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Superannuation
Productivity Commission
Locked Bag 2, Collins St East
Melbourne VIC 8003
AUSTRALIA

Email: www.pc.gov.au/inquiries/current/superannuation/alternative-default-models

Dear Chairman,

Alternative Default Models

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission on the Productivity Commission's draft report on Alternative Default Models.

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system so people can live in retirement with increasing prosperity. We focus on the issues that affect the entire superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90 per cent of the 14 million Australians with superannuation.

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If you have any queries regarding the contents of our submission, please contact Andrew Craston

Yours sincerely

Glen McCrea
Chief Policy Officer

1. Introduction

ASFA welcomes the opportunity to review the Productivity Commission's *Superannuation: Alternative Default Models* draft report and provide this submission. In drafting this submission, ASFA consulted with, and sought input from, its membership.

ASFA considers that a competitive, efficient and dynamic superannuation system is crucial to ensure people retire with dignity – where the system provides retirement income that supports a comfortable standard of living in retirement, supplementing or substituting the Age Pension. ASFA supports reforms to the superannuation system that are in the best long-term interests of fund members.

Each of the Commission's proposed models in its draft report would involve significant changes to the superannuation system, and would have consequences for the superannuation industry and fund members. As such, the potential impacts of any changes demand careful consideration.

The Australian superannuation system is widely considered to be one of the best in the world, and it touches the lives of almost every Australian. The $2.2 trillion in superannuation assets represents the accumulated retirement savings of Australian workers and retirees. The retirement incomes (and lump sums) generated from superannuation savings allows individuals to achieve a higher standard of living in retirement than otherwise would be the case.

For the Australian Government, the superannuation system helps the long-term sustainability of the Commonwealth budget. The projected growth in Australia's superannuation assets over coming decades – and the associated income – will limit the Commonwealth's Age Pension expenditure. The trajectory of Australia's expenditure on public-provided pensions is among the lowest in the OECD.

More broadly, the superannuation system is a significant and growing source of funding for the Australian economy, and saving via superannuation has helped to boost Australia's national savings rate.

2. The Commission's approach to assessing its models

ASFA has a number of high-level comments about the Commission's approach to assessing its models.

2.1 Assessment process

According to the Commission's Terms of Reference for its superannuation work, in Stage 2 the Commission will seek to determine which of its proposed models would work best to improve the efficiency and competitiveness of the default market. In Stage 3, the Commission will assess the efficiency and competitiveness of the broader superannuation system.

ASFA notes that the Commission's Stage 3 assessment may determine that certain areas of the system have issues around efficiency and competitiveness. As such, the Commission might determine that it has to adjust model settings, and that other policy changes – which potentially would improve system efficiency and competitiveness – might emerge.

2.2 Assessment methodology

In its draft report, the Commission assesses its proposed models relative to a (hypothetical) system that features unassisted choice (in qualitative terms), rather than current default arrangements. ASFA understands why the Commission has adopted this approach. It provides a 'baseline' by which to assess the models vis-à-vis a world with 'no defaults'. As such, ASFA's approach to assessing the Commission's proposed models is to outline the main pros and cons of each of the models relative to a baseline of 'no defaults' (in Sections 5 to 8).

In its draft report, the Commission states that its assessment of whether a model is better or worse than 'current default arrangements' will be 'core' to Stage 3.[1] ASFA considers that such assessment should include quantifying;

- any efficiency gains from imposing a default fund selection model – taking account of, among other things, the effects on the behaviour of system participants from imposing the model
- the costs (and risks) of transitioning from current settings.

With respect to the broader superannuation system, the Commission notes that 'the broader regulatory regime governing the system should be conducive to competition'. In this regard, the Commission puts forward a number of legislative changes that could potentially improve competition and outcomes for members – including by reducing barriers to exit.[2] As such, within the context of the broader superannuation system, ASFA considers that the Commission should consider;

- changes to the legislative framework that would reduce barriers to exit which ASFA has highlighted in previous submissions (see Section 10)
- benefits of recent improvements to ATO (SuperStream) architecture (see Section 11).

2.3 Assessment in a broader context

Further, ASFA considers that the models also should be assessed from a broad perspective that takes account of the economic wellbeing of the Australian population.

In this regard, ASFA has long advocated for the formalisation of a holistic objective for superannuation. Superannuation ultimately is about delivering income that affords a comfortable standard of living in retirement. In this context, ASFA considers that the objective of the system should be;

> *"To provide an adequate income to ensure all Australians achieve a comfortable standard of living in retirement, supplementing or substituting the Age Pension."*

As such, ASFA considers that the models should be assessed with respect to this objective. For example, each of the models could have implications for Commonwealth Age Pension expenditure.

[1] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 4.
[2] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 88.

3. The Commission's proposed models – key concerns

ASFA's approach to assessing the Commission's proposed models is to outline the main pros and cons of each of the models relative to a baseline of 'no defaults' (in Sections 5 to 8). That said, ASFA has particular concerns with some aspects of the models.

3.1 Treatment of insurance

In assessing each of the models, the Commission excludes bundled insurance products and instead treats insurance as a 'regulatory add-on'. The Commission assumes that trustees would choose to bundle their superannuation product with insurance so that they meet their fiduciary and legislative obligations, but "the models do not involve comparing the quality or price of bundled insurance".[3] The Commission's rationale for excluding insurance from assessment is;

> *"It should also be self-evident to funds and their advisers that the Government's stated objective for the superannuation system does not envisage insurance as an essential element of the system".*[4]

On this point ASFA disagrees with the Commission. Even if the primary objective legislation passes parliament (which it is yet to do), this will not preclude insurance continuing to play an important role in the system. The potential benefit payments to a dependant due to the premature death of the main income earner or to a person who retires early due to disablement, is in line with the objective of superannuation.

