The Policy Pitch

Super rip-off? Policy options for a better superannuation deal

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JIM MINIFIE: My name's Jim Minifie, I run the Productivity Growth Program at the Grattan Institute and I'd like to welcome you to tonight's *Policy Pitch*. Thank you so much to the State Library for having us here, it's a terrific venue, and I'd just like to note that the events being held on the traditional lands of the Kulin nation and to acknowledge them as traditional owners.

With me tonight I've got two conversation partners and the aim is that between the three of us we're going to touch on a range of issues, not just those that we covered in our recent paper on superannuation fees, *Super Sting,* we'll go a little more broadly into the world of policy for superannuation, but let me introduce the two conversants. First, to my left, Nicholas Gruen who is a widely published economist, an entrepreneur and a commentator on economy, society and innovation, he's the CEO of Lateral Economics; Nicholas, thank you for joining us. And then further to my left is Sally Patten, an Associate Editor at The Australian Financial Review who writes extensively about finance, superannuation and funds management; Sally, thank you so much for joining us. I'm sure that between the three of us we can cover a good range of interesting topics across the industry.

Now, I don't purport myself to be an expert on all aspects of what is a very complex Australian industry, but with two of my co-authors who are here tonight, Jim Savage and Tim Cameron, I did an exercise looking into the opportunities to drive efficiency in the superannuation industry. And what I'm proposing to do is for us to first kick-off with a very brief summary of some of the key findings from that report, I'll take about six or seven minutes to do that and then Nicholas and Sally will pick up various related points; and then, after that initial introduction, we'll have something of a discussion on the topics and then we'll open it for general discussion. And I welcome you all to, if you're interested, to stay on afterwards for an informal discussion out in the foyer.

So let me just introduce you to the key themes and the motivation for our paper, *Super Sting*. Over the last 20 years, superannuation has grown from really a policy innovation - Australia was one of the first countries to have a mandatory defined contribution system, there were a few others, but we were one of the early ones - and the system has grown into one of the largest funds management industries in the world. It's got a lot of complexity, but one feature that really struck us at Grattan Institute, as we were looking around for opportunities for policy makers to learn from what's done overseas and to make a significant improvement to the productivity of the Australian economy, is that the cost structure of the industry is really quite unusual. While there are other systems with a similar cost ratio to us, they're much, much smaller and many of the systems with scale on the order of the Australian one have much, much lower costs. Now, there are significant structural differences around all of those systems. Some of them are defined benefit systems where individuals are not as exposed to the returns of the funds that they happen to be invested in, and there's a whole range of structural differences across these segments, but it really stands out very markedly that Australia is an outlier. And that was, I guess, the starting point for our analysis and various of us were aware of research showing that individual systems, sometimes individual funds around the world, seemed to be doing things in a very different way and we tried to understand some of those.

And so in the report, what we lay out is our findings in a series of steps. So the first finding is that Australian superannuant account holders are paying on average about 1.2% a year, whereas the median around the OECD is more like about 0.4% a year, so about a third of the Australian fee level. And obviously we've got a range of fees; some of them are actually much higher than 1.2%, well above 2% a year. So we make that observation. Then we draw in just the very basic, sort of, accounting of an accumulation system over time, just to note that even those apparently small fees can really add up. So, a 1% increment to fees over a working life knocks about 20% off your retirement balances. So those numbers are big enough to matter.

We then explore whether the fee experience in Australia appears to be justified by increased gross returns, because you'd be quite comfortable paying high fees if it were the case that the funds that were charging those high fees were generating high net returns. But what we find is quite to the contrary, we show that over the last 12 years of data that's available through APRA plus the addition of a private sector data set which we purchased to enable us to get a comprehensive picture of the fees that are charged, the high fee funds reliably generate lower net returns than the low fee funds. And we go into some detail about why that is. There are a couple of factors: asset allocation is a little bit different for the high fee funds and the low fee funds, and that made a material difference; but predominantly the difference is fees, and it's very difficult in the Australian context to avoid the conclusion that there is not value generation by the high fee funds in the superannuation system that is offsetting in any way the increased fees that are being charged. And we do some additional tests that show that if you were to pick a fund without controlling for anything in terms of its asset allocation and you picked on the basis of high previous performance, you actually wouldn't get such a good return in future as you would if you picked the lowest fee funds. And so for us, that sets up a prima facie case to say, well, what can we do in Australia to preserve the good aspects of the system, provide people a lot of flexibility and choice, but try to really drive down fees?

And so we looked around the world and there are a range of policy instruments that different jurisdictions have worked on, they fall into three broad groups. So the first group is efforts to increase the comparability of fees and to make it easier for people to make sophisticated decisions, and the literature suggests that in reality for most people comparability doesn't help much. Education is very expensive and doesn't help much. It's a good first step and if you don't have it then you're going to get nowhere, but by itself it doesn't really drive good outcomes. And that seems to be because many people are just not that sophisticated financially and also because people tend to put off making these tough decisions.

The second big policy instrument is to just have a non-profit system, either run by the government or through a different mechanism that takes out the profit motive, and those systems tend to get quite low fees and seem to have good performance. And then the third model which, to us, was quite interesting in the Australian context is that it's possible to essentially bolt on a much more aggressive fee-based wholesale form of competition, especially for the default markets in which people are allocated if they don't make an explicit decision. A number of countries have undertaken variants of this model and they achieve fees that are comparable to those non-profit systems, and we document those in the report.

