

## REVIEWING COOPER

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There's a well known Irish answer to a traveller's question - "how should I get to x?" Answer: If I was you I wouldn't start from here. This article is about the direction of Australian public policy towards super particularly the regulation of super. It's as much about "Where's here" as the attributes of the desirable destination.

The first section of this article is background on the descriptive, policy and relevant analytic economic dimensions of our current super arrangements. The second section describes the outcomes of the Cooper Review as reported to date. (It hasn't finished yet). The third section assesses the policy attractiveness of some of the Cooper Review proposals.

The Cooper Review's answer to the question "where's here" is "near the hut of a cheaper guide who knows a shortcut." My response is – "that shortcut doesn't get as high up the mountain."

### 1. Background

#### 1.1 Descriptive

Thanks to compulsory super we have now got about \$1 trillion in super assets<sup>1</sup> (roughly 1 year's GDP)<sup>2</sup>. In regards the individual pattern of this holding the median balance in 05/06 was about \$25k the average a lot higher \$79k and there's a distinct favouring of men over women<sup>3</sup>.

The future path of this stock of super assets depends on:

- Contributions which have run at roughly 7% of GDP over the past decade. In most years employer contributions have significantly exceeded voluntary contributions from members<sup>4</sup>;
- Gross earnings less the "intermediary costs" (fees, expenses, commissions etc) of the superannuation industry and less tax.

Super represents about one fifth of identified net household wealth<sup>5</sup>. Just like the stock of super wealth the stock of this total wealth grows with saving and net returns. It's useful to think about it split into 2 logical portions. One portion (for example, dwellings) is immobile, so asset prices and returns depend on local conditions. The other portion, for example shares which represent a claim on business capital or fixed interest, is mobile, so returns are primarily determined on world markets.

#### 1.2 "System Input" Policy

There are three familiar pillars of our retirement income system:

- The pension;

- Tax preferred compulsory super contributions which currently enjoy their own little flat tax island. Labour income paid in virtually any other form is taxed progressively;
- Voluntary contributions and the government's co-contribution into the earnings tax preferred super environment.

Graph 1 below sets out the budget cost of these pension and co-contribution outlays and labour and capital income tax concessions. It's expensive. All up around \$50b (5% of GDP). The tax concessions cost more than the pension.

Graph 1 here<sup>6</sup>

Who benefits from this \$50b expense? Half is spent progressively – the outlays half - for example - the top one fifth get no pension. But the tax concessions are exceptionally regressive. Those 8% of persons in the highest tax bracket got about 29% of the labour income tax expenditure in 05/06. The median tax concession to these people exceeded the median super contribution. The same can be said for the tax concession on earnings. Whilst the median Australian super account in 2005/2006 was \$25k the average SMSF (which has got fewer than 2 members) had an \$800k balance<sup>7</sup>. Guides to SMSF strategy honestly and explicitly treat them as a tax haven vehicle.

If the tax concessions on super were abolished the pension could be doubled.

From the taxpayers' perspective the policy costs about 5% of GDP each year now. What do we get for that? Originally there was a positive real internal rate of return on tax expenditures on super due to lower future pension expenditure. It was around 4.5%<sup>8</sup>. Subsequent changes to tax and pension design have completely obliterated this justification for current arrangements.

From the social perspective there are 2 costs. Firstly, a very significant negative contribution to intragenerational fairness. Secondly, the economic efficiency costs of raising \$50 billion. Discounting some of the earnings tax concession and using an average efficiency burden of taxation of say 25% we are looking at almost \$10 billion social cost of this policy.

### **1.3 Economic Impact on Wealth and Savings**

In regard saving, the studies are pretty straight forward – compulsory works - a bit better than 50 cents of a dollar compelled – sticks. Voluntary savings however is unchanged (or perhaps even worse) because of the super regime<sup>9</sup>. People borrow more and save less in other forms. Because compulsory contributions are significantly larger than voluntary contributions there's no question the original “need to increase savings” justification for compulsory super remains a valid argument.

The harder thing to judge is the impact on the composition of the stock of wealth – and the return on that stock. In this context there are 2 important implications of our “small open economy with mobile business capital” status.

