ACTU Submission to the Government's Consultation on the Financial System Inquiry Recommendations

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INTRODUCTION

The ACTU represents over 1.7 million workers and their families. Many more have their pay and conditions of employment shaped by the work of our affiliates.

The ACTU welcomed the establishment of the Financial System Inquiry. Workers and unions have a strong interest in a financial system that efficiently allocates capital for the purposes of building a successful, innovative and sustainable economy that generates the jobs, incomes and skills we need as a nation.

However, as the events of the 2008 Global Financial Crisis have shown, there is an urgent need for governments and regulators around the world to take action to counter the tendency of financial markets to fuel destabilising speculative bubbles in property and commodities, and to reduce the excessive costs to investors that opaque and complex financial products allow banks and other financial agents to charge.

We therefore welcome a number of the recommendations contained in the Inquiry's Final Report. Recommendations to strengthen the powers of ASIC and APRA, improve the capital standards that apply to deposit taking institutions, and introduce a leverage ratio comparable to Australia's peers have the potential to significantly increase the stability and resilience of our financial system.

We hope the government will act to implement these recommendations in the months ahead.

The focus of this submission is on a number of recommendations made by the Inquiry in relation to our superannuation system. Unions have a strong and longstanding interest in super. For over thirty years Australian unions have played a leading role in campaigning for better retirement incomes for working people.

Without that campaigning there would be no Superannuation Guarantee and many workers in Australia today would not have their own super account containing savings that will help them live a more comfortable life in retirement. Without unions Australia would not have some of the largest, best performing and well-run not-for-profit superannuation funds in the world.

Most of these funds are governed by boards of directors that comprise equal or majority numbers of employer and employee representatives. Most employee representatives are union members nominated by their union to help ensure funds are operated in the best interests of fund members. Unions therefore have extensive knowledge and direct experience of many of the issues raised by those parts of the Inquiry's Final Report that discuss superannuation and retirement incomes.

In this submission we comment on the following issues:

Objectives of the Superannuation System

While we sympathise with the aim of creating a consensus about the objectives of the superannuation system that will help to stabilise policy settings, we doubt the recommendations made by the Inquiry will be effective. We therefore recommend that the government reject the proposals made by the FSI and instead consider implementing the previous government's plans for a Council of Superannuation Custodians.

Governance of Superannuation Funds

We oppose the Inquiry's recommendation that public offer superannuation funds be required to appoint a majority of independent directors to their trustee boards. There is no evidence that the equal representation model of governance is failing the interests of fund members and no evidence that mandating a majority of independent directors would better serve those interests.

Default Fund Selection

While agreeing with the Inquiry that a quality filter is required to ensure default members are allocated to the best MySuper products, and that employer choice would be an ineffective means of protecting the interests of such members, we oppose the recommendation that a new selection process outside the remit of the Fair Work Commission is either necessary or appropriate. Instead, the government should act immediately to allow the present legislated selection system to operate.

Choice of Fund

The ACTU does not support the Inquiry's recommendation that the Superannuation Guarantee (Administration) Act 1992 be amended to allow unlimited individual choice of fund in the context of enterprise agreements and other forms of collective workplace regulation. If implemented, this recommendation would significantly increase the risk that more employees will invest their contributions in superannuation products that are not in their best long-term interests.

Impact Investment

We oppose the Inquiry's recommendation that government should take further action to promote the development of the impact investment market in Australia. Impact investment in the form of Social Impact Bonds poses risks and costs to taxpayers that render them a more expensive and less accountable way of delivering complex social services than those provided by existing institutions and agencies. The Inquiry's views on impact investment lack a thorough and balanced grounding in evidence and should be rejected.

OBJECTIVES OF THE SUPERANNUATION SYSTEM

The FSI Final Report argues that our superannuation system lacks an agreed policy framework and widely shared objectives. This has the effect of encouraging short-term and ad hoc policy making that imposes considerable costs and uncertainty on funds and their members. The FSI therefore recommends that legislation should enshrine a primary objective for the superannuation system defined as follows:

> *'To provide income in retirement to substitute or supplement the Age Pension.'*

We share the Inquiry's view that superannuation policy settings lack stability. For a mix of commercial and political reasons superannuation has become an area of public policy subject to partisan politics, sectional interests and special pleading.