So that, for us, was a bit of a gold standard and evaluating the current policy reforms which are being phased in at the moment, the so-called Stronger Super Reforms which comprise, first, a new more comparable set of superannuation products which must be offered to all default account holders, My Super, and then some administrative backend reforms, Stronger Super, and there's a few other reforms as well in the package. What we observe is that, first, there's no evidence that fees are coming down to the extent that you're able to get data and there are a few gaps in the data, but there's no evidence that fees this year are any lower than they were in previous years. But more importantly, the character of competition in the sector has not been fundamentally shifted in our view. So what we would observe is that, just as today it's possible to get a good deal if you're a financially sophisticated shopper, but unlike in many other markets where the sophisticated tomato shoppers tend to push down the price of tomatoes for those who aren't perhaps paying as much attention; in this market you've got a huge range of fees being charged and the price pressure that might be imposed by the more sophisticated shoppers is not generating much fee pressure for the less sophisticated buyers. So, what you see in the market is really a very broad range of fees from about 0.6% of funds under management per year up to about 2.5% and we don't see My Super and the Super Stream reforms as generating much of an improvement in that area.

And let me just finish with one other fact which, I've got to say, shocked me as we went through it. As the system as grown in scale over the last decade and individual funds, incidentally, have grown very markedly - so since 2004 the average fund in today's dollars is now managing about seven times as much money as it was in 2004 - the fees charged in the industry have only dropped about 20 basis points. Now, you very sharply see a scale curve in the industry and I think if you had asked any industry experts, "What is going to happen to fees and expenses in this industry as it scales up massively in the coming decade?" the anticipation would have been we'll have very, very significant fee pressure. And that really hasn't occurred and, to my mind, that's an indictment on the form of competition and the type of regulation that we're tolerating in this country.

And so in the final chapter of the report we just put forward two very simple reforms. The first is that we should adopt a model whereby the government runs a wholesale tender whereby funds that pre-qualify and commit to invest in appropriate asset classes compete on the basis of fees for the right to be offered as a default. We think that would save about $2.5billion at today's scale and, obviously as the system scales up, it would save more. Chile did that, introduced a system of that type, and the default fees have dropped by a factor of four over repeated tenders and that's very encouraging to us. But we're suggesting a second reform as well, and that's to try to cut through the complexity of comparison and we're calling this second reform "make tax time super choice time" and the argument that we're making is that when we do our tax return – could be yearly, might be every couple of years – we would have the opportunity to look at a dashboard of information about our current fund, to observe comparable information about the winner of the default tender process that I just described and we'd be able to switch on the spot. And the reason why we think a model of that type is so important is that it's been shown in these other countries which have introduced tenders that really the back book hardly moves and the rest of the market hardly moves as a result of this aggressive price competition and that's, in our view, because people, with the best of intentions, just are not focusing on the issues.

So, those are the very concrete recommendations we've put forward. We see this as one of the more attractive opportunities for micro reform in the economy, we think it would preserve all of the attractive features of the super market today. We'd still retain choice, we'd still retain the opportunity for sophisticated people to define their exposures in a way that they're comfortable with, but it would drive a step change in the outcomes for the 70% of the population that are not that engaged and are currently getting a bad deal from the current system.

So that's a very high level summary, I'm happy to go into detail in discussion, but let me hand it over, Nick, to you for some observations which I know are going to touch on some interesting issues.

NICHOLAS GRUEN: Okay, thanks Jim. So I read the Grattan paper, and I think it's a terrific paper and I couldn't help thinking that it was a pity that it had taken this long for a credible centrist organisation to produce this sort of analysis and wished that perhaps the Productivity Commission and other organisations, the ACCC for instance, might have done something similar and pushed this, given that they have a remit for pushing micro-economic reform. I basically agree with the things that Jim has said and as I read the paper I thought to myself well, I know where this is happening in super elsewhere and that is in the self-managed super fund area, and I thought I would explain how the same kinds of things are happening there.

And I guess just in the last few months I've decided that you give me an issue and I'm going to tell you that my meta-critique, my meta-analysis of it, will always – I haven't found an area where this doesn't apply, which is that there is what I call Type 1 thinking, which is high level, usually ideologically laden conversation and it's usually about are you in favour of markets or regulation; are you in favour of free trade or protection; are you in favour of governments or markets? And that entertains us on the media and all of the important people who make the big decisions exercise themselves around those Type 1 questions. And the problem is that they're kind of irrelevant. In a mixed economy, pretty much everything is so the government and the market, the government and civil society, everything is so mixed up that what is called for is Type 2 thinking, which I would call essentially the question of how do you configure the interface between governments and markets? And that's much less susceptible to ideological thinking; it's much less useful to make emotional appeals; it's difficult; it's different in different areas; and you have to try and think things through on their merits. And we're pretty awful at that.

So let's have a look at superannuation, let's have a look at self-managed super. Before I do that, I might say one of the things I don't like doing is when people say to me, "Well, sum up what you've got to say in a single sentence" or something like that. But when we were doing a report on finance and particularly global funds management with a focus on why we happen to have such a huge industry that was incredibly inwardly oriented, did almost no exporting, it actually reminded me of the car industry in the 1960s. As we were doing this report, I decided I wanted to put a single sentence at the top of the report and so I wrote in the executive summary "If we were limited to a single finding from our research, if this report's for a single proposition it is this: global funds management should be thought of as a joint product between funds management firms and their regulators, including taxation authorities" and just change a few words and the same is true for superannuation, in fact it's even more true because superannuation is a creature of regulation.

Jim has shown us how poorly this, as I would put it, this predominance of Type 1 thinking has got us in the area of retail and industry funds, and there's the metric for you. We might be able to lower costs by 80%, okay, that's a pretty amazing story. So let's have a look at what's happened with self-managed super funds. We decided that we wanted to allow people to manage their own super funds, I think that's a good idea, especially with costs the way they are, so we need a regime. So what do we do? We ask the Type 1 people and the people who are already running these funds to help us set up a regime for self-managed funds. And so where do they start? They start with the sort of regime that you use to run a $10billion fund with trustees and actuaries and this and that and the other. So they say, "Well, this self-managed super system, we'll have it just like the big end of town but we'll cut it down a bit. So everyone'll have a trustee". I'm going to circulate my self-managed super trust deed. I'm going to out myself as a trustee of a self-managed super fund that's never read their trust deed.