Firstly, wealth owned by Australians likely grows faster because of compulsory super than it would in its absence. But the business capital stock with which Australians work does not. Simply, if we don't want to own it, foreigners will.

Secondly, in the absence of tax preferred compulsory super not only would savings be lower our net wealth would likely be more directed to other tax preferred immobile assets such as - residential housing, lower value range commercial property, agriculture and forestry.

Pre-tax social returns on these asset classes are pushed down (and asset prices up) by tax preferences so that after tax (private) returns get equalised. The super regime has increased the portion of our wealth invested in fixed interest and local and international equity. The pre-tax social return here is set more on world markets. As tax preferences go, the tax preference for super has a smaller negative impact on overall returns on our wealth. If we save more in the form of super we own more of the Australian business capital stock and more of the business capital stock of other countries. But we're such a small player in these markets our actions don't alter the pre-tax returns.

It's particularly important to understand regulatory arrangements in super in the light of this second best tax policy rationale.

#### **1.4 Current Regulatory Arrangements**

From a regulatory perspective there are 3 very distinct segments of the superannuation industry:

- Defined benefit funds in slow decline (and now most hybrid), still they represent 15% of assets plus an additional 20%<sup>10</sup> unfunded liability;
- An APRA regulated retail, corporate, and industry fund sector which represents about half the assets, but almost 90% of the member accounts;
- An essentially unregulated SMSF sector. The SMSF sector has a significantly different asset allocation to the APRA regulated segment – the main differences are the SMSF sector has minimal exposure to overseas equity and greater exposure to local property. What regulation there is of this sector focuses on the providers e.g. ASIC regulates financial advisers and financial advisers provide advice to SMSFs. This sector is the most rapidly growing; it represents about 1/3 of the assets in super but only 7% of the members.<sup>11</sup> It's important not to be misled by the “self managed” label in regards the sector. The sector is very fragmented. Only 11% of SMSFs “self administer all aspects”. Still, only about 1/3 receive professional financial advice regarding investments.

Current super regulation is heavily focussed on conduct. There is minimal capital requirement regulation nor is there much structural regulation of the “doctors can’t own chemists” sort. In the spirit of Glass-Steagall it’s easy to imagine structural regulation which might achieve public policy aims:

- Advisers can’t own packagers;
- Asset consultants, research houses and ratings agencies can’t do funds management;
- Administrators can’t own trustee companies;
- Margin lending products can only be sold to wealthy investors.
- Industry funds with large numbers of members from particular industries can’t overweight their asset allocation to such industries.

This sort of regulation has gone out of fashion. There are a few residual vestiges of it – prohibitions on in-house assets, separate auditor requirements. The hard earned lessons of generations of industry and financial economists and regulators have, in many ways been forgotten. The traditional paradigm “regulate structure, it determines conduct and thence performance” has been dispensed with. In its place there is an extensive framework of conduct obligations. For example APRA regulated super trustees are required to write, lodge for scrutiny and regularly review, long stories about potential risks their SMSF brethren haven’t even heard of.

## **2. The Cooper Review**

### ***Terms of Reference***

The terms of reference for the Cooper Review require it to

“...comprehensively examine and analyse the governance, efficiency, structure and operation of Australia’s super system...

2. The Review to be conducted around the concepts of the best interests of the member and the maximising of retirement incomes for Australians.”

The Review is explicitly excluded from considering “...system inputs such as the level of super contributions, tax including tax concessions and other exemptions.” These were reserved for the Henry Future Tax system review.

### **2.2 Gross returns**

Recall the ‘equation of motion’ of the stock of super assets, contributions, returns etc.

The Cooper Review is clearly precluded from considering the tax and contribution dimensions of this equation – “system inputs”. However it was not excluded from considering the impact on the retirement income of Australians and the best interests of members of various possible combinations of “system inputs” and regulatory design features. Nevertheless

in one sentence the Cooper Review made a choice to exclude from its scrutiny these issues.

“The Review Panel takes the view that wholesale investment markets are fairly efficient and so there are only marginal potential gains in efficiency that can be made through increased gross investment returns.” (Cooper Review, Operation and Efficiency, p4).