However, we doubt the Inquiry's proposals will secure the stability and consensus it seeks. This is for two related reasons.

Firstly, many of the very different views about how superannuation should be taxed, regulated and managed reflect sharp differences in material and political interest. They are not the result of a misunderstanding or lack of understanding about what superannuation should be for. Rather, there is a large and politically influential set of private financial institutions who view superannuation almost exclusively as a source of returns to shareholders and bonuses for executives.

They will therefore continually apply pressure to all governments to make it easier to charge commissions, maximise fees, exploit poor levels of financial literacy, and so on. They regard the success and market-share of not-for-profit funds as a barrier to maximising their returns. They will continue to lobby for legislative and regulatory change until that barrier is removed. Some in politics support these efforts. Some oppose them.

This conflict of interests is an important source of many of the recent attempts to reform and re-regulate superannuation and services such as financial advice.

Secondly, the primary objective proposed by the Inquiry, even if enshrined in legislation, is very unlikely to change existing attitudes and behaviours among industry participants and political representatives. This is because it lacks measureable and limiting content. It is sufficiently vague that all those institutions and political actors involved in superannuation can pay lip service to it while continuing to behave in ways they have always done.

Consensual support for the proposed objective may have some symbolic value but it will have little practical significance. We doubt it is currently possible to define a primary objective for superannuation that will enjoy lasting consensual support and significantly change industry and political behaviour.

Superannuation is a politically contested area of public policy and is very likely to remain so. Legislation will not resolve this.

In our submission to the FSI last year we argued that the previous government's proposals to establish a Council of Superannuation Custodians, charged with monitoring a Charter of Superannuation Adequacy and Sustainability, should be reinstated and allowed to operate as originally intended. The Council would assess future policy proposals relevant to superannuation and its interaction with the broader retirement income system against the Charter, with the aim of ensuring they were consistent with key principles such as adequacy, sustainability and fairness.

This Council and Charter will not by itself generate consensus. However, in an essentially contested area of policy it could serve as an important and authoritative counter-weight to the political expediency and short-termism that often characterises the making of superannuation policy. While the success of such an initiative cannot be guaranteed in advance, we believe it has the potential to make an important contribution to generating much needed stability and transparency to policy and the superannuation industry.

In summary, while the ACTU sympathises with the aims of the FSI in this area we doubt the recommendations it makes will achieve the stability and consensus it seeks. We recommend that the government rejects the proposals made by the FSI and instead consider implementing the previous government's plans for a Council of Superannuation Custodians.

GOVERNANCE OF SUPERANNUATION FUNDS

In relation to the governance of superannuation funds the FSI Final Report recommends that government should mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds.

Unfortunately the Final Report's arguments in support of mandating a majority of independent directors lack a basis in relevant evidence, are sometimes confused and misleading, and demonstrate an apparent ignorance of the important differences in law that distinguish the governance of superannuation funds from that of other financial institutions.

In short, the Final Report argues there are 'shortcomings' in the governance of superannuation funds that mandating majority independent directors will help to resolve. This would be consistent with international best practice in corporate governance. Better governance as a result of this mandated change may result in higher returns to members (pp. 133-134).

There are a number of problems with the argument presented in the Final Report.

Firstly, the Report asserts the existence of shortcomings in fund governance but does not specify what they are and how prevalent they may be. It is implied that funds governed on an equal representation basis suffer from poor decision making that may be damaging members' interests. However, the Report offers no evidence in support of this implication.

Which funds governed by representatives of employers and employees are making poor decisions? What is the nature of those poor decisions? Which members are suffering financial detriment as a consequence? The Report is silent on these important questions. We are not aware of any evidence that equal representation governance acts to disadvantage members. The FSI does not appear to be aware of any such evidence either. In place of evidence the FSI relies on assertion and assumption.

This is not an appropriate way to conduct the development of public policy.

