Executive Summary

The overriding consideration for the Financial System Inquiry should be to increase the allocative efficiency of the financial system.

Superannuation provides the greatest potential for reforms to improve allocative efficiencies because of its size and its uncompetitive state. MySuper indirectly promotes more passively-managed funds, which could undermine the price discovery function of the listed market. The introduction of a government-designed actively-managed MySuper product. To ensure the fund manager's incentives are aligned with those of members, such active funds should adopt a fulcrum fee model in which the manager is penalised if it underperforms an index and rewarded if it beats the index. Banning investment managers would remove an extra layer of agency costs, improving both the operational and allocative efficiency of the sector.

The rise of institutional investors has implications for corporate governance practice that may also undermine allocative efficiency. Institutional investors are less likely to engage in AGMs or other means of holding the board to account. The prevalence of short-term investment horizons by these institutional investors is biasing real investment decisions away from long-term growth. Providing tax concessions for longer-term investments by corporations and transitioning to annual reporting of fund returns will encourage funds to take longer-term investment horizons.

Disclosure can be improved to overcome the behavioural biases that have made it ineffective, if disclosure policy is used to frame the choice architecture for consumers and to strengthen reputational effects.

If direct product regulation replaces disclosure as the touchstone of consumer protection, consumers will cease to be matched to the most suitable product for their needs with severe implications for allocative efficiency. The nature of the financial system is that consumers have divergent preferences as to risk, investment horizon, and other features that direct product regulation cannot reconcile. Furthermore, direct product regulation and product intervention powers for ASIC, are inappropriate for regulating credence goods. Theoretical and empirical research suggest that it could perversely increase misconduct by financial services firms.

The Financial System Inquiry's primary goal should be increasing the allocative efficiency of the financial system

The Financial System Inquiry offers a rare opportunity to examine the allocative efficiency of the financial system. Allocative efficiency is the hidden efficiency, despite its greater importance, policy-makers are less likely to overtly consider a mooted policy's impact on allocative efficiency because of the difficulties observing or measuring that impact. Implicit in that view may be an assumption that the system works – that CLERP got the corporate governance system 'right', that the continuous disclosure framework is working if there haven't been any complaints. This once in a decade Inquiry permits policy-makers to interrogate this assumption.

This submission focuses on ways to further increase the allocative efficiency of the financial system through improvements to the regulation of the superannuation sector, corporate governance, and capital markets. It suggests reforms that would improve the allocative efficiency of the economy without strong trade-offs against other policy goals such as improving retirement incomes or technical efficiency.

Introducing an actively managed default superannuation product would improve allocative efficiency without compromising retirement incomes

The significant agency costs imposed by the compulsory nature of superannuation can be reduced by realigning the incentives of agents with members and the broader community through smart regulation.

More recent superannuation policy uses legal compulsion to force trustees to act in ways considered desirable by policymakers. The legal compulsion approach is reaching its limits, given the noted ability of the finance sector to slip through regulatory safety nets and exploit any loophole. The best interests duty and fiduciary duties placed on superannuation trustees have failed to reduce superannuation fees or to adapt products for superannuants entering the drawdown phase. Existing approaches, such as MySuper, should be supplemented by incentive-based regulation to improve the allocative efficiency of the financial system.

MySuper has the potential to improve the operational efficiency of superannuation by reducing fees whilst maintaining average fund returns. However, by indirectly promoting passive investment strategies by superannuation funds, it could reduce the allocative efficiency of the broader financial system.

It would undermine the price discovery function of the market in the short term and create stability issues in the long term for superannuation funds, which hold around 40% of the ASX by market capitalisation, to stop actively searching for undervalued companies. If an asset were to become over-priced, it would form a larger portion of the index and index-hugging funds would proportionately invest more in that asset. As such, passive funds would become the marginal investors swamping the effect of value investors selling out of the stock. On the other hand, value investors would become the marginal investors in under-priced stocks until it became fairly valued. This creates an imbalance, creating a tendency towards asset bubbles over the longer term.