You all there know what kind of document this is, it's one of those kinds of documents that you pay – I think we paid $600 for this thing – and it's a bunch of rules about having meetings that we never have and so on. So, if somebody wants to circulate those, you might be interested.

So we have trustees to administer a trust according to a written investment strategy and we have an annual audit complying with the SIS Act, the Superannuation Industry Supervision Act. This audit checks that the trustees aren't defrauding the beneficiaries. Well, the trustees are the beneficiaries. This isn't a very sensible regime. Each year my fund is audited, it costs about $2,000 and it is audited to comply with Sections 52 subsection E, Section 52 subsection 2d, Section 62, 65, 66, 67, 69 to 71e, 73 to 75, 80 to 85, 103, 106, 109, 111, 112 and four other sections. And this is about a bunch of shares that I manage and we run around after share certificates to make sure that I'm not ripping myself off. So this is really extraordinary stuff and yet there is something even worse about it. And by the way, I guess I should try and clarify, the obvious way to do this is to carve out particular types of portfolios and to say to people, "If you want to run a portfolio that looks a bit like this, go for your life, make a self-declaration every year like you do with your tax and the Tax Office will randomly audit people, and if you're lying we're going to get you". That's how you would do this and it wouldn't cost $2,000 a year, it would cost an absolute fraction of that.

But the tragedy is that of course the word "audit" makes you think that these investments are safe, but they're not safe because take the example of Alison Cook who got an $800,000 payout from an accident in which she was made paraplegic and, of course, an advisor was able to fit her up with a set of investments that effectively complied with these arrangements, it had an investment strategy, the investment strategy it seems allowed her to invest in mezzanine finance and IT start-up and a hedge fund – that's diversification for you, I guess – and two-thirds of it is gone. And auditing that every year would have cost her $2,000, maybe $5,000, and we don't know what commissions were paid on that. So that's the sort of thing we're looking at. I might say that recommendation 30 of a 2007 Joint Parliamentary Committee recommended that where funds consistently comply with their audits that we revert to five-yearly audits, probably less efficient than what I've suggested but, anyway, we've gone nowhere with that. One of the signatories was Penny Wong who found herself in a position as the Minister for Finance and - don't laugh - Deregulation, and, in fact, oversaw a red tape chasing exercise. That, on my rough back of the envelope figuring, would cost over 40 years around about $200,000 in today's money to a retiree.

So, let's leave it there, there are lots of other things to talk about, lots of other ways in which what might have been a great social institution is letting us down, but Sally might be able to tell us some of those things and maybe she'll tell us some good things as well. Thank you.

SALLY PATTEN: Good evening. I thought I would start by talking about some of the challenges facing policy makers and the superannuation industry. But at the risk of starting off a brawl before I launch into that, I have to say, Nicholas, I'm slightly less concerned that there are all these rules around self-managed superannuation funds, because whereas I personally don't mind if you rip yourself off, I do mind as a taxpayer if you rip yourself off and then have to go onto a government pension or a part pension.

NICHOLAS GRUEN: But the audit doesn't stop that. The audit isn't addressed to that.

SALLY PATTEN: But the auditors actually have another role and that is they're the gatekeepers; they're going to check that you are not breaching lots of rules in a self-managed superannuation fund;

they are going to make sure that your fund is not lending you $100,000 or $200,000 which would give you advantages in your superannuation fund that I would not have as a member of a pooled fund.

NICHOLAS GRUEN: And why can't we do that much more cheaply? Why does it cost $2,000 a year to do that?

SALLY PATTEN: I guess I think that's your prerogative if you want to have a self-managed fund and choose your own investments, then, I guess that's not such a high price.

JIM MINIFIE: Can I just check, does this discussion constitute financial advice?

SALLY PATTEN: No, it certainly does not for me. Anyway, perhaps we'll leave that alone and I'll launch into my talk about the challenges of policy makers.

I guess if you're looking at the challenges for the government, and the government's got over the next couple of years, you need to start and look at what was the purpose of superannuation in the first place and is superannuation meeting its goals? Now, in 1992, when the Super Guarantee was launched, John Dawkins, the former Treasurer, said that superannuation had basically four roles: one was to increase national savings; one was to reduce pressure on the budget; one was to allow people to save money so they could afford a lifestyle that would have been a better lifestyle in retirement than they would have, had they just relied on the age pension; the fourth one was to constrain wage inflation.

Now, the fourth one has pretty much gone out the window because we have quite a different economy. The increase in national savings I'm not going to get into because I'm not an economist. But I might look at the other two things and, first of all, looking at the aim of reducing pressure on the budget. Now, if you look at the figures that are coming out recently you would say that it's clearly not doing this. Joe Hockey said a couple of weeks ago that the cost of the age pension was set to rise to $72billion in 10 years' time. In the meantime, Treasury – and I know these figures are hotly contested, but bear with me – Treasury in the meantime has said that by 2015/16 the cost of superannuation concessions will be about $45billion. So you'd have to say that as of right now it is certainly not easing the pressure on the budget and I'm sure we're going to see a lot more about this in the upcoming tax review. Now, some of this of course is because of the aging population, but it's not just the aging population. I think there are some issues there with the eligibility criteria for the age pension and there are also issues around workforce participation, particularly for people over the age of 50 and 60.