The strong and consistent evidence is that members of funds governed on an equal representation basis receive higher average net returns than those who are members of retail funds. For example, the 2014 Annual Superannuation Bulletin reports that over periods of 1, 10 and 15 years industry funds outperformed retail funds by over 1 per cent.[1]

We believe equal representation is a form of good governance that has contributed to this performance in large part because those directors who represent employers and employees have no beneficial interest in the funds they govern and in the entities that provide relevant investment products and services.

The FSI presents no evidence to the contrary and yet asserts that mandating the effective abolition of equal representation is necessary.

The FSI suggests that 'good governance', when it involves independent directors, could increase returns to members by 1 per cent (p. 133). However, when funds are governed on an equal representation basis, and actually deliver returns that are 1 per cent higher than many others, the FSI appears to believe that the source of this better performance must lie somewhere other than in how the funds are governed (p. 135).

It is hard to escape the conclusion that the FSI is not interested in evidence and reasoned argument when it comes to assessing the contribution of equal representation governance to fund performance. Boards that comprise a majority of independent directors are simply assumed to be the ideal that all boards should emulate. Any other form of governance is, by definition, sub-optimal and so must be subject to shortcomings none of which require substantiation.

Secondly, the FSI does not appear to be aware that a number of researchers in corporate governance have tested the claim that independent directors tend to improve the financial performance of the organisations they govern – and found no convincing evidence that they do. For example, a University of Melbourne study in 1999 examined the relationship between board composition and corporate performance in Australia and internationally during the 1980s and 1990s. It drew the following conclusions:

> 'Those studies that have sought to find a relationship (direct or indirect) between board composition and corporate performance have, overall, not produced convincing evidence that independent directors enhance corporate performance…As far as Australia's largest listed companies are concerned, independent directors do not appear to have added value over the 1985 to 1995 period.'[2]

In the context of considering why independent directors do not necessarily add value the University of Melbourne research concluded that formal independence may be an inappropriate proxy for what makes a director an effective monitor of a CEO and executive management. In short, there is no necessary relationship between being an independent director and being willing and able to devote the time, energy and critical thinking needed to hold management to account.

Since the University of Melbourne study other research has also questioned the assumed value of independent directors on boards. For example, a recent quantitative study by researchers at the

[1] APRA (2014) *Annual Superannuation Bulletin*, APRA, Sydney.
[2] Lawrence, J. and G. Stapledon (1999) *Do Independent Directors Add Value?* Centre for Corporate Law and Securities Regulation, University of Melbourne, pp. vi-vii.

University of New South Wales that examined the impact of independent directors on the performance of a sample of large ASX listed firms between 2002 and 2012 found that the replacement of more knowledgeable directors with newly appointed independents resulted in poor takeover decisions that destroyed up to $10 billion in shareholder value.

The authors are critical of the tendency by regulators, such as APRA and the ASX Corporate Governance Council (ASX CGC), to develop new governance rules on the basis of gathering industry opinion rather than on the basis of empirical research. They also pointed out that director governance rules around the world varied significantly, and so claims that there is one global standard to which ASX rules comply is simply incorrect:

> 'The ASX CGC/APRA rules do not seem to be based on any quantitative research into the likely effects of the [independent director] rules. Nor after these rules have been in place for over a decade does the ASX CGC appear to have even asked simple questions about what their rules may have actually achieved. Was shareholder wealth actually created or destroyed?...Moreover, the claim made by the ASX Governance Council that their recommendations represent 'international best practice' seems to be misleading and possibly deceptive. In fact, doing the reverse of their recommendations would seem to provide a better guide to genuine wealth creation and progress toward an effective corporate governance framework in many instances.'[3]

The FSI, in common with many uncritical advocates of majority independent directors, does not engage with any of the complex empirical, conceptual and policy issues thrown up by research into the actual impact of independent directors on real world organisations. There is a consensus among business leaders, many of whom serve as independent directors on multiple boards, that such directors are inherently 'a good thing.' That appears to be good enough for the FSI.