The paper goes on to describe its sole focus on “intermediary” costs as its intended contribution to improving member benefits. To my mind, at this point the review has gone seriously awry. There are 3 reasons. Firstly the Review ignores the distinction between private and social gross investment returns. Secondly, pre-tax returns can be very significantly impacted by regulatory factors. Thirdly, an individual’s aggregate return is a weighted average which depends on the asset class composition of the portfolio they have invested in. If regulatory factors influence this asset composition they will influence member returns.

To my mind the review should have focussed far more on gross returns and the design of regulatory structures which enhance these returns. I’ll give 2 examples of where I see such an approach might lead.

I want to illustrate my point about social costs by a thought experiment. Imagine some 50 years ago you were a trustee for a super fund for the people whose members were inhabitants of Nauru. Assume also this fund owned the phosphate mine. If you are not familiar with Nauru, a potted history goes as follows. A tropical paradise was mined for phosphate, turned into a desert, a reasonable pot of wealth was accumulated, it was squandered so the people of Nauru have been left with neither wealth nor enjoyment of their once pristine tropical island. Now imagine you were asked to do a “Cooper Review” “around the concepts of the best interests of the members” in Nauru. How would your tome be viewed in hindsight? You “glided” from the best interests of members to their financial interests which are not necessarily synonymous. Then you “glided” to focus on choosing managers based on their fees on the now defunct fund. Reasonably you’d be remembered for missing the point.

In the absence of any income tax system business wealth would be relatively much more an attractive investment than it is at present. Sacrosanct features of our tax arrangements (negative gearing, no tax on the family home, tax preferred capital gains, concessions for agriculture, etc.) bias our wealth away from business capital. Compulsion, super tax design and prudential regulation of super to redress this problem can have a significant social benefit. Business wealth pays a higher return which doesn’t fall because of the super tax preference.

### **2.3 *Intermediary Costs***

At a conceptual level there are 6 ways by which public policy might reduce the “spread cost” of the super industry. They are easiest split as to whether they

are intended to improve productive, allocative or dynamic economic efficiency. They are:

- (a) Reduce public policy mandated complexity;
- (b) Reduce public policy mandated levels of service “quality” e.g. accuracy of administrative record keeping, withdrawal notice periods;
- (c) Enhance service provider competition with a consequent lowering of service provider profit margins if they are excessive;
- (d) Introduce public policy changes which improve external economies of scale and scope, for example, define universal protocols to lower the IT processing costs of a member moving from one fund to another. Provided service provision is competitive, public policy arranged external economies can then result in lower costs to members.
- (e) Public policy can also enhance allocative efficiency, for example by mandating harmonised disclosure to ease comparison.
- (f) Improve dynamic efficiency i.e. reduce the search cost of introducing products and arrangements which lower costs.

The terms of reference for the Cooper Review encompass all these possibilities. However the Review has shown little interest in (a), (b) and (f). Complexity is discussed and dismissed in a few paragraphs.<sup>12</sup> There is a brief discussion of licensing administrators.<sup>13</sup> No mention of asset/liability term matching. There is minimal explicit discussion in regards (f).

In the absence of final recommendations I am personally confused about the Review’s attitude to (c). The Review appears to have a preference for a far more concentrated industry, sanguine about the potential adverse impact of that concentration on the ‘spread cost’ and dynamic efficiency.

I found the Review’s arguments about the desirability of achieving economies of scale by significantly reducing the number of funds unconvincing. As the Review notes in areas where there are significant scale economies (e.g. administration) there are a fairly small number of providers supplying outsourcing solutions. I felt more convinced about the potential for significant economies of scale in SMSF operation.

The main focus of the Review has been on (d) and (e).

The “Superstream” proposal to “bring the back office of super into the 21<sup>st</sup> century” is a clear example of (d). The proposed “new choice architecture” is an example of (e). Personally I am attracted to the Super stream proposal but unsure about the “new choice architecture” aka MySuper.

MySuper is a proposal to vary default arrangements at the fund level. To accept default contributions funds would be obliged to offer a plain vanilla “MySuper” default strategy. It’s not a proposal to vary the way a member gets

into a default strategy i.e. the industrial relations arrangements and employer obligations. Rather it's a proposal for mandatory treatment of people who do end up in a default strategy. To my mind the attractiveness and significance of this proposal depends very much on its detail. Little numerical background is provided by the review to assess its significance. It could well represent a major increase in complexity which effectively provides a limited benefit for a few.