So then you have a look at are we meeting the goal of having more people affording a better lifestyle in retirement than they would have had they just been on the age pension? Now, Treasury here has some figures which show that yes that is arguably the case. I think between now and 2050 the proportion of people expected to be on a full age pension will drop from 55% to about 30%, so that would suggest that more people are making more money and are probably having a better lifestyle. Except that then you have a look at the number of people who are expected to receive no pension, i.e. to be fully self-funded retirees, over that period of time and that is not expected to change between now and 2050. And then if you look at where the superannuation contributions are going, most of them arguably are going towards those people who are in any case not going to receive any sort of pension and will be self-funded retirees. I think it was the Australia Institute a little while ago pointed out at the highest 10% of income earners in fact get 31% of the superannuation tax concessions and Treasury augmented that figure when it said that the top 5% of income earners actually get 23.4% of all superannuation concessions. So you would have to think in that case that it would make more sense for the government to take away some of the superannuation concessions from the wealthier people and give them towards the people on lower incomes and you might actually improve their situation in retirement.

So, I think if you take those things into account, some of the measures that as a government you might do are, first of all, tighten the eligibility for the age pension. There was some talk a couple of weeks ago in the Commission of Audit report that the family home should be included. I think that is actually not an unreasonable idea, however I do think that if you're going to start including the family home in various criteria or, I should say, start using the family home to afford our lifestyle in retirement, our aged care and our healthcare, you are going to have to have some better products where we can release equity from our homes, such as better reverse mortgages and that sort of thing. If you don't have better products in that area you will see a lot of the wealth from retirees just go to the wealth of the big four banks.

The other thing you might do is change the way we apply the superannuation contribution concessions. You might say that they should be applied at the top marginal tax rate minus some figure, like 15 percentage points, which is sort of what happens not but not quite, and you would also reintroduce or you would retain the rebate for low income earners. You would probably also either/and end tax-free super payouts or you would start taxing the income on superannuation in the pension phase. At the moment, superannuation earnings are taxed at 15% while we are still all accumulating super, but that drops off to zero in the pension phase, and you might introduce that at say 15% or even 10%. And the other thing you might try and do is increase the workforce participation rates and try and do something about age discrimination.

The other thing I actually would say, another challenge the government's got, and I'm sure Nicholas will love this, I do worry that there could be some disaster waiting to happen in the self-managed super fund market. At the moment, about 7% or 8% of all superannuation fund members have self-managed funds and that number is growing quite dramatically. Now at the moment, I'm sure that most self-managed super fund trustees are financially fairly literate and there may be no problems, but as that number grows so quickly you would have to assume that in time you will have less financially literate people running their own super funds. And as a journalist, the number of press releases I get is unbelievable about products that are being offered that are specifically targeted to self-managed funds. So as a government you'd want to be pretty careful that you're not going to have to have any blow-ups because that's going to destroy confidence in the industry as a whole.

NICHOLAS GRUEN: There'll be blow-ups and this is with a gold-plated regulatory regime that you can see now doesn't stop the blow-ups. I'm surprised there have been so few.

SALLY PATTEN: So then if we have a look at some of the challenges facing the industry, I agree there is a lack of competition in the industry. The fact that we have, I think it's 310 pooled superannuation funds does not create competition because most members don't know very much about superannuation, they wouldn't know how to compare a super fund. So they're not out there like they are buying tomatoes or pairs of jeans and comparing prices and styles; they just go into the fund that is delivered to them. And that fund that's delivered to them is usually chosen by an employer and an employer does not have a fiduciary responsibility to act in the best interests of their employees from a retirement savings point of view, so no-one's really taking a lot of responsibility.

So then you have this issue of a lack of competition and what does that lead to? It leads to fees that are higher than you might want. It potentially leads to inferior products. And we know these issues exist because people who do accumulate lots of savings and do have an interest in their super, they get up and they go and they set up a self-managed fund. So in a sense, they're voting with their feet.

So I would say that super funds need to look hard at the way they operate; they need to look at the number of investment options they offer, do we really need all these investment options when most people just choose the default fund; do they really need to be employing as much active funds management as they do? This is particularly true for large funds because the very large funds have much more trouble in trying to generate above-market returns which you typically get from boutique investments or from small caps, not from investing in just the mainstream ASX200. And should there not be a lot of consolidation in the industry, and I would say that this is perhaps where APRA needs to play a much bigger role and try and consolidate funds. We don't need 310 funds with all the management costs and the admin costs and the costs of running that the trustee takes.

And then I would say that we probably need better products. Potentially there needs to be much more what we call lifestyle products, which is where a super fund asset mix will become less defensive so it will contain more bonds and more cash over time to reduce the risk in the fund. Perhaps we need to be tailoring a lot more super funds towards the members and, on that note, QSuper is doing something quite interesting where they are segmenting their members into smaller cohorts and they are trying to manage their retirement savings in a way that is specific to those cohorts. And then I think there are governance dangers for the industry. You don't want any more situations like we had with HIP Super a couple of weeks ago where there was an expenses scandal. In order to maintain confidence in the industry, the industry does need to be whiter than white because we are, by law, required to put 9.25% of our salary into superannuation.

So I might on that note leave it there and back to you.

JIM MINIFIE: Sally, thank you. So you can see why we only want to deal with one of those issues in our paper because it is a large and complex industry, but you've been quite compelling on the numerous dimensions on which you could see substantial improvements in a system that would still achieve the fundamental goals but at much lower costs. So thank you. Nick, do you have any responses to what Sally has said? I'm thinking particularly around some of the discussions we had before this evening around the paradox, in a sense, that often the experts in an industry themselves are interested parties and so the prospect for an industry-led reform effort doesn't appear particularly promising.