In 2012 the Productivity Commission conducted an inquiry into the selection of default funds in modern awards. As part of its inquiry the Commission considered the relevance of governance to the selection of funds to serve as defaults. The Commission concluded that the evidence relating to board composition and organisational performance was inconclusive. In its Draft Report the Commission therefore recommended that the 'government should consider assembling a panel of corporate governance experts and relevant regulators to assess the appropriateness of board structures of default superannuation funds.'[4]

In its Final Report the Commission revised this recommendation:

> '...in view of the lack of definitive evidence in favour of any particular board structure, it does not consider that this exercise would provide net benefits at this time. The Commission prefers that the impact of the Stronger Super reforms on governance be observed before recommending such a review.'[5]

In short, the Commission concluded that there was no evidence to justify mandating changes to board structures, but any further consideration given to this issue should await an assessment of the impact of the recent reforms to governance already being implemented by government and APRA.

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[3] Swan, P.L. and D. Forsberg (2014) *Does Board Independence Destroy Corporate Value?*, University of New South Wales Business School, Sydney.
[4] Productivity Commission (2012) *Default Superannuation Funds in Modern Awards Draft Report*, p. 89.
[5] Productivity Commission (2012) *Default Superannuation Funds in Modern Awards Inquiry Report*, p. 103.

The ACTU would welcome an evidence-based assessment of the different composition of boards across Australian superannuation funds and their relationship to net investment performance. We are confident that such an assessment would establish the effectiveness of equal representation governance. However, the FSI does not discuss the reforms to the quality of fund governance that are currently underway and how these may address the (unsubstantiated) shortcomings it appears to believe characterise the equal representation model. This again reinforces the impression that on this issue the FSI's view is resistant and indifferent to evidence.

Finally, in their Final Report the FSI does not appear to appreciate the distinctive legal framework within which Registered Superannuation Entities operate and the important implications this has for the nature of the relationship between funds and their members. This leads them to assume that it is appropriate to compare superannuation funds with banks and insurance companies for the purposes of identifying potential reforms to how funds are governed. However, such a comparison is not appropriate.

With the exception of public sector funds and Retirement Savings Accounts, all superannuation funds in Australia must be established as trusts. Trust law proscribes a set of principles and rules of general application that govern the relationship between the trustee and beneficiaries of the trust, central to which is the notion of fiduciary duty. This duty means that the trustee is expected to serve faithfully the interests of the fund members within the terms of trust to the exclusion of the fiduciary's own interests.

This general law expectation is codified and reinforced by a set of non-excludable and irrevocable covenants prescribed by Section 52(2) of the Superannuation Industry (Supervision) Act 1993 and Regulations. In particular, the trustee must act in the best interests of the beneficiaries [s.52(2)(c)] and exercise due care, diligence and skill in dealing with the property of another [s.52(2)(b)].

The Stronger Super reforms resulted in the Section 52(2)(b) covenant being strengthened. Previously, trustees were expected to exercise judgement in a manner comparable with an 'ordinary prudent person'. The SIS Act has been amended so that all judgements must be consistent with those that would be made by a 'prudent superannuation trustee'.

The legal obligations placed on the directors of superannuation funds are therefore qualitatively different than those placed on the directors of banks and insurance companies. Fund directors have a fiduciary relationship with fund members, one which imposes standards of trust, care, diligence and prudence that are not comparable to the commercial contractual relationships that banks and insurance companies have with their customers.

In the context of Equal Representation governance this fiduciary relationship is further enhanced by the appointment of directors all of whom are independent of executive management and are therefore well placed to hold management to account. The willingness of member and employer-nominated directors to apply independent critical judgement to how fund management perform is reinforced by the fact that they are nominated by shareholders and sponsoring organisations none of whom have a beneficial interest in how funds operate.

This contrasts sharply with the practice of retail funds where many directors are appointed by a related corporate body which has a strong commercial interest in how member contributions are managed and invested.