Industry is working to improve insurance in superannuation through self-regulation and believes it is a key criterion in any default fund selection process.

These issues are explored in greater detail in Section 9.

3.2 The 'last-resort fund'

The *Assisted Employee Choice Model* envisages that a 'last-resort fund' – for members that do not exercise choice – would be run by the Future Fund (FF) or an existing eligible rollover fund (ERF) or funds.

ASFA considers that there are significant problems with this proposal. Neither the FF nor an existing ERF are suited for the proposed purpose.

The FF effectively operates as the Australian Government's wholesale investment manager. However, the FF lacks the required governance framework and administrative capabilities needed for it to operate in a superannuation context.

Further, broadening the role of the FF – from managing money to meet public liabilities to also managing private superannuation assets – would represent an erosion of the investment governance frameworks that are critical to the delivery of member returns. It also would increase political risk for the FF and the Government, and risk heightening market or member perceptions that savings are underwritten by the Government.

[3] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 10.
[4] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 81.

An ERF(s) also would require significant governance and operational changes. The investment strategy of an ERF is generally capital stable or conservative, and thus would be expected to underperform relative to typical MySuper products over the medium to long term. Indeed, an ERF may struggle to satisfy APRA that its investment strategy is suitable for 'default' members who have contributions made on their behalf.

Given their purpose, neither the FF nor ERFs offer insurance (unlike MySuper products), nor have the capability to do so.

These issues are explored in greater detail in Section 5.

3.3 The Fee-based Auction Model

ASFA considers that the *Fee-based Auction Model* would pose a significant risk to members' long-term outcomes and the stability of the broader system. The Chilean experience – with a fee-based tender – highlights a host of problems with this type of model.

Over the long term, this model would risk a 'race to the bottom' among funds. In particular, it would likely provide funds with incentives to develop products (for the auction) that focus on lower fees at the expense of long-term returns. Further, a system focused on fees (and thus costs) would not be conducive to innovation. This would be detrimental to member outcomes over the long term.

It is doubtful that this model would generate effective competition that would be in the best long-term interests of members. In Chile, successive tender rounds have not led to an increase in competition for the market, or in the market. For example, participation by Chilean (pension fund) providers in successive tender rounds has declined markedly – from four participants in the first round in 2010, down to a single participant in the latest round in 2016.

This model would introduce a range of risks to stability – both with respect to funds and the broader system. For example, successive auction rounds may push down fees to levels that compromise fund viability. In addition, in an effort to reduce costs, funds might reduce resources for compliance and risk management, and may not invest sufficiently in quality controls.

These issues are explored in greater detail in Section 8.

3.4 Centralised clearing house

The Commission is proposing to explore further the option of a centralised clearing house. Employers would remit all superannuation contributions directly to a single centralised clearing house. In turn, the clearinghouse would direct the contributions (money and data) to the relevant superannuation funds.

ASFA strongly opposes a centralised clearing house for the Australian market as it would introduce new and substantial risks and costs to government, employers and funds (and therefore members) without continuing to leverage the benefits of SuperStream.

Most importantly, the costs and risks of transitioning from the current multi-provider model (with mandated payment and data standards) to a single provider model are likely to be significant, without any benefit for superannuation members.

An alternative and proven approach to a more efficient processing of contributions is universal money and data processing standards (this is what SuperStream is all about). Since its introduction in 2012, SuperStream has considerably improved the quality and completeness of superannuation data and replaced costly and cumbersome manual processes. Because of the introduction of SuperStream, most (if not all) contributions are currently processed and allocated to members' accounts within three business days upon receipt of money and complete data.

These issues are explored in greater detail in Section 11.

3.5 References to scale

The Commission makes references to the number of funds and fund scale in the superannuation industry, which require greater context.

At the fund level, industry consolidation has been a significant source of scale over the last two decades. Since 1996, the headline number of APRA-regulated institutional funds has declined from just less than 5,000 funds to 225.[5] However, the headline number understates the degree of market concentration. After accounting for funds that exist under the same RSE licensee (or within the same corporate entity), ERFs and funds that only provide insurance (that is, no investment/accumulation element), the number of APRA-regulated institutional funds is around 160. Indeed, the number of funds has fallen by 9 since the Commission started its superannuation work.

Fund mergers have driven much of this consolidation. ASFA is supportive of fund mergers, where it is in the best interests of both groups of members.

However, consolidation is not the only source of scale for funds. Smaller funds, in particular, can achieve significant scale economies by outsourcing their functions to external service providers (where some service-provider markets have undergone significant consolidation in recent years). Trustees outsource a broad range of functions – which typically include fund administration, investment management and asset consulting, custodial services, insurance, advice and trustee services. It is important to note that although funds outsource many of their functions, they cannot outsource their responsibility for the performance of those functions.

4. The Commission's proposed models – model design

Throughout its draft report, the Commission notes various challenges regarding model design, which apply to its proposed models to varying degrees. ASFA has a number of high-level comments in this regard.

4.1 Government-appointed bodies

Three of the four models (that is, excluding the *Fee-based Auction Model*) envisage a government-appointed body that would oversee the selection of 'default' funds and would be required to exercise significant judgement in this regard (in each case, the body would exist only for the selection task for each selection round).[6]

[5] At the end of the December quarter 2016 (APRA, *Quarterly Superannuation Performance*, December 2016).
[6] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 16.

It may prove difficult to find individuals who have the required depth of skill, and are free from conflicts of interest. The Commission acknowledges this in its draft report.[7] There is also the risk of political influence – in particular, that the membership of the body would be reviewed and altered upon a change of government.