NICHOLAS GRUEN: Yes, look, I think this is kind of the great issue of our age. It isn't spoken about much by economists talking about microeconomic reform, but it's kind of obvious that as a society becomes more knowledge-intensive the issues of managing expertise, of delivering expertise to solve problems, is the paradigm problem. And a nice example of how you can have a functional system and a dysfunctional system is – and again, I'm speaking relatively and practically because all these systems are very messy because they involve human beings – but if you compare the American health system with everybody else's health system, the American health system does roughly the same thing for exactly twice the cost. I won't pose as a great expert on this, but my hypothesis is that this is an industry in the United States a bit like Wall Street, a bit like finance, in which – to use economic jargon – asymmetric information is rife, that is parties to transactions know different things on each side and each try and take advantage of the other. And in a health system there are plenty of opportunities for health operatives to pursue their own interests, rather than the interests of people who know less than they do.

I wouldn't be so naïve as to suggest that that doesn't happen in every health system and isn't a perennial problem of our fallen state, but there has been a kind of social compact in medicine since medicine became a modern profession in the late 19th century, perhaps the early 20th century, in which notions of professional responsibility, fiduciary duty really are important parts of the economic landscape. And economists don't tend to kind of appreciate that stuff and so economists will say, "Look, it's kind of crazy not to let surgeons advertise lower fees" which, in a sense, it is crazy to do, and I'm not really trying to get into that debate. In a sense, I'd argue that that debate is a sort of Type 1 question, but the underlying mechanics of expertise and a huge network and hierarchy of expertise describes a situation where it's easy for people to be taken advantage of. And if you have an industry where that is kind of expected that that's kept within limits, I suspect you'd end up with the sort of industry that we have in health and every other developed country has in health, except for the United States. And you might end up with the sort of finance industry that you have in Germany compared with the finance industry that you have in the United States, which is if you can find a way to drive up your revenue you just go for it.

JIM MINIFIE: Thanks. Sally, just a question for you, we've had some pushback on our findings, in particular around the outcome that I think you'd expect from running a tender of this type is that you would tend to find in asset classes where an index-type product, a passive-type product would be the lowest cost, that that product is the one that would win the tender. And we've had pushback from the industry saying that this would be contributing to a kind of dysfunctional disengagement in the capital markets, that you'd have super funds that weren't exercising oversight over the firms in which they're invested. Do you have a sense about whether that's a genuine risk from a shift to essentially a lower share of active management in the Australian stock market?

SALLY PATTEN: I guess that debate between active management and passive management goes back decades, and a lot of people will say to me that actually it's very much a cyclical debate. At the moment we are moving back towards a greater focus on passive funds management, but there are a lot of super funds that will argue until they're black and blue that active management does indeed deliver returns. And I think that REST is one fund, which is one of the country's biggest superannuation funds, which as far as I know has no passive management, and they've been the top-performing fund, or they're right up there and have been for many years.

Having said that, markets are a bit of a zero sum game, so if someone is picking the winner that, by definition, means that someone is not picking the winners, and picking the winners is a very, very difficult thing to do. So as a superannuation fund trustee, you would have to have a lot of confidence in your expertise that you are allowed to do that. And, in fact, Mercer had some figures which they sent to me a couple of days ago which said that out of a universe of 150 fund managers, only about 20 of them performed well over two three-year periods, where nearly 30 of them were in the third and the fourth quartiles over that same period of time. So the thing is that whereas it works for some people, it doesn't work for everybody.

JIM MINIFIE: Thank you. I'm aware of time and I'm also aware that there are some people in the audience with expertise and interest, so I wanted to move quickly over to questions and if I could just kick-off with a couple of the questions that were put to us in advance when people registered. Let me start with one – actually, I think this question is for myself, so if you don't mind me reading one? Question now for myself, what makes you believe that this can be sold to key stakeholders? And look, I think it's an excellent question. Our view would be that we think there's a huge win here for the political actors who take a significant step to drive value for default account holders. We think that there’s a narrative you can tell about preserving competition, preserving all of the good features of the industry, as I mentioned before, and driving better outcomes for people who are not engaged.

Now the downside is, well, if there are people not engaged they’re probably not voting on this issue and you’ve got a powerful industry on both the industry and the retail side in whose interests a reform of this type is probably not. And so, as always, we’re doomed to act with ignorance of the future, but it struck us at Grattan that this is the sort of policy reform that is exactly the kind of thing that we ought to be proposing. It’s a policy reform for which there’s very strong evidence in the Australian data that we’ve got a problem; there’s strong cross-country evidence that there are alternative approaches that do it better; and so I wouldn’t say that we wrote this report in the belief that it would be successfully sold, but we certainly wrote it in the belief that it deserved to be taken up. So that would be my answer to that question.

NICHOLAS GRUEN: I’ll jump in and agree with you and say that it would be much easier – this threatened sufficient interests that there will be some people who will try and stop you introducing it and will tell horror stories about what you’re trying to do. But compared with tax reform, compared with tariff reform, this is easy stuff, and I guess if I was a politician what I’d be trying to do is I would be trying to find some simple arguments that I could win in a period of a few years. And it seems to me that what you’re about as a politician is trying to build and then at some stage invest and spend political capital, and you want to do that over five years with elections very clearly in your mind, not over 24 hours. And so I think this is a perfect thing for even an opposition to maybe take up, but certainly for a government. It’s much easier from government to do these things.

JIM MINIFIE: So Sally, can I spring on you another question that we received in advance, then we’ll go over to the floor? Are there any politically palatable solutions to individual longevity risk?

NICHOLAS GRUEN: I’ve got to say, this reminds me when I was getting into a lift in Canberra one day and one person asked the other whether they’d got permanency or not, and I thought, “If only”. Anyway.