The introduction of an active management MySuper default product would address these concerns. Younger superannuants and others with higher risk appetites could be defaulted into this product. To realign the incentives of the trustee with those of the members, the portion of the assets invested in riskier assets should be managed on a fulcrum fee basis.[1]

Under such a fee structure, the trustee would be paid on a fixed fee basis for assets allocated to lower risk, passive investments. The expected return of these passive investments should be sufficient to fund the superannuant's minimum acceptable level of consumption over the course of their retirement. Superannuants should provide information about their retirement consumption preferences to their fund to enable this amount to be calculated. The remainder of the portfolio should be allocated to a regulated actively managed fund. The trustee should be paid a performance fee which is symmetrical about the best passively-managed benchmark portfolio. This ensures that any active management is genuinely directed at obtaining higher returns for members rather than earning higher fees. The ability to charge other kinds of fees should be tightly circumscribed. For example, transaction costs should be borne by the trustee to avoid churning of investments.

Outsourcing investment management adds another layer of agency costs

The Treasury argues that the superannuation sector is broadly conducive to the efficient allocation of investment, primarily because superannuation trustees allocate funds within a highly contested investment market.[2] It argues that, in the absence of evidence of barriers to efficient allocation, it should be assumed that the sector is efficient.

This argument is difficult to reconcile with Treasury's argument that there is scope to improve the technical or operational efficiency of the sector. If the disengagement of superannuants is weakening

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1 Kingston, Geoffrey and Weng, Haijie, Agency Theory and Financial Planning Practice, Australian Economic Review, September 2014.

2 The Department of the Treasury, Submission to the Financial System Inquiry, page 50.

the competitive pressure on superannuation funds with respect to fees, it is difficult to argue there is sufficient competitive pressure on fund returns. And if there is no significant pressure on trustees to improve returns, there is no pressure from trustees for investment managers to improve returns.

Fiduciary duties do not compel a fund trustee to seek the best returns for members That is not how the law works. Fiduciary duties are negative duties to not profit from their position as a fiduciary and not to have a conflict of duty or interest.[3] There is no positive fiduciary duty to improve the investment returns of fund members. There is a duty to exercise the power of investment in the best interests of present and future members, but again, this is a negative duty.[4]

The courts have never found a superannuation trustee in breach of their obligations for having obtained a poor return for their members. Because a trustee's effort level is not readily observable, it is difficult for regulators to enforce the duty.

When under a negative duty not to harm the best interests of members, trustees have an incentive to stick with the pack because of the asymmetric returns for trustees. A trustee which undertook an innovative strategy to improve fund returns might face legal consequences if the fund underperformed but would have limited upside if it performed better than average.

Investment managers are a way for trustees to outsource responsibility to an external party and to stick with the pack. It is difficult to see the value that a trustee adds once the investment function is outsourced to investment managers. Yet the costs in terms of duplication and agency costs is readily apparent.

Restricting the use of investment managers would increase diversity of investment strategies amongst funds and increase competition. It would also encourage consolidation amongst smaller funds.

Short investment horizons are distorting real investment decisions

The nature of modern investment markets is such that most investors take a very short-term outlook on investments. The corporate governance framework relies upon sophisticated investors to scrutinise the long-term consequences of corporate strategies. Hyperbolic discounting of future returns distorts the price signalling function of the listed market, leading to underinvestment by companies and reducing the long-term growth potential of the economy. It also distorts corporate decision-making, so that resources are not allocated to their most productive function.

Focus on short-term returns can lead to companies engaging in excessively risky activities for short-term gains, particularly where investors believe they can exit an investment before risks eventuate. This undermines the stability of the broader economy and can worsen the impact on any economic downturns.

Whilst amending liquidity requirements for superannuation funds and removing dividend imputation will assist in lengthening investment horizons, it cannot overcome the market expectation that superannuation and managed funds consistently achieve high returns each quarter.

The issue would better be addressed by providing tax-advantages for long-term investors similar to the CGT discount provided to retail investors. Academic studies have also shown that quarterly investment return reporting also exacerbates short-termism. Moving to half-yearly or yearly reporting of investment returns would lengthen investment returns for both funds and members.

The Inquiry should also recommend that institutional investors be given more incentives to improve

3 *Hospital Products Ltd v United States Surgical Ltd* (1984) 156 CLR 41.

4 *Cowan v Scargill* [1985] Ch 270.

the corporate governance of listed companies. The corporate governance rules contained in the *Corporations Act 2001* and the ASX Listing Rules are intended only to form a baseline, relying on industry to develop and improve best practices. Market practice can only evolve where a significant portion of shareholders attempt to hold directors to account. Actively managed superannuation funds should be required to justify how they have attempted to increase shareholder value through holding directors to account.