An additional issue is that the draft report is not clear as to whether the cost of running the government-appointed body would be recouped from the superannuation industry (and, as such, ultimately borne by fund members).

4.2 Loss of 'default' status

For each of the models, it would be expected that future selection rounds would see some of the initial set of 'default' funds lose their 'default' status (or 'preferred default' status for the *Assisted Employer Choice Model*). A fund that loses its 'default' status (or 'preferred default' status) might still be a 'good' fund – this is more likely to be an issue where a model has a very small number of players.

In this regard, for 'first-timer' members, their funds' loss of 'default' status (or 'preferred default' status) may signal that it is inferior – even if the fund is just 'outside' the cohort of selected funds (ASFA notes that this is less likely to be an issue for the *Assisted Employer Choice Model*).

Some 'first-timer' members of such a fund might have difficulty comprehending why they were allocated to a particular fund (by the government-appointed body), only to have their funds' status down-graded. The Commission alludes to these issues in its discussion of the *Multi-criteria Tender Model*, but they also apply to other models.

4.3 Model design and product differentiation

For a particular model, model design would likely affect the degree of differentiation in 'default' product offerings. Broadly speaking, the smaller the number of funds to be selected for a 'default' market, and the heavier the filter used to select those funds, the greater the risk that product features would tend to converge. This is a particular risk for the *Fee-based Auction Model* – where a fee-based auction is, in effect, a very heavy filter (as acknowledged by the Commission), and the awarded tender (as proposed) could be limited to a single fund.[8]

In this regard, there may be some industries that have specific characteristics – a particular type of employee, employment group or other demographic – that may not be able to be provided for in a generic default product.

4.4 Model design and competition

Model design would likely affect the degree of rivalry in a 'default' market. This is particularly relevant to those models with a very small number of players, where there is only periodic threat of market entry. There is trade-off between the (higher) cost of more frequent selection rounds and providing more frequent opportunities for market entry.

[7] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 183.
[8] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 14.

If selection rounds are too seldom, there is a risk that incumbent funds would lack incentives to innovate, improve the quality of their products and services, and tailor their products and services so they meet customers' preferences.

Assessment of the models

5. Assisted Employee Choice Model

To be consistent with the Commission's methodology in its draft report, ASFA's assessment of the pros and cons is relative to the baseline of 'no defaults'.

Pros

This model involves a shortlist of 4 to 10 'default' funds (chosen by a government-appointed body). To the extent that the criteria for inclusion in the shortlist were clear and unambiguous, the selection process would be transparent. Appropriately designed and applied filters could lead to the selected products meeting a high set of standards deemed appropriate for 'default' members.

This model could support member ownership of, and engagement with, their superannuation. Making available a shortlist of funds to employees may see some members, who might otherwise not take an interest in superannuation, engage and choose a fund.

For those members that are already engaged with their superannuation, the shortlist would provide a benchmark against which to compare fund performance, including funds that are not on the shortlist.

For employers, this model would mean that there are no costs associated with assessing and selecting a fund on behalf of their employees.

Cons

By design, the proposed 'default' market would exclude funds that provide value for new members that do not otherwise choose. This model places an arbitrary limit on the number of 'good' funds (in the proposed 'default' market) of 4 to 10 funds.

ASFA contends that regardless of the filter applied to select funds, there is likely to be many more than ten 'good' funds. This position is based on evidence from the current market. APRA has authorised over 100 MySuper products (around 80 of which are public-offer). Funds have made substantial investments to ensure they meet the regulatory requirements to achieve MySuper authorisation for their products, and APRA is working with funds that are not meeting expectations.

This model attempts to generate engagement and choice among members in the proposed 'default' market. However, since all of the funds on the shortlist are deemed to be 'good', there is a risk that this approach might not lead to an increase in member engagement in choosing a fund from that list.

ASFA considers that any model that promotes choice should seek to educate consumers at the decision point. This model would be improved if it provided employees with guidance on how to

make an informed decision utilising the diverse suite of support options available to them, rather than discounting such options as the Commission has done. For employees who wish to select their fund, there is a range of existing mechanisms available for them to determine whether a product suits their needs. These include short-form PDS's, general advice, comparison sites and research house information, and personal financial advice.

Box 1: MySuper authorisation

Prior to the advent of MySuper, any licensed superannuation fund was able to receive default contributions (subject to any restrictions on receiving contributions applying to non-public offer funds and any restrictions imposed on employers by industrial awards and agreements). However, the Stronger Super regime required default contributions to be paid only to a MySuper fund from 1 January 2014. Existing "default" balances (utilising the "accrued default amount" definition) must be transferred to a MySuper product by 1 July 2017. So in effect, the recently regulated MySuper system will only be fully consolidated and operational from 1 July 2017.

MySuper authorised funds and trustees must pass a high bar and regulatory hurdles in order to gain APRA authorisation (and be offered in the market). According to ASIC's Moneysmart website, MySuper funds offer:

- Lower fees (and restrictions on the type of fees members can be charged)
- Simple features so members do not pay for services they do not need
- A single, diversified investment option or a lifecycle investment option

It is compulsory for MySuper funds to offer default insurance to members on an opt-out basis. The ASIC Moneysmart notes the following benefits from having life insurance through superannuation:

- It is often cheaper because super funds purchase insurance policies in bulk
- Individuals can get the cover needed, even if money is tight
- It is easy to manage because premiums are automatically deducted
- Some funds automatically accept cover without requiring a health check
- There is choice regarding the amount of cover

An alternative to the Commission's proposed models could be a more stringent MySuper authorisation – which could entail a more stringent quality filter. This would not require additional processes for assessing and selecting funds (that impose costs on the system).