SALLY PATTEN: It seems to me that one of the most sensible products that we could develop to sell this issue of longevity risk is to have what we call deferred annuities. So this would mean that when you get to the age of 50 or 60 you would set some money aside which would go into a fund that would then guarantee you an income when you reach, say, the age of 85; the rest of that money you would then be able to put into a private pension and be able to use that money to fund your lifestyle until you reach 85. I can see that that is something that I think that I would be prepared to do and most people I’ve spoken to would be prepared to do. These products are talked a lot about, they don’t exist yet. I think there are still quite a lot of regulatory barriers to doing that, in fact, I’m not even sure that they exist in many countries at all, if anywhere. But I think that would be a pretty good solution.

JIM MINIFIE: Nick?

NICHOLAS GRUEN: Yes, look, I think that that raises another question, which is that we’ve witnessed a kind of wholesale withdrawal from defined benefit to defined contribution. And for those who don’t get that jargon, defined benefit super is a super fund into which you pay and you receive a benefit usually in the form of a pension of an agreed amount. And what we mostly use now is defined contribution, which we define the contribution and what you get at the end depends on how lucky you are or skilful you are as an investment manager and, to quote that Chinese proverb, whether you have lived through interesting times.

Now, if you take this stuff seriously, if you take economic thinking seriously, one of the main reasons we invented government or evolved government was to pool risk, to share risks. Governments are actually better at bearing risk than the market. There are products that a government could offer the superannuation market that people could buy or managers could buy and put in a super portfolio. Before the last election, I tried to persuade both major political parties to issue savings bonds. Savings bonds would be defined, well, there are different ways of defining them, but one way to define them would be to say that the most – well, it's not the most efficient method, but let's say that savings bonds are capital guaranteed, pay no interest unless there is a serious market downturn in which case they pay 20%. That essentially represents the government taking on some intergenerational risk and it would be calibrated to return positive money over time to the government. So I'll say that again in a different way, the government would make money out of this. It would be a trade between the government and those people who wanted to take up the offer in which both would benefit. What is there not to like?

So these are the sorts of ways we could be thinking about this institution if we can try and focus our minds on configuring the interface between government and competitive activity. There are lots of these things and we were the best economic reformers in the world circa 2000 and we've kind of all gone back to sleep again. But these are the sorts of things that we should be thinking about, and they're not actually that hard. They're not like cutting tariffs or tax reform; they're sort of win-win.

JIM MINIFIE: Thanks, well let's open up for questions. Please get in early because things do run by.

AUDIENCE: I'd like to ask a question about lump sum withdrawals from superannuation funds. Currently on retirement you can take out an unlimited amount of money as a lump sum and spend it however you like, whereas the government's objective is for you to look after your own retirement and minimise the amount of pension you get. Should there be a ban or a limit on the amount of lump sums that people can take out of super funds?

SALLY PATTEN: Yes, I think there probably should be a limit on how much you can take out of superannuation as a lump sum and I am fairly sure that one day a government will introduce such a limit. The super funds that I talk to say there is no evidence yet, or there is very little evidence of people actually taking their money out of superannuation in a lump sum, spending it all on overseas trips and fancy cars and then going on the age pension. However, you'd have to think that, as you point out, you really don't want people to be spending their money in a lump sum; you want them to be funding their retirement. So I think it should happen and I'm fairly sure that one day in the next five/ten years, even earlier than that, it probably will happen.

AUDIENCE: A little off-topic, but can you please further explain on the family house exclusion from pension? I don't really understand how that would ever work.

SALLY PATTEN: So at the moment when you apply for an age pension there are two tests that you need to meet, there's an assets test and a test of how much income you earn, and in your assets test the family home is excluded. So you can live in a $2million or $3million or $5million home and still receive a pension. And there is an argument to say that some of the value of your home, if not all of it, should be included in that eligibility test for the pension so that if you, say, had a $2million home the government may say, "Okay, if you've got a $2million home you cannot receive the pension at all because we consider you to be a wealthy person". Or they could say, "Okay, you've got a $2million, but $500,000 must be included in the eligibility test for the aged pension" and you still, if they only took that amount of money, you still may or may not be eligible. Does that help?

AUDIENCE: So, following on from that, most people, especially in Australia, invest a lot of their life in paying off their house and once they've reached that, whether their house is $1million, $2million or $600,000, why should they be faced with a situation of having to move out of their house because they are no longer able to support themselves, family home kind of situation?

SALLY PATTEN: So policy makers may argue that there is a budget problem, you know, the age pension is becoming increasingly expensive and why should you, even though I'm sure you have worked very hard for your entire life, if you have earned enough money to own a $5million house, why should you then receive an age pension which other taxpayers have to finance? But that is also where we need more products that will allow you to take equity out of your home, such as reverse mortgages. So there are products available at the moment but they're very expensive. So what we would need to have is a lot more and a lot cheaper of these sorts of products around if it was going to be viable.

AUDIENCE: I guess this is a question about what I'm increasingly thinking about is the mirage of annuities, certainly from the private sector perspective. The UK used to be held up as a market where annuities were much more common than they are here, and yet in fact the UK arrangements are walking back from that is my understanding, not least because annuities in a low interest rate environment look like a much less attractive product than they used to. I guess that I feel therefore fairly sceptical about responses that say we need to rely on annuities as a solution to the longevity problem, and in particular annuities where we reasonably expect private people to be able to finance the residual of their retirement over an ever longer period of life.

JIM MINIFIE: Well look, I think many share your scepticism. The UK experience was that most people appeared not to shop around for the annuities that they purchased and I think it's the case – and correct me, Tim, if I'm wrong – but I believe that the average person received a flow benefit that was 7% less than they could have if they bought the best product in the market. And even those best products tended to be relatively high cost. So, some of the same issues with disengagement that plague our current accumulation phase products would probably plague private annuity products if we mandated those. I think that's a reasonable expectation. And there are obviously a number of other ways to manage longevity risk and one of them is to do it through the institution of the state, we do that to some extent with the age pension today, and there would be a range of alternatives that would permit that.