The view of the FSI appears to assume that the logic for recommending or mandating the appointment of independent directors to the boards of large listed companies is relevant to superannuation funds that are governed wholly or mostly by representative trustees. However, this assumption is misplaced. The primary reason for including independent directors on the boards of listed companies is to check the influence and interests of directors who are also members of executive management. In Australia, no fund with a representative governance structure has a director who is also a member of the fund's executive management.

In conclusion, the ACTU believes the government should reject the FSI recommendation that public offer superannuation funds be required to appoint a majority of independent directors to their trustee boards. There is no evidence that the equal representation model of governance is failing the interests of fund members and no evidence that mandating a majority of independent directors would better serve those interests.

DEFAULT FUND SELECTION

The Final Report argues that the absence of strong consumer-driven competition, particularly in the context of how default funds are chosen, is a key reason why the increasing scale of the Australian superannuation system has not resulted in expected reductions in fees. The FSI agree that some form of quality filter is needed to protect disengaged members from the wide variation in costs and performance that currently characterise the MySuper market.

The Report recommends that if the recently introduced Stronger Super reforms do not result in significant improvements in system efficiency for default members by 2020, then a new formal competitive process to allocate new default members to MySuper products should be introduced. We welcome some of what the FSI has to say on the matter of default funds and how the interests of disengaged fund members should be protected.

Members of the current government, along with bank-owned super funds, have expressed the view that the primary barrier to better outcomes for default members lies in the inability of employers to choose any MySuper product they wish. If were allowed to so do, it is argued, competition would increase and default members would benefit accordingly.

The FSI Final Report firmly rebuts this view. The primary barrier to effective competition in default super is persistently low levels of member engagement and financial literacy. This will not be overcome by forcing employers to unilaterally choose default funds. In fact, as the Final Report notes, employers 'are generally ineffective in driving competition in the superannuation market.' This is because 'employers face high search costs, may lack information and expertise to make an appropriate choice for their employees and may choose a fund based on auxiliary benefits specific to the employer, such as low administrative costs' (p. 106).

We also agree with the FSI that simply because a product complies with current MySuper regulations does not mean it would necessarily serve as a suitable product for default purposes. There must be a quality filter that means only the best performing and most appropriate MySuper products receive the contributions of disengaged members.

The ACTU agrees with the FSI on these matters. These conclusions contradict key aspects of the current government's declared thinking about how default superannuation should be regulated. We hope the government will take note of what the FSI says and conclude that it would not be in the best interests of millions of disengaged workers to introduce a new default selection system based on allowing employers to choose any MySuper product they wish.

However, while we agree with the FSI on these issues we strongly disagree with the FSI on a number of others.

It is important to recognise what superannuation contributions are. This helps to clarify how they should be regulated.

Superannuation contributions are deferred wages. They are a benefit of employment that is a product of the employment relationship and which belong to each employee. Some unions successfully bargain to increase the contribution rate above the legislated minimum. Because the performance of superannuation funds varies widely, unions also place a high priority on making sure contributions are made to those funds that best represent their members' interests. In addition, many unions are actively involved in making sure employers fully comply with their obligations by taking action to ensure that contributions are paid in full and on time.

Superannuation is therefore an industrial issue. The payment, quantum and allocation of contributions vary between employers. Unions play an important role in making sure the interests of millions of employees, many of whom are disengaged from their super, are adequately protected. It is therefore appropriate that workers and their representatives have a say in relation to the level of contributions and which funds those contributions are made to. Having such a say not only helps to protect workers long-term financial interests, it helps to promote engagement with, and understanding of, superannuation more generally.

The ACTU is therefore a strong supporter of the arrangements for selecting default funds to be listed in modern awards that began to be implemented after 1 January 2014. Full implementation has been delayed because the current government has failed to fulfil its obligation to appoint additional members to the Expert Panel of the Fair Work Commission (FWC).

Our view is that the new system, when fully operational, will provide an effective quality filter that will help to ensure that only the best performing and most appropriate MySuper products are named in awards. The 2012 Productivity Commission inquiry into default funds recognised that the FWC's role in selecting default funds had successfully advanced the interests of most default members. There is no reason to believe that this would change under the system that is currently awaiting full implementation.[6]

In their Final Report the FSI recognise that choosing between MySuper products is not a simple fee-based comparison. Fees can be reduced quite easily if the associated contributions are invested in cheap, passive and underperforming assets. That would not serve the best interests of members. The question of fees has to be considered in the context of likely net returns and the suitability of associated products such as insurance.