There is a risk that this model would result in limited competitive pressure among funds in the 'default' market. This could be expected in a market with a small number of players, where there is only periodic threat of market entry. Limited competitive pressure would reduce incentives among incumbent funds to innovate products.

Instead, this model is more likely to generate competition for the market (rather than in the market), as funds strive to be chosen by the government-appointed body. There is a risk that this dynamic would limit incentives for funds (both those in the market and potential new entrants) to innovate as the boundaries for product design narrow to the selection criteria.

There would be the lack of ability to tailor insurance for particular cohorts of employees that have specific insurance requirements.

The 'last-resort fund'

The *Assisted Employee Choice Model* envisages that a 'last-resort fund' – for members that do not exercise choice – would be run by the Future Fund (FF) or an existing eligible rollover fund (ERF) or funds.

The FF effectively operates as the Australian Government's wholesale investment manager and is responsible for managing various pools of funds under investment mandates determined through legislation.

To perform the role of a 'last resort fund', the FF – assuming that it would need to be set up as a SIS fund to maintain critical prudential safeguards – would need to establish a governance framework to enable it to operate in a superannuation context. This would include application to APRA for an RSE License, appointment of a trustee board, application for MySuper authorisation, establishment of an appropriate compliance and operational risk framework, and monitoring and reporting to APRA and the ATO. Even exempt public sector superannuation schemes are required to comply with the spirit of the SIS legislation in relation to MySuper whereas the FF, given its separate focus, is not well placed to perform this role.

The FF also would have to develop significant operational infrastructure. For example, the FF does not have the administrative capabilities enabling it to receive and allocate member contributions, unitise holdings, deliver appropriate insurance arrangements, provide regular reporting to fund members and "encourage them to choose their own product" as proposed by the Commission.

Finally, the purpose of the FF is to manage money to meet public liabilities or other specific public purposes. Superannuation money is exclusively private and owned by individual fund members. Broadening the role and scope of the FF in such a fashion would heighten political risk for the FF, the Government and superannuation fund members. It also would risk heightening market or member perceptions that savings are underwritten by the Government.

Utilising an eligible rollover fund (ERF) as a 'last resort fund' also would require significant governance and operational changes. ERFs are currently designed as a temporary repository for member benefits and ERF's are required, as a condition of their license, to facilitate consolidation of members' active superannuation accounts.

Furthermore, utilising an ERF would likely have a detrimental effect on the superannuation balances of 'default' members who do not choose a fund. The investment strategy of an ERF is generally capital stable or conservative, and thus would be expected to underperform relative to typical MySuper products over the medium to long term. Indeed, an ERF may struggle to satisfy APRA that its investment strategy is suitable for 'default' members who have contributions made on their behalf.

Given their purpose, neither the FF nor ERFs offer insurance (unlike MySuper products). If 'default' products under this model were to provide insurance – consistent with current regulatory requirements – the FF or ERF 'last resort fund' would be required to arrange suitable default insurance for last resort members (for which they currently lack the required capability).

Finally, a process would be required to determine where members had not made a choice, and to allocate those members to the 'last resort fund'. This would require new infrastructure.

6. Assisted Employer Choice Model

To be consistent with the Commission's methodology in its draft report, ASFA's assessment of the pros and cons is relative to the baseline of 'no defaults'.

Overall comments

This model incorporates multiple filters to determine which products would be eligible to be used as 'default' funds by employers for employees entering the paid labour force for the first time (and who have not exercised choice of fund). Whether or not 'light' or 'heavy' filters would improve efficiency and outcomes for those members would depend, at least in part, on how the filters were designed and implemented.

The frequency of the review of the lists of funds (that employers could use), also would have significant implications for efficiency and outcomes. On the one hand, more frequent reviews could improve the flexibility and accuracy of the filters, as well as provide more opportunities for new products to qualify and increase competition.

However, this would need to be weighed against higher compliance and administrative costs, reduced certainty for funds and employees, and the risk of incentivising short-term investment performance.

Pros

As is the case for the *Assisted Employee Choice Model*, appropriately designed and applied filters could lead to the selected products meeting a high set of standards deemed appropriate for 'default' members. To the extent that the criteria for inclusion in the 'default' or 'preferred default' lists were clear and unambiguous, the selection process would be transparent.

A filter, such as risk-adjusted net returns, could support supply-side competition for the 'default' market, on the proviso that the number of 'default' products was not limited to too few products and the criteria were appropriate. Fund trustees would endeavour to meet the required standard in order to be one of relatively few 'default' products and the even fewer 'preferred default' products.

The filters, if appropriately formulated, could reflect and encourage behaviours supportive of an efficient and low cost superannuation system. For example, a model that would reduce the number of products eligible to be selected as a 'default' fund would assist employers in the selection of their 'default' arrangement – and so would reduce search and evaluation costs.

A 'light' minimum standards filter, if administered by APRA, would not require the creation of an additional expert panel or substantial new processes. In addition, through not involving any quota of approved funds and being able to accommodate new entrants or new applications by product providers at any time, it would be more supportive of new entrants and innovation than most of the other proposed models.

Further, allowing employers some choice could increase employer engagement, such as greater employer attention regarding which fund or funds best suit the needs of their employees (including evaluation of insurance cover and conditions), and possibly provision or facilitation of workplace financial education.

Cons

The design of filters, to the extent possible, would need to contemplate and mitigate against perverse incentives. This includes design aspects such as criteria, the particular metrics and the time period over which metrics would be measured.

For example, under the 'heavy' filter, the four-year cycle for applying and being approved would likely stifle innovation and the number of entrants to the 'default market'.

