_WEB.pdf

[128] https://www researchgate net/profile/Zvi_Bodie/publication/228224831_A_Conceptual_Framework_for_Analyzing_the_Financial_Environment/links/0deec51a38bb1ce588000000/A-Conceptual-Framework-for-Analyzing-the-Financial-Environment.pdf

They will have to set up structures to be able to evaluate the soundness of new projects, and secondary markets to allow for trading as necessary. Government and regulators will have to permit funds to collaborate in this process.

Trustees will also need to take the lead and give members access to annuity products, and disinterested and expert advice as to when these are suitable.

Question 825. 24 – System changes

There is evidence that investment turnover can create particularly poor investment performance.[129] Given this, and the uncertainty of investment outcomes, any focus on investment outcomes would be inappropriate especially if it encouraged trustees or members to switch to assets that had recently performed well and were therefore likely to be overpriced.

A focus on the total investment costs however might well pay dividends. The RC has identified an issue (CS [131, 132, 154] where it can be argued that an inadequate amount was allocated to investment charges, which goes to suggest that a cap should not be imposed. However, it is important that trustees should apply their minds very carefully to monitoring investment returns and ensuring that they are obtaining value. As part of this process, funds should develop internal investment management expertise. One of the key findings of the Canadian experience is that internal staff can be as good and cost significantly less.[130] For smaller funds, it should be possible to collaborate to create a shared internal capacity.

It is unlikely that trustees will have the capacity do make these decisions unless they are freed from conflicts of interest (see section 4.1), made more accountable to members (section 4.2), and encouraged by APRA to obtain the necessary reports as part of their normal governance procedures.

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[129] The most persuasive and colourful evidence can be found in Barber, B.M. and Odean, T., 2001. Boys will be boys: Gender, overconfidence, and common stock investment. *The quarterly journal of economics*, *116*(1), pp.261-292.

[130] This is one of the keys to success mentioned in World Bank Group (2017) The Evolution of the Canadian It is suggested that the role of

CS [813] : "It is submitted that one of the critical functions of a conduct regulator is to take strategic action that will specifically deter the targeted entity from engaging in misconduct and generally deter other entities from engaging in misconduct"

Pension Model Practical Lessons for Building World-class Pension Organizations

Appendix: Financial Condition Report[131]

It seems to me that the wider responsibilities of the trustees to consider all the financial interests of the beneficiaries would be well served if they were to be provided with a regular FCR. Such a report could address all elements of the wider scope that I believe is envisaged in the concept of "retirement incomes standards" in the APRA Act. This section sets out a potential scope for such a report, which would incorporate the risk management framework included in the discussion paper.

A FCR would provide an independent review of whether the Trustee had fulfilled its duty of care to:

- Financial soundness and the management of risks
- Optimise financial performance
- Make allocation decisions fairly
- Providing appropriate member products and services

An FCR would normally be produced by an actuary, or someone else with appropriate skills and experience, who would need to be given powers to obtain information from the administrators, investors and insurers of the fund. The complier of the FCR might well need to access other professional expertise to ensure that he or she has an adequate view of the financial consequences of elements of the funds operation.

1 Financial soundness

Most Australian superannuation funds are designed not to take financial risks, but they cannot be entirely avoided (and are identified in the discussion paper):

- Investment risk may be present in residual DB promises – and if fund marketing material creates benefit expectations of any investment guarantees – possibly related to exotic (or merely risky) investment options
- Insurance risk comes from residual self-insurance and risks arising from the solvency of insurers, especially in pandemic scenarios
- Operational risk from unit pricing errors or other inadequacies, benefit payments, and other administrative functions whether managed in-house or outsourced – combined possible with inadequate insurance
- Strategic & business risks from loss of membership leading to subscale operations or excessive expenditure on unsuccessful expansion
- Regulatory and political risks from compliance failures or sudden changes that cannot be met timeously
- Liquidity risk arises from unlisted assets, and listed assets with limited turnover. I would suggest that member choice requires that all assets be made liquid so that they can be sold on an exchange or at least distributed in specie if necessary.

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[131] Taken from my unpublished submission to APRA on Prudential Standards for Superannuation, 23 December 2011.

This section of the FCR would provide the monitoring of the trustee's risk management framework and business plan, and provide evidence to APRA that the fund was adequately resourced as will be required by the new standards.

2 Financial performance

Given that risks to a DC fund are minimised, members are often more concerned about their value for money from the fund than its financial soundness. To fulfil their duty of care, the trustee needs to ensure that it is monitoring this adequately. This would include:

- **Relative investment returns.** Ultimately performance should be measured relative to the benchmarks that have been set in fund PDSs. This relative performance should also be compared with similar funds.
- **Investment performance attribution.** Investment returns are subject to significant random fluctuations, and the components of the returns should be monitored to ensure that they meet expectations (and inexplicably poor returns from some investments have been swamped by randomly good returns from others).
- **Stewardship of power to vote at AGM's.** Compulsory voting is required by the USA's ERISA legislation governing retirement funds on the grounds that the votes represent an asset of the fund. The fund ought to have processes in place to ensure this.
- **Stock lending.** Trustees need to fully understand and monitor the risks in stock lending. My experience is that they do not. The main risk faced is that of the bear squeeze, which is not uncommon in falling markets particularly.
- **Relative expenses.** Investment management, insurance premiums and administrative expenses should be monitored for reasonability and competitiveness. Investment and insurance brokerage and other costs that may be subject to conflicts of interest need particularly careful monitoring.