A further issue is 'flipping': the widespread practice among retail funds of moving a member into a higher-cost product when they leave an employer and are no longer entitled to remain a member of that employer's super plan. It is clearly not in the interests of a disengaged member to find

[6] Productivity Commission (2012) *Default Superannuation Funds in Modern Awards Inquiry Report*.

themselves in a high-cost plan that will significantly reduce their retirement balance simply because they change employer.

Under the current system the FWC, with input from experts and representatives of employers and employees, will have the scope to consider the full range of issues relevant to choosing a MySuper product. These include: the likely net return; the risk of being charged higher fees following a change in employment; the availability of an insurance product that is appropriate to a particular industry and occupation.

This selection process will screen-out poorly performing funds, allocate the best performing MySuper products to the most appropriate awards, and allow workers and their representatives to have a say about how their contributions should be managed on their behalf. This constitutes an effective, transparent and accountable quality filter that should be allowed to work and generate results before alternatives are considered by government.

Unfortunately, the FSI Final Report does not contain a meaningful discussion of the FWC process and how it might deliver many of the outcomes the Inquiry seeks. Instead the FSI argues that if the superannuation system as whole does not display greater efficiency by 2020, then the arrangements for selecting default funds should be changed.

The FSI appears to believe that the reason for 'system inefficiency' (i.e. higher fees than should be the case) is the way default funds are regulated. It seems that default funds are expected to carry responsibility for the performance of the whole superannuation system.

This perspective wilfully ignores the role of retail 'choice products' in sustaining high fees while delivering poor returns. The assumption appears to be that members of choice products can be assumed to have made rational decisions and can therefore be left to pay whatever fees are charged to their accounts. This ignores the prevalence of low financial literacy and how this is exploited by retail funds via product proliferation, misleading branding and incessant advertising noise. This is compounded by the use of commissions to incentivise their distribution and sale.

Up to a quarter of all superannuation assets in Australia take the form of retail choice products.[7] And yet the FSI has little to say about how fees attached to these should be reduced and returns increased. Unless action is taken to reduce choice product-related costs, such as by banning commissions, it is difficult to see how real progress can be made in increasing the efficiency of our superannuation system as a whole.

In summary, the ACTU does not support the recommendations made by the FSI that a new default selection process should be considered for implementation. Default selection via the FWC has a proven record of protecting members' interests. Looking forward, the new FWC system offers a transparent, flexible and accountable process that recognises the industrial status of superannuation contributions and the right of workers to have a say about how their retirement savings are managed. The government should therefore reject the recommendations made by the FSI and immediately enable the currently legislated process to operate.

[7] APRA Superannuation Statistics, December Quarter 2014.

CHOICE OF FUND

The Inquiry argues that a significant minority of employees, partly because of enterprise agreements, are prevented from choosing which fund their superannuation contributions should be paid to. The Inquiry takes the view that all employees should be allowed to choose their own fund and recommends that the provisions in the Superannuation Guarantee (Administration Act) 1992 that prevent this should be removed.

The ACTU does not support the Inquiry's recommendation for the following reasons.
Firstly, the FSI appears to believe that the provisions in enterprise agreements relating to superannuation are inherently limiting of individual choice. This is not the case. Most agreements do not name any fund, name a number of funds from which employees can choose, or specify a default fund while allowing choice of any other.

Enterprise agreements allow workers to collectively decide which provisions relating to choice of superannuation fund are most appropriate to their industry and workplace. This is appropriate in a context where contributions are deferred wages and should therefore be subject to collective determination and regulation.

Secondly, the FSI argues that unlimited individual choice in the context of superannuation is, as a matter of principle, a good thing. However, we know that across much of the working population financial literacy is generally low and informed engagement with superannuation is rare. The advocacy of unlimited choice in this context will generate costs and risks to employees that the FSI appears indifferent to.