Disclosure must remain the touchstone of consumer engagement – only it can fully solve the suitability problem

The Interim Report asked for views on whether disclosure could be improved or whether there should be direct regulation of financial product features. Whilst it is clear that disclosure cannot be the sole guardian of consumer interests, it must remain the touchstone of consumer engagement with financial products.

The proposed alternatives to disclosure cannot address the fundamental problem which disclosure is intended to solve. It cannot match consumers with those products best suited to their needs, except at a high level of generality. Direct product regulation has the potential to serve consumers' interests in a negative manner by protecting them against certain risks, but it cannot positively serve their interests by selecting the most suitable product or by developing products that better meet their needs. Disclosure is the most effective tool for empowering consumers to protect their own interests and maximise their own utility.

Whilst investor self-assessment tools have the potential to determine an investor's suitability for a particular product class, it cannot determine the best product for that investor. Designing such tools requires assumptions to be made about investor preferences that are too general to be applied to all consumers and cannot readily take into account personal circumstances.

Similarly, imposing positive obligations regarding suitability on product issuers can determine whether a product is unsuitable for a particular consumer, but it cannot determine whether the issuer's product is the most suitable compared to the universe of comparable products. Legal compulsion cannot force an issuer to act against its own interests to determine its product was less suitable for an investors than a competitor's product. Furthermore, it would dilute the consumer's responsibility for selecting the most suitable product, severely undermining the caveat emptor principle.

A new philosophy for disclosure can overcome behavioural biases and other barriers

Refreshing the philosophy behind disclosure can allow it to overcome the behavioural biases that have prevented its effectiveness to date. Under Wallis, there was an assumption that once private information was disclosed to the market and became public information, that this alone could overcome information asymmetries. Disclosure policy should instead be focussed upon creating a 'choice architecture' around investment choices.

Disclosure documents should frame choices for consumers. 'Just-in-time financial literacy' weaves important messages about how to make better decisions just as consumers are making those decisions. This can bypass persistent issues with financial illiteracy in the wider community that are unlikely to be addressed through adult financial literacy programs.

One simple application of 'just in time' messaging is for disclosure documents to tell consumers how to use the information disclosed. Consumers could be told that "smart consumers generally choose the lowest fee fund at their chosen level of risk, because they know research has shown that most fund managers cannot consistently obtain higher returns." Behavioural economics experts agree that the framing of the message is as important as the content of the message. This compares favourably to current day warnings which read more like liability waivers: "past returns are not indicative of future returns". Such warnings are unhelpful to consumers who might ask, "if returns aren't a reliable guide to future returns, why are you telling me about them?"

Simplifying and reducing the amount of information in disclosure documents can overcome the 'information overload' effect. Layering information, so that consumers receive relevant information as they require it, can significantly reduce the information required at any point in time. Through layering information, the government is shaping the choice architecture for consumers – dictating the stages of a consumer's decision-making lifecycle and what information is available to them at each stage.

Australia should also follow the international trend towards mandating shorter-form disclosure documents – even our short-form PDS for simple managed investment schemes are eight pages long. This is longer than equivalent overseas documents and certainly longer than the two to three pages that the average consumer will read.[5]

The search costs involved in sourcing and comparing each PDS have invalidated the Wallis Committee's assumption that the mere act of creating PDSs would enable comparability of similar products. Technological developments can now radically reduce these search costs. Governments have a role in co-ordinating these developments through the creating technology and disclosure standards.

Shift responsibility for making disclosure work onto third parties

The current law requires product issuers to disclose information that is against their interests to disclose. They therefore have an incentive to obfuscate and make their disclosure documents as non-comparable as possible.

Disclosure policy should shift responsibility for making disclosure comprehensible to third parties. The concept of smart disclosure is more wide-reaching than encouraging the development of online comparators. It includes app developers, research houses and financial advisers.

Smart disclosure can be adapted to each kind of financial product. It would be harder to adapt it to more complex, novel, or unique products, though it would be easier than adapting direct product regulation regimes to those products. Direct regulation is time-intensive to develop and generally too cumbersome to adapt to novel products. On the other hand, smart disclosure could be adapted by requiring bare bones disclosure of information that is standard across all products (e.g. price/fees, risks) in machine-readable format, with a comment box for the issuer to make any necessary qualifications to the data.

The smart disclosure approach is already active. The United States Treasury is making data available in standardised and machine-readable formats at www.treasury.gov/financedata. The UK has done the same through www.data.gov.uk. This has activated a wide range of innovations across most product classes.