With respect to metrics, risk-adjusted performance measures are difficult to design and there are data issues. With respect to the latter, many funds have only three years of MySuper product performance data. This is too short a period to evaluate investment performance – which should be assessed over a full financial cycle. Investment metrics with short time periods could lead to an undue concentration by product designers on short-term performance.

If not well designed, filters could create incentives for trustees to focus on particular aspects of their fund's performance in order to meet the filters, which may not be in the best interests of some or all of their members. This is especially the case over the longer term, where achievement of short-term goals/indicators may be achieved at the expense of medium- to long-term considerations. In particular, incentives to innovate might be reduced, as the selection of 'default' products would occur only infrequently.

In addition, there is a risk that if the range of filters employed was specified too narrowly, they might not support arrangements tailored for specific industries, workplaces, demographics or other characteristics of the membership of particular funds or segments of the market. Such arrangements can meet the particular needs of members and/or employers through tailored product design or servicing.

In this regard, it needs to be acknowledged that not all MySuper products are public offer and there would need to be consideration of what happens to corporate MySuper products that are currently non-public offer. Corporate superannuation funds are able to tailor their default product to the demographics of their employees. As at December 2016 there were 108 approved MySuper products, with 28 of those non-public offer.

A 'heavy' filter could rule out corporate funds being used as a default where such funds, by definition, are not available to employers generally. As well, some employers made contributions in excess of the compulsory SG rate to their associated corporate fund to the considerable benefit of the employees concerned. This should not be ruled out by the application of either a 'heavy' or 'light' filter being applied.

There are also some issues around competition. For the 'heavy' filter, restricting the number of products eligible to receive 'default' contributions to an arbitrary number of funds, or some cut-off in terms of a composite performance measure, potentially could reduce competition unduly. This could result in too-high market concentration, with corresponding adverse consequences for

competition between providers. It also could create considerable disruption to existing providers in the market, including affecting the scale of their activities, and ultimately outcomes for members.

7. Multi-criteria Tender Model

To be consistent with the Commission's methodology in its draft report, ASFA's assessment of the pros and cons is relative to the baseline of 'no defaults'.

Overall comments

In Australia, there are certainly precedents for using tenders to replicate elements of market-based competition – by both the private and public sectors. For example, the Australian Government regularly uses tender processes, including for large defence procurement projects. Tenders are also a feature of the superannuation system – by employers to select a default fund for their employees, and by funds to select service providers.

Pros

A multi-criteria tender has the capacity to bring market forces to bear on the 'default' fund selection process. A tender with well-specified criteria would incorporate price and quality into decision-making. As such, by using well-specified criteria to select funds (based on price and quality), the tender process could replicate a market to some extent. Superannuation funds would then compete directly to win the tender.

Such a model could limit the costs of 'default' superannuation. The level of fees is one of the criteria in this model, and fees are one the clearest and simplest fund comparators (notwithstanding variations in the ways that funds report fees). For a repeating tender process, tender competition would tend to put downward pressure on funds' fees (the influence of fees in the tender process would depend on the weighting given to fees in the multi-criteria framework).

Cons

Firstly, despite being presented as an objective framework, the fund selection process would entail a significant degree of judgement.

In terms of model design, judgement would be required not only in selecting which criteria to include in the multi-criteria framework, but also the relative weights. It might be clear that some criteria would be more important than others, but how much more important would be a matter of significant judgement. This is reflected in the different weightings assigned to particular criteria in existing multi-criteria models.[9]

In terms of fund assessment, the proposed criteria include non-numeric factors (qualitative factors), such as the effectiveness of funds' investment governance. Although assessing relative performance

[9] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 171.

with respect to numerical criteria – such as historical net investment returns – is relatively straightforward (notwithstanding efficacy issues),[10] the same cannot be said for qualitative factors.

The broader issue is that it would be difficult to design a set of performance criteria that would reflect members' preferred outcomes – particularly given that members' preferences change over time (and that within funds, members are not homogenous). The longer-term risk in this regard is that the tender process would change funds' behaviour such that the products and services that funds deliver would 'drift' away from members' preferred outcomes.

This is particularly relevant as to whether the framework would impose a constraint on innovation activity. The Commission states that this risk could be ameliorated by "The use of non-prescriptive criteria with no pre-defined solutions can provide incentives for innovation".[11] It is unclear what this would mean in practical terms – other than introducing more judgement into the framework. The bottom line, however, is that funds might limit expenditure and resources (that are ultimately reflected in costs and fees) that are devoted to innovation. This would not be in the long-term interests of members.

As the Commission acknowledges, there is a risk that the model would fail to generate competition in the broader superannuation market (though this risk is more acute for the *Fee-based Auction Model*).[12] Competitive pressure on funds depends, in part, on the degree of switching pressure from fund members. However, this requires an adequate degree of engagement to monitor funds' performance and to make the decision to switch.

This model envisages a government-appointed body that would administer the tender process. The body would be subject to similar risks around conflicts of interest and political influence as those for the *Assisted Employee Choice Model* and the *Assisted Employer Choice Model*. However, since the body for this model would have less scope for making decisions (about which funds would comprise the 'default' market), such risks would likely be lower.

The Commission states the cost of the tender process might be around $2.5 million per process – which is the same as the estimated cost for the *Fee-based Auction Model*. However, given the additional complexities in the tender process, the cost would likely be higher. For example, one of the proposed selection criteria is member satisfaction surveys. It is likely that the government-appointed body would have to out-source surveys – to ensure they meet requirements for quality and coverage.

[10] The Commission rightly states that the role of the role of net returns may be limited, since past returns are not necessarily indicative of future returns (page 171).
[11] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 181.
[12] 2017 Productivity Commission, *Superannuation: Alternative Default Models*, draft report, page 182.