Unlimited choice in a market suffused by consumer inertia, information asymmetries and principle-agent problems will significantly increase the risk that more employees invest their contributions in products that are not in their best long-term interests. In a context where employees are compelled by law to make contributions to privately operated funds, public policy should be concerned to protect the interests of employees. One way of doing this is to allow workers, in consultation with their representatives, to collectively determine which funds are most appropriate for them.

The ACTU recommends that the government reject the Inquiry's proposals relating to choice of fund.

IMPACT INVESTMENT

The Final Report recommends that government should explore ways to facilitate further development of the impact investment market and so encourage innovation in funding social service delivery.
The ACTU does not support government action to develop the investment impact market.

To date, the record of impact investing in the form of Social Impact Bonds (SIBs) does not indicate that they will generate the positive transformations in social programs on a scale that justifies the costs and risks to taxpayers. The experience of SIBs in the UK (e.g. Peterborough Prison), the US (e.g. Rikers Island) and Australia (e.g. Newpin) is that investors are prepared to fund complex and high-risk social programs under two conditions:

a) When their financial interests are already mediated by strongly held social and philanthropic concerns.

For example, most of the investors in the Peterborough Prison SIB were charitable trusts and foundations with an interest in reducing re-offending among former prisoners as part of their broader social concern to promote the well-being and rehabilitation of those sentenced to prison for short periods of time. Their primary concern was not to secure a financial return. This meant they were prepared to accept all the financial risk that the SIB involved. If the SIB failed to meet agreed targets, then the investors would receive no performance payments and would lose all of their principle investment. This form of full-risk transfer in the context of delivering complex social services is very unlikely to appeal to commercial investors.

b) When the SIB involves only a partial transfer of financial and performance risk to the investors.

In this context government may agree to make payments and return some or all of the investment principle even when only a proportion of the target performance is met. To further attract investors, government may set targets that are sufficiently low to effectively guarantee a given rate of return. For example, in the case of the Rikers Island SIB in New York most of the $9.6 million investment by Goldman Sachs has been guaranteed by a grant from Bloomberg Philanthropies that effectively limits the maximum possible loss to $2.4 million. In addition, the City authorities have agreed a performance schedule for the SIB which means that the investors will receive back the full value of their principle even when their performance fails to generate sufficient savings to the City to cover the costs of the SIB to the taxpayer.

A key rationale for SIBs is that the transfer of risk from government to private investors will provide powerful incentives to innovate and secure high levels of performance. However, the evidence so far suggests that many commercial investors do not regard this risk transfer as acceptable. To attract such investors governments have increasingly been prepared to guarantee returns and soften targets. How this will spur innovation, and deliver savings for taxpayers, is far from clear.

Given the increasing willingness of governments to subsidise SIBs, it is not surprising that in its recent review of their performance McKinsey concluded:

> ‘SIBs are a more expensive way to finance the scaling up of preventative programs than if the government simply went directly to service providers and paid them to expand an intervention to more constituents.’[8]

Many of those who have advocated the further development of the ‘impact investment’ market to the FSI have a material financial interest in using such a market to secure taxpayer-subsidised returns and to charge for the advisory and financial services that an expanding market will generate demand for.[9]

Unfortunately, the FSI does not appear to have engaged with evidence relevant to the evolving structure and performance of SIBs and the risks they present to taxpayers. The Inquiry appears to have made no effort to seek the views of those critical of this controversial area of policy prior to

[8] McKinsey (2012) *From Potential to Action: Bringing Social Impact Bonds to the US*, p. 49.
[9] Advocates of ‘impact investment’ cited by the FSI Final Report (p. 262) include Westpac, Impact Investing Australia (which is sponsored by NAB and QBE Insurance), and the Impact Investment Group (an investment funds manager).

making its recommendations. Instead, it has preferred to uncritically accept the views of organisations who have a vested interest in their wider use and who view them primarily as a potential source of quick and easy profit.

The ACTU therefore recommends that the government should reject the proposals made by the FSI in relation to impact investment.

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