The Chairman
Financial System Inquiry
PO Box 89
Sydney NSW 2001

Over the last 35 years the Australian Financial System has experienced first, an extended period of deregulation, following the Report of the Campbell Committee in 1981, followed by an extended period of re-regulation following the Wallis Inquiry. This submission focuses on a number of excesses and errors in this re-regulation, specifically related to superannuation, that pose significant threats to the effectiveness of operation of the financial system.

I address these issues in two Parts, related first to the investment components of the MySuper product, and secondly to the reporting standards related to investment fees of superannuation funds.

Part I - MySuper

"*MySuper is a new, simple and cost-effective superannuation product that will replace existing default products. MySuper products will have a simple set of product features, irrespective of who provides them. This will enable members, employers and market analysts to compare funds more easily based on a few key differences. It will also ensure members do not pay for any unnecessary 'bells and whistles' they do not need or use.*"

My Super Information Pack
http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/information_pack/mysuper.htm

The MySuper concept is mainly good, and incorporates a number of useful and beneficial ideas. An underlying premise of MySuper, as implicit in a number of components of the enabling Legislation (Superannuation Industry (Supervision) Act 1993) is that active management of superannuation investments (i.e. the use of manager skill) does not, on average, give a beneficial risk / return over returns from taking market-based risks. This is particularly reflected in parts of Sections 29V (Fees that may be charged in relation to a MySuper product), 29VD

(Performance-based fees) and 29VN (Additional obligations of a trustee in relation to a MySuper product).

My primary contention in this submission is that this assumption is, at best, unfounded and, based on the available evidence, is in fact incorrect. (The analysis supporting this contention is set out in the accompanying Appendix. This analysis is commercial and provided to the Committee on a ***confidential basis***.)

The principal results from this analysis, as they relate to superannuation investment returns and risks are:

1. **The Australian Superannuation Industry has successfully identified and employed active investment management skills;**
2. **As a result net investment returns have been increased while overall investment risk has been decreased ; and**
3. **There appears to be no material relationship between superannuation fund size (scale) and investment returns.**

In the context of the philosophy of financial system regulation, it appears that the members of the 2010 Superannuation System Review (the Cooper Review) have, I suspect by accident, imposed a structural rigidity on the Australian Financial System, in MySuper that is analogous to the 30/20 Rule that existed prior to the Campbell Committee Inquiry.

By legislation, regulation and suasion, it is well understood within the superannuation industry that the reduction of fees, including investment related fees, is seen as a major positive outcome of the MySuper and Stronger Super strategies. Specifically in sections 6.11 of Part 1 of the Cooper Review it is stated that:

"For a variety of reasons, fees currently paid by super fund members cover a wide range across the different fund types and sectors. However, nearly all default fund members are today paying more than the 0.66 per cent total fees projected by Deloitte for the highest cost investment option in a $20B MySuper product, with

some members paying more than twice this amount. ***This estimated saving would represent a significant boost to retirement savings****."* (Emphasis added)

Further, section 6.12 discusses the likelihood of a lowering of investment returns as a result of a lowering of investment fees through a move from more active to passive strategies. The Report states that, *"There is no justification for the assertion that MySuper would prevent trustees and fund managers from pursuing certain types of investment strategies that they might otherwise consider".* Unfortunately, the interplay of the investment conditions imposed under MySuper, "*sharper duties on trustees*" (section 6.11), and weaknesses in reporting methodology, has seen superannuation fund trustees, for logical reasons, follow exactly this path, with a significant reduction across the industry of the use of manager skill. I believe that Section 29VN of the Legislation is particularly germane to these decisions.

By my estimates, **the opportunity cost of reduced investment return is likely to be in the order of double the benefit achieved through reduced investment fees.** Unfortunately, as is usually the case, the "benefits" of reduced fees are measured, whereas the costs of lower returns are not. As a result principal-agency issues are created for superannuation fund trustees between member and personal interests.

A further structural effect of a shift to a more passive approach to investment by superannuation funds is likely to be an overall reduction in the level of innovation and dynamism in the Australian Financial System. I believe that the current level of legislation and regulation of the Australian Financial System is akin to that applying prior to the release of the Campbell Committee Report in 1981. Thus, while I recognize that each piece of regulation that has been introduced over the last 15 years has individual purpose, the cumulative effect is rapidly creating a stasis within the System that is analogous to that experienced during the 1970's. **This would be detrimental to the efficient operation of the Financial System and allocation of capital.**

Part II – Measurement and Reporting of Investment Fees

A further recommendation of the Cooper Review was for the introduction of changes to the measurement and reporting of fees in superannuation funds, including investment fees. While I again commend and support this initiative, unfortunately the definition of 'Investment Fees' as proposed by the Review and implemented by APRA is flawed, and as a result may create significant agency issues and conflicts of interest for superannuation fund trustees.

The key source of error is that 'Investment Fees' as currently defined includes investment management fees (both base and performance) paid to investment managers that are unrelated to the Superannuation Fund Trustee. (See Section 29V(3) of the Act and APRA Reporting Standard SRS 540.0.)

The effect of this definition is that when comparing superannuation funds a member is unable to distinguish between investment fees paid to the Trustee (RSE Licence holder) or its associates, and investment fees paid to independent investment managers. Investment fees that are paid to independent investment managers should best be reflected in net investment returns and not counted as a fee.

There is no benefit to fund members in including these fees in the measure of investment fees, as the decision by the Trustee to invest with that manager should be based solely on expected **net** return and risk. 'Double counting' these costs by including them in investment fees creates an unnecessary **disincentive to alter the fund's investments** to include managers with lower fees, and presumably less management skill.

On the other hand, it would make sense for **any payment or benefit** received by the Trustee and its associates to be fully disclosed to investors, even where these payments were for investment purposes. This is a basic requirement for the maintenance of proper principal-agent relationships.

I believe that the current process of including fees paid to independent investment managers in “Investment Fees” creates:

1. A disincentive to allocate funds to active managers who would be expected to produce a higher net return and lower investment risk for the members; and
2. As a result of this disincentive, an over allocation of funds to Trustees’ in-house or related investment managers resulting in the potential misalignment of Principal and Agency interests. (Given my personal experience as an independent member of Compliance Committees, I believe that this more likely to be a potential issue rather than an actual concern.)

Thank you for the opportunity to contribute to the Committee’s deliberations.

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31 March 2014