Superannuation
Productivity Commission
Locked Bag 2, Collins Street East
Melbourne Vic 8003

RE: Response to the Productivity Commission's Draft Report – How to Assess the Competitiveness and Efficiency of the Superannuation System

Dear Commissioners,

The Australian Centre for Financial Studies (ACFS) welcomes the opportunity to make a submission in response to the Productivity Commission's Draft Report, *How to Assess the Competitiveness and Efficiency of the Superannuation System*.

ACFS is an independent research centre of Monash Business School, which draws on expertise from academia, industry and government to promote thought leadership in the financial sector. We produce a wide range of industry-relevant financial and economic research, including the *Melbourne Mercer Pension Index* – which compares the pension systems of 27 countries – and the *CSIRO-Monash Superannuation Research Cluster* – a multi-year research collaboration between the CSIRO, universities in Australia and the UK, industry stakeholders, and government organisations, which examines issues pertaining to the future of Australia's superannuation and retirement systems.

This submission takes the form of a short brief which highlights key conceptual and practical shortcomings in the Commission's approach to assessing the superannuation system.

Should you wish to discuss the submission further, please do not hesitate to contact me at (03) 9666 1050.

Sincerely,

Rod Maddock

Professor Rodney Maddock
Executive Director

FINANCIAL POLICY BRIEF

Response to the Productivity Commission Draft Report: How to Assess the Competitiveness and Efficiency of the Superannuation System

FPB 2016 – 02: 07 September, 2016

The Productivity Commission (PC) released it draft Report on *How to Assess the Competitiveness and Efficiency of the Superannuation* in August 2016. It is a huge report of over some 300 pages and ambitious in its aspiration.

A. Conceptual problems

Despite the ambition, it is not always clear that the PC had got the underlying logic right.

Objectives of the system

The first problem concerns the objective of the system.

The Report starts out by explaining the Government's objective for the system as being to "to provide income in retirement to substitute or supplement the Age Pension" (p57). There is now little argument around the industry that this is a reasonable objective for the Government to set. The Commission then proposes implementing this by reviewing whether: "The superannuation system maximises net returns on member contributions and balances over the long term".

While this sounds sensible it ignores the fact that investment is (almost) inevitably risky, so that maximizing net returns amounts to maximizing the expected value of returns. Around that mean value there is inevitably a distribution of other outcomes which could well occur.

With investment, of course, we all understand that higher returns come with higher risks. By setting the standard as being to maximize the average return, the PC runs the risk of increasing the spread of outcomes which might occur. What that means is that more people might have poor returns, and finish up on the Age Pension.

In statistical terms, the Government wants to have few people in the left-hand tail of the distribution of returns. By contrast the Commission is trying to establish a system which has the highest possible mean. These are very different objectives. The PC's implementation will increase the variance of returns and the risk of more people having to rely on the Age Pension than is really necessary.

Misuse of the concept of allocative efficiency

The second major problem with the PC's approach to what is called allocative efficiency – broadly whether resources in the economy finish up in their best uses.

The problem is that superannuation is compulsory: we are forced to save even if we do not want to. As a result you and I cannot really signal our desires and preferences, and so there are no signals to the market as to what to produce. We have some limited choice, but there is no sense in which the flow of funds reflects our real views.

The PC could get around this problem. It could have a narrower view of allocative efficiency, taking the compulsion for granted, not worrying about whether we make good choices in selecting options, and then ask whether the superannuation funds make good decisions once they have the money.

This would allow it to ask whether the superannuation system as a whole directs money to its best uses. There is some sense in the community that more money should flow into infrastructure, into small businesses, and start-ups. The important question that needs to be asked is whether the structure of the superannuation system is part of the reason that money does not seem to be allocated optimally.

For example, most of the investment options shown to us by our super funds have a large allocation to listed equities. Funds also allocate a large part of our savings offshore. The PC might well inquire about whether the way these choices are constructed results in money failing to flow to its most productive use.

Confusion about insurance

The third issue the PC shies away from is that of insurance.

If the objective of the superannuation system is to provide income in retirement, the case for diverting some of our savings to pay for insurance is pretty weak. Yes, insurance may provide income to some people in particular circumstances but it absolutely certainly detracts from the ability of the system to reach the goal of keeping people off the Age Pension. In that it works directly against the Government's stated objective.

Life insurance is even more problematic. The Australian superannuation system is based on a model of individual accounts. The idea that I should pay for life insurance from my retirement savings to provide a benefit to somebody else, somebody who has her/his own individual retirement account, is particularly odd.

Irrelevance of macro-prudential discussion

The paper sets out various areas of focus. One is to ensure "the superannuation system complements a stable financial system and does not impeded long-term improvements in efficiency" (p70).

It is also odd that the Commission wants to address the issue of macro-prudential supervision at all. APRA already has responsibility for macroprudence, shared to some extent with the Council of Financial Regulators, and has oversight of most of the superannuation sector. It is the competent authority. There is no need to the PC to address the issue at all.

B. Practical problems

Treatment of retirement income

The Government's stated objective for the system relates to income. The PC's implementation as maximizing expected return can be a good approximation for potential income during the accumulation but makes little sense during retirement phase.

The PC should develop a view as to an optimal consumption path in retirement and review its interaction with the Age Pension. The focus should be clearly on income at all stages, and the adequacy of income in retirement as the fundamental goal.

Assumptions about data availability

Productive efficiency, possibly measured by data envelopment analysis, must make a clear distinction between inputs and outputs. It is not clear that the available data allows this.

The PC needs to look thorough the full process by which products are delivered to retail customers, through wraps and master platforms, and through other means by which inputs such as research are paid for indirectly and obscurely through trading, in order to assess productively efficiency.