8. Fee-based Auction Model

To be consistent with the Commission's methodology in its draft report, ASFA's assessment of the pros and cons is relative to the baseline of 'no defaults'.

Overall comments

This model would pose significant risks to members' long-term outcomes and system stability. Over the longer term, the auction process would risk a 'race to the bottom' among funds to reduce fees at the expense of returns and member services.

Forms of the *Fee-based Auction Model* are used in other countries – most notably in Chile. However, the Chilean experience – with a fee-based tender – highlights a host of problems with this type of model.

Pros

ASFA does not consider that there are any notable advantages of this model. The model would tend to reduce fees for those funds that win the auction, but as noted above, this dynamic poses significant risks to member outcomes.

Cons

A fee-based auction process would likely provide funds with incentives to develop products (for the auction process) that focus on lower fees at the expense of long-term returns. Such products would likely incorporate investment portfolios with little exposure to asset classes that are relatively higher-cost, but are potentially higher yielding and provide diversification benefits.

This model could lead to a 'race to the bottom' in terms of member services. To reduce costs to a minimum, and thus reduce fees, funds would likely reduce non-core services for members. Although the model envisages that funds would have to comply with minimum service standards, in practical terms, this would be difficult to monitor.

Further, a system that is focused on fund fees (and thus costs) would not be conducive to innovation. Lack of innovation would be detrimental to member outcomes over the long-term.

The Commission considers that risks around returns and service quality could be ameliorated by the use of service agreements (and the like). However, the experience in Chile highlights the problems with this approach – if standards are set too low, they are likely to be ineffective as performance incentives.

As a further protection, the Commission envisages some form of quality overlay that would assess aspects of funds' performance beyond fees. This, in essence, is a version of the *Multi-criteria Tender Model* where the level of fee is the primary criterion and the secondary criteria include returns and the quality of member services. In this sense, the fee-based model suffers from the same shortcomings as the multi-criteria model, but with the added problems around targeting fees.

The Chilean experience suggests that it is doubtful that this model would generate effective competition that would be in the best long-term interests of members. In Chile, successive tender rounds have not led to an increase competition for the market, or in the market.

In this model, funds that win the auction would have to apply the winning fee to all of their members – not just their new members allocated via the auction. Thus, a fund's decision whether to participate in the auction, and what fee to bid, would be based on whether the expected loss of fee revenue (on a per member basis) during the period of its incumbency would be more than offset by the effect of a higher number of members. As such, for some funds, it may not be worthwhile to win the auction.

This would tend to reduce competition among funds for the market. Indeed, in Chile, participation by (pension fund) providers in successive tender rounds has declined markedly since the Chilean Government introduced the fee-based tender (in August 2010) – from four participants in the first tender round in 2010, down to a single participant in the latest tender round in 2016.

As the Commission notes, the fee based-auction may fail to generate competition in the broader superannuation market. This is certainly the case in the Chilean system. Since the fee-based tender was introduced, only on one occasion has a fund reduced its fees independent of the tender process.[13] Further, in Chile, there has been little evidence of people switching to tender-winning funds (which would put pressure on the other funds to lower their fees).

Adoption of a Chilean-style tender process would introduce a range of risks to stability – both with respect to funds that participate in the auction and the broader system.

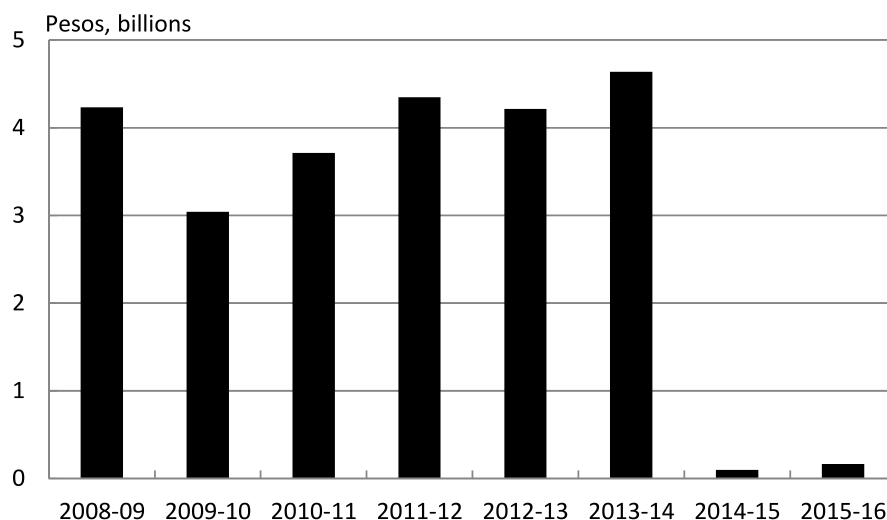
Successive auction rounds might push down fees to potentially unsustainable levels. As noted above, winning the auction (with a lower fee) would lead to a large fall in fee revenue from the stock of existing members. In Chile, where providers are for-profit entities, the profits of the current tender holder – Planvital – have fallen markedly since winning the tender (Chart 1). This has increased the provider's vulnerability to adverse shocks – such as an economic downturn that reduces the flow of new members. Further, this has likely reduced incentives for other providers to participate in future tenders, and compete for the market.

Funds might loss lead with their bid in an attempt to gain 'default' members with a view to upselling a higher cost service at a later date (or realise scale economies). Although this might drive cost reductions in the short run, it also would increase risks for those funds and their members. In particular, if a fund was unable to make good on its strategy to up-sell, then the fund would be at greater risk of failing to cover its costs on the 'default' segment of its book.