So certainly I think it seems that the view at the moment would be that while annuities have got some attractive features and while there are reasons to think that the private market might tend to unravel because people have got a view about their own expected longevity and so the pool doesn't necessarily support itself, mandating annuities would be associated with its own problems.

NICHOLAS GRUEN: Yes, and you've got real problems providing with, either the governments or the market generate problems over such long times. And this is one of the things that happens in the super system, that you put money in and then someone can make a decision about taxation on the way out which can have massive capital effects. And I actually remember when I was at a government institution and a person who worked next door to me had turned up from the corporate sector, had a large amount of money that he could deposit in his super fund, and then left a couple of years later and was able to take this out at a rate which represented about half the price of an equivalent annuity in the private market, so these huge capital effects. So I'm always very sceptical of grand plans for super if they involve constraining what might happen in the future because they'll make up their own mind then. We can say what we like about what we think it should be, but it will have its own political logic and it's not something we can constrain.

AUDIENCE: I think the Grattan report is very useful in focusing on an achievable part of the policy puzzle to improve Australia's superannuation. I am concerned though when I see commentators, and I notice there's some comment about tax revenue and the claims about excessive cost of superannuation and so on, and I think that what we need is some much higher quality tax analysis than we've seen. I think some research bodies or institutes, not the Grattan Institute, who've been pointing to the Treasury tax expenditure statement alleging that there are vast costs of superannuation really missed the point that the bulk of those claimed costs are in fact employers contributing or getting a tax deduction for the superannuation guarantee levy which goes to average weekly earnings and so on. And so we see stories of outliers, John Houston talking about some huge amount in some particular person's superannuation fund which doesn't represent the norm in Australia.

So I think what we need is some care and, as noted to pick up your observation, that what we don't want to do is to disrupt Australian savings patterns or change them. I think, as Treasury has identified in its tax expenditure statement, that its estimates are dangerous or can be misused because if some particular claimed tax expenditure is reduced then people will just rearrange their affairs in some other way, and that doesn't mean to say that the government will collect the claimed tax expenditure amount. So perhaps the speakers might comment about, if you will, if one was to refine and improve Australia's superannuation system into the future whether out of David Murray's review or some future tax white paper process, what might be the interval and the correct calibration of changes so that we avoid the same churn or superannuation rules as we've seen recently?

NICHOLAS GRUEN: Well, you're quite right that one way of saying what you've said is that everything's connected to everything else, so you can identify these tax concessions but also those tax concessions are increasing the rate at which accumulation takes place and that has an impact on pensions and things like that. I guess it seems to me one very simple idea, which I haven't seen really discussed very much, is that we have a system which relies on two things: incentives and compulsion. And I would have thought it would make more sense to pick one not both, a little like Lady Bracknell in the Importance of Being Earnest, you know, to lose one parent is a misfortune but to lose two looks like carelessness.

And if we did that, then if we said superannuation should not be concessional, that actually gives you some quite simple ways of interacting with super and ways in which you would also, if you wanted to achieve retirement objectives, you would crank up the rate of contribution in return for tax cuts, I guess, not in the super but outside of super. But the attraction of that is that you're not in this very fragile state of making huge calls on a massive system that holds assets for 40 years in peoples' lives where changes in government policy towards the end of your life can see you lose the value of 20% or 30% of your savings. So that's something that I guess I'd like to see people with a more intimate knowledge of the system and the economics comment on a bit more.

JIM MINIFIE: Sally, any thoughts on the question?

SALLY PATTEN: Yes, I think it is very, very dangerous and has proved very problematic for the – actually, this budget I must say was an exception, but every budget for the last seven or eight years has had this constant tinkering with superannuation, the rules and the taxes, and it does make people very, very nervous about the system and whether it's still going to be there in the same way in 20 or

30 or 40 years' time. And I know that right now there are a lot of financial advisors who are saying to their clients in their 30s and 40s, by all means put some money into superannuation because it's still a tax-friendly vehicle, but if I were you I wouldn't be putting all your money into superannuation because who knows what sorts of restrictions there will be on the accessibility and how knows what the tax regime will be like in years to come? Perhaps we do need a system where you have five year reviews of superannuation and you ask the question every five years "Is superannuation on track? Is it doing what we expect it to do? Are our objectives of superannuation changing?" and actually have some sort of formal system that then at least might give people a little bit of confidence.

AUDIENCE: A few years ago the government initiated a national financial literacy program. Do the speakers know what's going on there? Has it fizzled out or are there some real things happening?

JIM MINIFIE: I'm sorry, but I don't know where that's up to.

NICHOLAS GRUEN: I don't know and I don't much care, I'm afraid. As Jim has said, it's chasing a rainbow. Yes, it's a nice thing to have, but it's not really where the problem is.

SALLY PATTEN: Actually, I don't know the answer to your question I'm afraid, but I was thinking in the car on the way in here that one of the problems that the government has got is that they're mandating us to put 9.25% of our salary into superannuation into a defined contribution scheme where our savings are dependent on market fluctuations. But, by and large, most of us in the population don't know the first thing about shares and bonds and markets, and actually I was thinking that when I was at high school in a business studies class – which I think was compulsory – we did basic accounting and I had to learn about the credit ledger and the debit, and I had to learn how to write cheques. And I wonder if we shouldn't be introducing classes to high school students and just telling them about compound interest and what is a share and what is a bond, and basically how do these things work? What is the rate of return? What is the risk-return reward? And just a basic lesson like if this rate of return sounds too good to be true, it probably is.