It has permitted the development of tools that make equity research easier for retail investors. Research houses have used the data to provide ratings for US pension funds, for financial advisers. Consumers are able to securely access their private health data then use it to find the best health coverage for themselves. One company even helps consumers monitor their credit/debit card transaction data to identify errors in their bills using data released by the US Consumer Financial Protection Bureau.

Direct product regulation does not work for credence goods or where consumers have

5 Godwin, Andrew and Ramsay, Ian, Financial Products and Short-form Disclosure Documents – Challenges and Trends, University of Melbourne Working Paper.

non-homogeneous preferences

If disclosure does not work for certain financial products, then a logical conclusion is that such products are either 'credence goods' or 'experience goods'. These are goods for which a consumer cannot readily ascertain the utility of the good before acquiring it. However, according to economic theory, providers of credence goods are more likely to engage in misconduct when their behaviour is monitored. There is also empirical evidence for this proposition.[6] The intuition is that monitored providers cannot extract rents through changing product features in a manner detrimental to consumers so they extract it through misconduct. Therefore, more direct product regulation, including granting of temporary product intervention powers to ASIC, may ironically backfire and increase misconduct by issuers of financial products.

Direct product regulation can only work where consumers have relatively homogeneous preferences about the core features of a product or about the undesirable features of a product. This is untrue of financial products, where consumers have different preferences about most core features. Consumers vary in their appetite for risk, hence the need for varying levels of cover. Consumers vary in their investment horizons and need for liquidity, hence the need for varying investment term limits and the proliferation of high dividend stocks. Consumers vary in their tax preferences, hence the existence of tax-advantaged investments. The matching of consumers' preferences to products is fundamental to the nature of the financial system. Any system of direct regulation that purported to match consumers without taking into account their individual characteristics at a granular level would significantly detract from the allocative efficiency of the financial system.

Furthermore, differences in product features do not always reflect the needs of consumers. Sometimes, they reflect the needs of the product issuer in financing or manufacturing the product. Direct product regulation would lead to increased homogeneity in business models for product issuers, which would restrict competition and dynamic efficiency.

Where the conditions for direct product regulation are met, governments should prohibit features that are undesirable for all consumers. Yet such an approach would be inapplicable in the vast majority of cases and cannot form the foundation of the consumer protection framework.

Enhancing reputation effects can improve the market for credence goods

Reputation effects can partially resolve the information asymmetries associated with credence goods. However, the infrequency of interaction between an individual customer and an individual product issuer result in weak reputation effects.

Disclosure policy can strengthen reputation effects by amalgamating the interactions of many consumers with a particular product issuer. The disclosure of certain key information, such as the number of complaints to the Financial Ombudsman Service, can establish a negative reputation for bad firms. Product rating websites can support good players and hurt bad firms. Again, this approach can be targeted at different product classes.

A reputational approach to disclosure is different to the Wallis approach to disclosure, though the differences are subtle. Under Wallis, product issuers are required to disclose all information relevant to a consumer's calculation of their expected utility from acquiring a product. Under the reputational approach, it is admitted that consumers are unable to make that calculation. Issuers are required to disclose information relevant to a different calculation – a consumer's calculation about whether the issuer is sufficiently trustworthy.

The proposed enhanced register for financial advisers is a good first step, but it should include

6 Brown, Jennifer and Minor, Dylan, Misconduct in Credence Good Markets, NBER Working Paper 18608.

information about how effectively advisers met their clients' needs. For example, they should disclose the returns received by clients desiring a low risk, medium risk and high risk portfolio respectively. In theory, the returns should increase with the desired level of risk – other results may indicate the adviser takes a one-size-fits-all approach.

For insurance products, the release of payout ratios and average processing times would improve consumer decision-making and deter insurer misconduct.

For investment-based products, data on historical post-fee risk-adjusted returns, 'alpha', and standard risk measurements can be used to determine whether funds' claims that they can consistently beat the market have any truth. Even if individual consumers cannot understand this data, research houses and more sophisticated investors can change industry norms and place market pressure on fund managers who attempt to churn their members' assets to earn transactional fees.

A path forward for disclosure

The Inquiry should recommend that industry be given a period of 5 years to develop best practice for disclosure that significantly improves consumer outcomes. An industry body for disclosure should be created to establish industry norms around disclosure. The body could be modelled upon the advertising standards board. This would permit time to ascertain whether the proposed reforms to disclosure policy can result in better consumer outcomes. If there is no marked improvement in consumer outcomes, then the government should consider more interventionist approaches to consumer protection.