It's difficult to see the proposals outlined so far amounting to any significant change in intermediary costs. Nevertheless for purposes of comparison assume generously that intermediary costs are reduced by 10% per year for every year into the future as a result of the introduction of the Cooper Review proposals. Table 1 below sets out selected items of Australian households' aggregate balance sheet as at June 2009.<sup>14</sup> Non SMSF super assets are about \$0.7t<sup>15</sup>. The operating expense of the non-SMSF super sector is estimated at 0.6%, i.e. 60 basis points.<sup>16</sup>

Table 2 here.

Suppose the Cooper Review proposals could reduce this intermediary cost by 6 basis points i.e. 10% that would represent a 1 basis point improvement in the return on total wealth. (As non SMSF super represents about 16% of the \$4.5t of net assets).

The table also sets out across the rows an indicative listing of the "wholesale" asset composition of each of the "retail" assets. Further it sets out an indicative real long term private return on each of these assets. Because of the design of our tax arrangements we have:

- Ø Too much wealth invested in housing which consequently pays a lower social rate of return than it would in the absence of an income tax system;
- Ø Not enough in bank deposits and shares where, the returns are set more on world markets;

Minor changes in super arrangements which influence overall household gearing or asset allocation dwarf intermediary costs in regard impact on total return. If the Cooper Review proposals result in an unintended 0.14% reallocation of household wealth (\$6b) away from business equity the benefit of the 10% reduction in the intermediary cost will be cancelled.

### **3. Conclusion**

The Terms of Reference required the Cooper Review "to be conducted around the concepts of the best interests of the member and the maximising of retirement incomes for Australians."

The best interest of members are not served when private investment returns are earned at the expense of social or environmental costs passed to others.

Nor are Australians retirement incomes maximised. Governance of super can address this issue, so far the Cooper Review has ignored it.

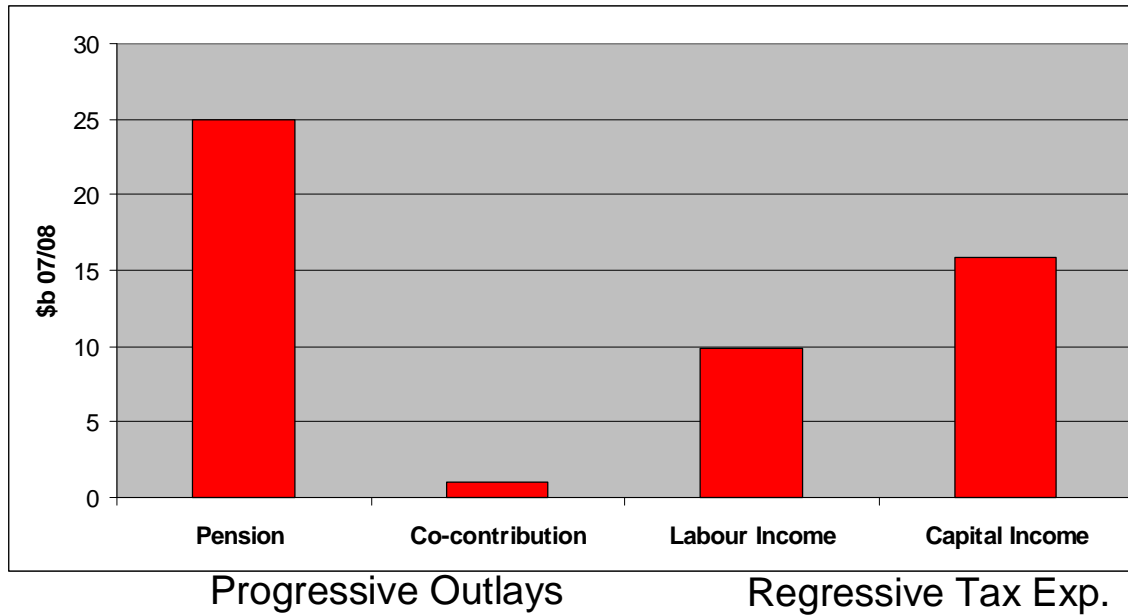
Retirement income generated by a quantum of saving depends on the stock of wealth accumulated. In turn that depends on individual asset returns and the portfolio composition of that wealth. So “maximising retirement incomes” is mostly about the overall portfolio allocation of Australian wealth and the super component of that wealth. It’s also about watching the extent to which locally determined tax and regulatory preferred asset class returns fall because of such preferences. Minor changes in super arrangements can have a significant impact on portfolio allocation, regulatory preference, locally determined returns and consequently retirement incomes. So far the Cooper Review has ignored these issues.