It seems likely that some of the apparent difference in returns between retail and industry funds is caused by some inputs being charged against the return by the retail funds, rather than measured as an input.

These data are not easily available and are essential if a fair comparison of productive efficiency is to be made. It seems likely that the PC will have to generate new data sets to do this and not rely on information currently generated.

Lack of clarity about what to measure

The industry is designed to produce income in retirement. This makes the specification of the production function quite complex: outcomes are probabilistic, multifaceted and targeted at different points in time.

The methods outlined in the paper seem likely to require bundling of quite different products together, especially products with different risk characteristics or products for which investors have expressed a clear preference. Ethical funds might be an example. The need to impose additional screens on an ethical investment decision, means that an investor who opts for an ethical fund will almost certainly incur greater costs, and lower returns as a consequence. Here the investor has chosen to take lower returns but the methodologies discussed in the paper do not appear to be clear about such non-income -maximizing choices.

The paper also discusses the idea of measuring annual returns as an indicator of output. This seems confused: annual returns constitute an input to the generation of retirement income and not an output.

Inadequate treatment of risk

It is not clear that the PC has thought sufficiently about the treatment of risk. All superannuation products, as long term investments, have elements of risk embedded in their structure. Some of this is simply return volatility, but market risk, sequencing risk, longevity risk and so on do not seem to be adequately addressed.

The idea of using 20 year runs of data to capture the risk implicitly in various portfolio-types, is not adequate. The last twenty years have been very unusual, particularly because of the long run-down in inflations. This historical episode has advantaged particular types of asset allocations over other. Equally, the currency experiences over the next twenty years seems very unlikely to track what has happened in the last decade, and against this event has favoured particular types of allocations.

This problems shows up when the PC proposes questions such as "Are net investment returns being maximised over the long term, taking account of services features provided to members?" A more appropriate formulation would be "Are returns being maximised for the levels of risk being taken"? Products which provide greater certainty will inevitably produce lower returns: they are designed to do so. It is important to compare like for like and risk is fundamental to this judgement.

Use of idiosyncratic criteria

The PC proposes implementing the competition objective through five system properties:

1. The market structures should facilitate rivalrous behaviour
2. Rivalry should take place across dimensions of value to investors
3. The system should maximise net returns to investors over the long term
4. The system should provide appropriate insurance at least cost
5. The system should complement overall financial stability.

Number three is poorly worded at best. There are thee problems:

i. It fails to recognise the probabilistic nature of investment. There is no way in which providers can maximise net returns except by luck. At least this should be changed to "the system should target a high level of expected net returns consistent with prudent management of downside risks".
ii. This however still fails to capture the draw-down phase of superannuation.
iii. The objective should be to maximise expected returns during the draw-down phase, not "over the long term".

Taking the provision of insurance within super as a given (but noting that his is inconsistent with the Government's stated objective for the system – see above), it is not clear that the 'least cost' approach is appropriate. It is very possible that tendering for insurance on a least cost approach will lead to the bidder with the lowest price winning the tender, but this being an entity which underestimates the risks (winner's curse). This is especially a risk when bidding for a pool of investors whose individual characteristics are unknown.

Point four should read "The system should provide appropriate insurance at a cost reflective of the risks involved".

The idea that the system should "complement overall financial stability" overstates the objective. At most the superannuation system should not undermine systemic stability. There are lots of other tools available to establish systemic stability and to also charge the superannuation system with it is duplicative and unnecessary.

It also almost certainly cuts against the legal obligations of trustees. Their duty is to the people whose money they hold in trust.

Question of fee structures

There paper seems not to address the issue of fee structures. One of the important reasons why we may not be seeing the economies of scale we might have expected is the prevalence of proportional changing structures.

It may be appropriate to ban certain fee structures, structures which impede Australians getting the benefit of the very large scale towards which the Australian system is growing.

Rivalrous behaviour

It is not clear that the criteria the PC intends to sue to asses rivalry is adequate.

Rivalrous behaviour involves businesses seeing each other's behaviour and responding to it. It is essentially a dynamic process of action and reaction, and particularly conscious and deliberate reactions.

The issue requires an event study of some sort, for example: how have for-profit funds responded to the reporting of better returns by the not-for-profit sector; or how have all funds responded to the rapid growth of the SMSF sector? How do funds respond when one of the major entities introduces a new product line, for example an age-sensitive allocation?

Non-commercial focus

The Commission asks "Are member preferences and needs being met by the system providing high-quality information and financial advice to members to help them make decisions?"

The problem is that it is very expensive to provide high quality, individual, financial advice: every person's circumstances are different (income trajectory, consumption patterns, health situation, relationships, tax position, holding of other assets and so on). The request for high quality advice is unlikely to be reasonable for most people.

The more appropriate request is that:

- funds provide the information to investors that someone would need to complete a financial plan; and
- in designing products, funds meet the 'reasonable man' test.

This Financial Policy Brief was prepared by Professor Rodney Maddock, Executive Director of the Australian Centre for Financial Studies.

ACFS Financial Policy Briefs (previously called Financial Regulation Discussion Papers) provide independent analysis and commentary on current issues in financial regulation with the objective of promoting constructive dialogue among academics, industry practitioners, policymakers and regulators and contributing to excellence in Australian financial system regulation.

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About the Australian Centre for Financial Studies

The Australian Centre for Financial Studies (ACFS) is a part of Monash Business School. It aims to facilitate industry-relevant, rigorous research and independent commentary, drawing on expertise from academia, industry and government to promote thought leadership in the financial sector. Together, ACFS and Monash Business School aim to boost the global credentials of Australia's finance industry, bridging the gap between research and industry and supporting Melbourne as an international centre for finance practice, research and education.

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