In an effort to reduce costs, fund providers might compromise the control environment. Funds could reduce the level of staff in critical areas such as compliance and risk management, and might not invest sufficiently in quality controls. For those providers, this would increase operational risk and, more broadly, increase systemic risk.

[13] In Chile, on only one occasion has a provider reduced its administration fees independent of the tender process – AFP Habitat reduced its administration fee by 0.09 percentage points in June 2012.

Chart 1: Profit of Planvital, financial year



Source: Superintendence of Pensions and ASFA calculations.[14]

9. Insurance in superannuation

9.1 Introduction

ASFA rejects the Commission's draft finding 3.3 that the assessment of 'default' products in all models should specifically exclude bundled insurance products and that bundled insurance is best dealt with as a 'regulatory add-on'.

The superannuation industry is currently working together to improve insurance in superannuation through self-regulation and believes it is a key criterion in any default fund selection process.

ASFA also considers that the Commission is being premature in its judgements that:

> *'the Government's stated objective for the superannuation system does not envisage insurance as an essential element of the system'.*

On this point ASFA disagrees with the Commission. Even if the primary objective legislation passes parliament, which it is yet to do, this will not preclude insurance continuing to play an important role in the system. The potential benefit payments to a dependant due to the premature death of the main income earner or to a person who retired early due to disablement, is in line with the objective of superannuation.

The Commission itself settled on the following objective in its framework to assess the competitiveness and efficiency of the superannuation system:

> *"The superannuation system provides value for money insurance without unduly eroding member balances".*[15]

[14] Data from Superintendence of Pensions: *Boletín Estadístico Electrónico, Estados Financieros* (https://www.spensiones.cl/apps/boletinEstadistico/).

[15] Productivity Commission 2016, How to Assess the Competiveness and Efficiency of the Superannuation System.

It was unexpected when, contrary to earlier signals, the Commission proposed to exclude insurance in the assessment process for allocating members to 'default' funds.

9.2 Benefits of insurance in superannuation

The benefits of insurance in superannuation are well known and recognised as being an integral element of Australia's superannuation system. Broadly, these benefits relate to:

- lower cost, as polices are purchased in bulk with risk shared across groups of lives
- affordability, as premiums do not have to be met by individuals' personal cash flow
- automatic acceptance often with minimal or no health checking
- flexibility to tailor cover to suit individual needs.

The strength of these benefits has led to the automatic allocation of group insurance cover on an opt-out basis being prescribed as a mandatory feature of default (MySuper) products.[16]

These policy settings have contributed significantly to the current situation, where approximately 70% of life insurance cover in Australia is held within superannuation.[17] In the financial year ending 30 June 2016, approximately 75,000 death and disablement benefit payments – which amounted to approximately $5.2 billion – were made.[18] The contribution that insurance in superannuation makes to alleviating Australia's under-insurance problems is unquestionably significant.

9.3 The role insurance plays in competition

With the standardisation of default products that has occurred since MySuper was introduced in 2014, the opportunities for superannuation funds to differentiate themselves and compete have been somewhat constrained.

In response to this, many funds have turned to improving their insurance offerings and adjusting a range of benefits and features (most commonly) to suit a like group of members. An example of innovation in insurance design is staggered Total and Permanent and Disability (TPD) benefits that promote rehabilitation and a return to work. In many cases, funds have been able to lessen their premiums at the direction of Trustees – who are constantly challenged to limit premia while providing valuable insurance benefits.

In the last quarter of 2016 alone, approximately 20% of superannuation funds changed insurance rates or cover.[19] On average, cover per dollar of weekly premiums increased for members across all insurance types – death, TPD and income protection.[20] This highlights that the insurance in superannuation market is continuing to adapt and sharpen its focus on pricing for risk in market segments.

These characteristics demonstrate that a significant element of the competitive rivalry that exists between superannuation funds occurs because of differences in insurance benefits and features.

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[16] SIS Act
[17] Rice Warner 2016, Insurance through Superannuation.
[18] APRA 2016, Annual Statistics.
[19] Rainmaker 2017, Superannuation Benchmarking Report 2017.
[20] For a 40 year old white-collar worker as a proxy.

Considering the mandate the Commission has to develop models for a new formal competitive process, it is difficult to comprehend the exclusion of such a fundamentally competitive element.

9.4 Consequences of removing insurance from 'default' fund assessment

Under the proposed models, there is the risk that new members would not be able to secure a meaningful level of insurance cover when they join a 'default' fund. This is particularly the case for models that involve only a small number of eligible 'default' funds following a rigid filtering, tender or auction process (that ignores insurance).

For 'default', disengaged members, it is unlikely that when insurance needs change they would seek out an alternative insurance solution. Over time, this would worsen Australia's under-insurance problem and leave many of the most vulnerable in the community significantly worse off than they would have been in the current system.

By extension, it is likely that there would be a significant reduction in the level of cover across the total pool of lives in the 'default' segment. This would place pressure on the sustainability of existing arrangements that default members currently enjoy and inevitably lead to higher cost and/or a reduction of benefits. Again, it is unlikely that current default members would seek out alternative insurance arrangements if current benefits change to their detriment.

10. Efficiency gains for current system – changes to legislative settings

As noted in Section 2 of this submission, ASFA has highlighted numerous potential changes to the current legislative framework (in previous submissions) that would improve the efficiency of the superannuation system.

10.1 Barriers to exit

As ASFA has stated in previous submissions, there are a number of regulatory barriers to exit with respect to superannuation funds. Reducing these barriers would materially improve market contestability and competition.