The Review has focussed narrowly on the “intermediary costs” of the super industry. The most significant public policy impact on “intermediary cost” is complexity. So far the Review has ignored this issue. The Review has focussed on 2 dimensions of intermediary costs. Its proposals in this regard are reasonable. But to my mind the narrow focus is a cop out.

# Graph 1: RETIREMENT INCOMES POLICY

Budget Cost and Equity Impact

## 1. Budget Cost



## 2. Who Benefits

**Top fifth  
get 0**

**Top 88%  
get 0**

**Top 8%  
get 29%**

**Top 7%  
own 27%**

**Table 1: Household balance sheet – selected items  
Stocks and indicative returns**

	<b>Stocks \$t, June 09</b>	<b>Indicative Long Term Private Returns % pa</b>		
	<b>Assets</b>	<b>Component Assets</b>		<b>Equity</b>
		<b>Immobile</b>	<b>Debt</b>	
<b>ASSETS</b>				
Housing (1)	3.7	<3		
Deposits	0.5		3	
Super (2)				
Non SMSF	0.7		3	10
SMSF	0.3	<3	3	10
Shares	0.3			10
Other	0.4	?		
<b>LIABILITIES</b>				
Borrowing	<u>1.4</u>	3+ bank spread		
	4.5			
<b>MEMO</b>				
Operating expenses non SMSF super sector	0.60%			
Value of ecosystem services	?			
Future taxpayer liabilities	?			
Notes:				
(1) Including Durables				
(2) Excluding unfunded Super				
(3) Real Interest Rate to lender = 3% equity premium = 7%				

## FOOTNOTES

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1. RBA Bulletin Table B.20 P.S26 Aug. 2009
2. ibid Table G11 p. S85
3. Rothman, A. & Tellis, D. July. 2008, *Projecting the Distributions of Superannuation Flows and Assets*; Retirement and Intergenerational Modelling and Analysis Unit, Department of the Treasury.
4. ibid p. 14, p. 19
5. RBA Bulletin, B20
6. Graph 1, FAHCSIA Budget Statement 2008/2009, Estimated 2007/2008 Age Pension appropriation = \$24.67b

Co-contribution estimate for 2006/2007 prior to one-off doubling was \$1.1b. See – Budget 2007/2008 BP No 2 Expense Measures, Treasury

Treasury TES Jan 2009, 2007/2008. Pension coverage IGR 2007 p. 112

Co-contributions paid to 1.2m in 2005/2006 Rothman p. 12 cf 9.6m <65 getting employee contribution.

Employer contribution: 8% (Chart 5) >\$95k get median contribution \$10k (Chart 3)

2005/2006 scale = 48.5% > \$95k – 15% = 33.5%

(No surcharge applied in 2005/2006) = \$2.57b  
Total = \$8.95 (TES) i.e. 29%

SMSF figures from Rainmaker Roundup, March 2008 p. 3

7. Jun 2007, Rainmaker ibid
8. Pender, H. Joy of Tax p. 61
9. Allen, p. 34, The Allen Consulting Group, Better living standards and a stronger economy: the role of superannuation in Australia.
10. See Cooper Review, structure, p4 and RBA Bulletin, Table B20, PS26 November 2009
11. Cooper Review statistical summary of SMSFs p2.
12. See Cooper Review Matching governance solutions, Dec. 2009 p16.
13. See Cooper Review, Super Stream p15.
14. RBA Bulletin Table B20
15. t = US trillion =  $1 \times 10^{12}$  = one thousand billion
16. See APRA Annual Super Bulletin, June 2009, released Feb. 2010. Appendix Table B. p.23.