An FCR would review other reports received by the trustees on financial performance, and comment on whether the reports met best practice standards. This section needs to go further than that envisaged in section 8.4.2 of the discussion paper. Trustees are not sufficiently aware of the ways in which they are overpaying for investment services.

- Stockbroker charges vary considerably; I have been told that they add another 50% to the charges of investment managers – on average, and it is not clear that they always add value of money, particularly as they are generally not reported to the trustees. [132]
- There are risks that funds are not given fair prices for shares, various hedging contacts and currency deals. Again trustees seldom get reports on prices they are paying relatively to the value weighted average price (VWAP) of the day. There is little local evidence, but it can be noted that BNY Mellon is currently facing charges in the USA

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[132] See Schwartz, R.A. & Steil, B. (2002) Controlling Institutional Trading Costs, *Journal of Portfolio Management* 28.4 39-49 and Glass, S. & Wagner, W. (1998) The Dynamics of Trading and Directed Brokerage, *Journal of Pension Plan Investing 2:* 53-72, available at: http://zenocg.com/pdf/DynamicsOfTrading.pdf

of having defrauded its pension fund clients of $2bn in currency charges over the last decade.[133]
- It is widely held that investment banks overcharge for IPO and other services. While Howa and Yeo[134] found no evidence of mispricing in the nineties in Australia, this needs ongoing monitoring.

3 Allocation of costs and benefits

There are limited "cross subsidies" in DC funds, but members (and regulators) expect none at all. Trustees therefore need to particularly careful in exercising and monitoring their discretions where cross subsidies might be seen to occur. They need to maintain documented reasons for their decisions.

- **Expense charges** can be allocated by member, by service provided or in proportion to account balances.
- **Insurance premiums** can be differentiated by age, sex, occupation, income level, habits or state of health.
- **Tax** can be allocated accurately or using approximate formulae. The allocation of deferred tax assets particularly requires judgement as to their recoverability. Another issue is the allocation of imputation credits – particularly to pensioners.
- **Unlisted assets** require a subjective valuation that affects transacting members
- **Unit prices** can be based on stale prices, subjective valuations or approximations. It should be noted that audit requirements do not currently extend to the audit of the prices used by funds in spite of their importance.

An FCR would review the documentation of these decisions, and report whether the reasons for making allocation decisions remained valid – and that processes for making decisions are being appropriately monitored.

4 Member services and products are appropriate

Some of the greatest damage to financial institutions has come from a failure to give reasonable value or meet real client needs. The mis-selling scandals in the UK cost the industry billions provide ongoing examples. These issues might be classified as business risks, but also incorporate questions relating to performance and allocations of expenses

- **Investment options.** These, particularly those involving additional risks such as gearing or inadequate diversification, are covered by section 8.4 of the discussion paper.
- **Information for exercise of choice.** As options proliferate, the information on each is at risk of becoming perfunctory.

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[133] http://www.boston.com/Boston/businessupdates/2011/11/bank-new-york-mellon-ceo-defends-company-against-foreign-exchange-suits/UN3zNtY9O4ttfWBna3axvI/index.html

[134] Janice C.Y. Howa & Julian J.L. Yeo (2000) The pricing of underwriting services in the Australian capital market, *Pacific-Basin Finance Journal* 3-4: 347-373

- **Life, disability & longevity insurance**. Insurance covers should be "MECE" – mutually exclusive and comprehensively exhaustive. In many cases, members are covered more than once for some adverse events (particularly accidents and some traumatic diseases) but not at all for others (particularly temporary and partial disability). Often they do not know what they are covered for. Progress has been made in recent years in improving the situation.
- **Intra fund advice**. Members should be given illustrations as to the range of income that they might get from their funds. Trustees have been caught between expectations of members that they be given useful advice, and ASIC and other legal rules that mean that advice may be misunderstood or lead to claims for losses. Regular review is therefore important.
- **Rights and expectations of dependents.** Decisions to allocate benefits to dependents frequently have to be made in the face of insufficient information, which may later invalidate the decision. The process needs ongoing reviews

An FCR would review the products and services offered, and report whether they remained fit for purpose.

Overall, I believe that there is sufficient evidence in practice and in the literature to suggest that trustees do not adequately monitor performance, expenses or the appropriateness of benefits. This arises partly from their inexperience and partly from institutional inertia that makes innovation in this area difficult: service providers resist monitoring in a variety of ways. APRA's new powers allow it to ensure that trustees are empowered to obtain a more complete picture of their stewardship of members' financial interests.