NICHOLAS GRUEN: Yes, can I offer a provocative thought? That it's extremely difficult to raise the level of interest and competence here and it is possible to look at it as possibly a good thing. And the term that I would use to just give you the flavour of the thought is to ask the question what is cognitively efficient? It is not cognitively efficient necessarily for more people than is necessary to discipline the capital market to know about it. This is called the division of labour and, for instance in the area of banking, we have regulated a situation where we've made a social decision, by default in a sense, that people are entitled to put their money in a bank and think that it's safe without doing the due diligence on the bank. So it's a utility.

And so it's great if people want to become financially literature, that's an important thing, and they will actually be making contributions to the community beyond the amount that they capture themselves, but we also should have social institutions for people who say, "I actually prefer to do surgery on prostates for what I really spend my time doing. I want to sell real estate. I want to look after adopted children. And I want that to be managed professionally and well, even if it isn't being managed as well as George Soros could manage it" and the thousands of people who think they can manage as well as George Soros. That's actually quite an efficient system. In fact, it's a very efficient system and it's sort of the system we had in some ways, that we've unpicked chasing this fiction that everybody should make choices and optimise their own decision making about everything. And in fact, in knowledge economies none of us do and we can't. It's actually by chasing a fiction that you get this impression that that's an improvement.

JIM MINIFIE: Sure, follow-up and then one more question.

AUDIENCE: Shall I just follow-up? I wasn't asking for expert training, but just a literacy part because ordinary people are asked to choose their super funds, but they don't know what they don't know. And they are making their decisions just based on TV ads compared to pair and that sort of stuff, which is not transparent at all.

NICHOLAS GRUEN: I agree and it would be good to address that, but one can also ask the question a different way. You can say, should it be part of our social and economic infrastructure that somebody who doesn't want to go down that path can tick a box and say, "I want this managed reasonably professionally at a reasonable price"? And if people want to do better than that, if they think they can, that's just great. You know, it's kind of amazing that we don't have that. We have it everywhere else. We have it for surgeons, you know, you go and see a surgeon, you get a surgeon who's kind of okay. That's the idea, anyway.

JIM MINIFIE: Yes, and Nick, in our discussions with experts in pensions from around the world, one of the messages that came back very strongly is precisely the point you're making which is you should have a system where people feel absolutely comfortable that the default will be adequate.

NICHOLAS GRUEN: Yes. It's extremely efficient, that's very fair.

JIM MINIFIE: And the Stronger Super system was initially envisaged to have something of that characteristic and the words that were used in selling this system were that the My Super product would be a product for people who just want somebody else to take care of everything for them. But what we actually have in the market is a spread of prices and a huge variety of asset allocations such that if you're on the receiving end of one of the lower quality products you are going to be well out of the money, by more than 25%, compared to somebody with one of the better products. And so the Stronger Super system has comprehensively failed the test that you've just put forward.

AUDIENCE: You mentioned your recommendation that you'd prefer tender to government for default funds. I was wondering what your view on the Fair Work Commission role in default funds for awards?

JIM MINIFIE: Yes, that's an interesting question. In a sense, our report dodged the question of the role of Fair Work Australia. So just to give people context, what's envisaged under the current legislation that was put in place by the previous government is that Fair Work Australia would play an important role in winnowing down from the 130 My Super products which are out there on the market to a shorter list that would be included for selection onto individual awards by another individual group. And so this really only applies to workers whose employment arrangements are affected by an award, so that's about a quarter of workers I think. So our view would be that if the Fair Work assessment process really engaged with what is known about what drives value, that they would place significant emphasis on asset allocation, on fees, and on non-fee drivers of net returns like tax and churn. And if the Fair Work Commission played that role in a very rigorous way, they could make a very significant contribution to the outcomes of workers. So, it's an option. We don't see it necessarily as a negative; we didn't go into that in the report.

NICHOLAS GRUEN: Can I just make one other comment which isn't directly on the Fair Work Commission, but I think there's also a role here for the notion of competitive neutrality and I mean that in a way somewhat inverted from the way it's normally used. It's normally used by aggrieved business people, and often rightly aggrieved business people, who say it's not fair that they're expected to compete with some government agency that perhaps doesn't have to pay as much tax as they do or isn't subject to the same regulation or whatever. And generally speaking that's a sound principle of public policy. There is another way of deploying the principle, well, it's the same principle and it is to say if the Commonwealth Government or the State Government makes available to its own employees a super scheme, why the hell shouldn't it make it available to me, so long as the terms on which I'm offered access to it are not concessional and so long as I pay my way?

And again, I had a chat with Jim about this beforehand, and one of the reasons I think Jim hasn't spoken about that – and he can speak for himself if he wants to contradict me – but the fees that are charged in most of these government schemes, if you look at the report, they're better than the industry average, certainly the retail industry average, but they're not that stellar. You compare that however to what was the Norwegian Petroleum Fund, and has now got a different name, but it's this huge sovereign wealth fund. I think it's got about $600billion in it, which is a bit larger than our super system weight for age in terms of their population, and I think that's run very effectively with good returns at an extremely low MER (Management Expense Ratio). So I would have thought that if we're in this world of super choice, that that's something which we could back because it's another way that somebody who wants it off their case, off their mind as a worry, that's another direction they can go.

JIM MINIFIE: Thanks Nick. Can I suggest we pick up that discussion if you're interested after the end of the event, but can I first thank all of you for joining us? I think on a probably almost winter evening, terrific that you're able to come out. I look forward to the discussion. Sally, thank you so much for coming down from Sydney to join us. Nicholas, thank you. To my co-authors, Jim Savage and Tim Cameron, thanks for working with me on this report which we learnt a huge amount on and we hope that you have found valuable and, finally, to the State Library, thanks for hosting this series. Look forward to seeing you at our next one if you're interested which is on higher education, it's in June, the details are on our website. And I think I can declare the pre-orange juice part of the event now closed. So thank you.

END OF RECORDING