<u>Bulk transfer rules</u>

Constraints on mergers imposed by the bulk transfer rules essentially relate to the difficulties that funds face in meeting the regulatory requirement to ensure that members receive 'equivalent rights' (on a 'bundled' basis) in the new fund to those they received in their old fund.

<u>Fund level – absence of on-going CGT relief</u>

The absence of on-going CGT rollover relief creates a significant barrier to fund mergers.

The triggering of CGT events on merger, such as the realisation of otherwise unrealised gains, and the inability to carry forward losses, can prevent a trustee from entering into a successor fund transfer arrangement.

In determining whether to merge with another fund, a trustee of a superannuation fund is under a trust law and fiduciary duty to act in the best interests of the members of the fund. As such, the

threshold decision as to whether or not to merge is made taking into consideration the various benefits and costs to members of the potential merger – such as CGT.

Depending on the volatility of the market, after a downturn, a fund can carry deferred tax assets of an amount equivalent to 1.5 per cent or more of member account balances, the benefit of which would be lost if a merger were to go ahead without CGT relief. For a member with an average account balance (approximately $70,000), this could represent a reduction in the value of their superannuation account of over $1,000.

In such circumstances, the absence of CGT rollover relief may cause the costs to members, through the extinguishment of deferred tax assets, to outweigh the benefits of any proposed merger.

Fund level – other tax issues

There is a similar issue with respect to the loss of imputation credits, due to the deemed disposal of assets, and the potential reduction in the 'tax-free component' of some member accounts. These can act as barriers to a superannuation fund merger being agreed.

Further examination of the loss transfer rules may be warranted, especially the look through aspects, as there can be many losses captured in Pooled Superannuation Trusts held by superannuation funds. If there is a holding in an underlying fund that has deferred tax liabilities, there should be an ability to take that up a proportionate amount into the superannuation fund and transfer it across to the successor fund.

Product level – legacy products

Notwithstanding the benefits of product innovation, various legal and regulatory barriers have often seen products forced to continue where it would be more efficient to rationalise them. For an individual fund, the existence of legacy products can be a barrier to a potential merger.

Frequently these products are closed to new members (legacy products), when new products are launched for new members.

In some cases – a lifetime pension product by way of example – an inability to commute (under the regulatory provisions), combined with reversionary provisions, may see providers compelled to support such products for decades, even if they are not commercially viable.

Some legacy products also have early termination fees for members attached to them, reflecting the fact that in such products advice and other costs are recovered from the member's account over a period of time. The existence of such legacy fees may act as a disincentive for members to exit affected products.

10.2 Inactive accounts

One initiative to reduce the number of inactive account would be to require the ATO to reunite small inactive accounts with the active account of the fund member rather than sending such accounts to consolidated revenue.

ASFA considers that section 24G of the *Superannuation (Unclaimed Money and Lost Members) Act 1999* should be amended to empower the Commissioner to pay unclaimed money to a complying

superannuation plan where the Commissioner is satisfied as to the identity of the lost member account owner and that the person holds an account in the proposed destination fund.

11. Efficiency gains for current system – the full benefits of SuperStream architecture

There needs to be an ongoing commitment to continuous improvement of SuperStream (led by the ATO and APRA) to maximise efficiency of the system, and a commitment from the Government to reduce the amount of regulatory change.

In 2012, the Government introduced SuperStream to enhance the 'back office' of superannuation, and generate efficiencies that would ultimately improve member outcomes. Although it is early days, lasting benefits already have been realised – and these will increase as SuperStream is further bedded-down and matures. Of particular relevance to the Commission's draft report is the potential to leverage the SuperStream architecture to generate efficiency gains beyond the expected gains from the current arrangements.

11.1 Efficiencies from SuperStream

SuperStream represents a significant investment. Overall, the superannuation industry has invested over $900 million into SuperStream over the past five years – including a $390 million levy to fund the ATO program of work. Funds' costs are ultimately borne by fund members.[21] Thus, it is incumbent on the Government to help industry utilise SuperStream to its full potential (see Box 2).

Alternative arrangements to SuperStream would come with significant costs and risks. Firstly, the unrealised potential of SuperStream represents unrealised efficiency gains – which members have already paid for. The cost to members of SuperStream is not recoverable. Secondly, alternative mechanisms to SuperStream would involve further investment for yet-to-be proven efficiency gains, with the attendant transformation and implementation risks. The ultimate cost of additional investment would be borne by members (or taxpayers).

11.2 Leveraging SuperStream

There is potential to leverage the SuperStream architecture to generate efficiency gains beyond the expected gains from the current arrangements.

The Super System Review recognised the importance of providing members with regular and up to date information.[22] A number of reforms to support regular and improved superannuation information were considered by the then Government, however were ultimately never legislated due to technical or practical constraints at the time.

SuperStream in its current form provides the opportunity and the infrastructure to develop and operate a 'single source of truth' platform – a basic version of which is available on MyGov (there are several other countries where such a service has been successfully operating for many years). This would provide members with timelier and more detailed superannuation information. It also would allow members to make more informed decisions about their superannuation – including whether to initiate a rollover from one account to another.

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[21] Total investment was $1.5 billion - $900 million by funds and $600 million by employers. 2011-12 to 2017-18 – is $421.8 million (including the 2017/18 year).
[22] http://www.treasury.gov.au/ConsultationsandReviews/Reviews/2009/Super-System-Review

In this regard, the superannuation industry is already working with the ATO. The design of 'more frequent fund reporting to the ATO' is expected to be completed by mid-2017, with implementation scheduled for the second half of 2018.

Box 2: SuperStream benefits to come

As can be expected with any large program, it can take some time before the benefits are realised in full. The Financial System Inquiry acknowledged that "it is too early to draw firm conclusions about the long term effects of these reforms…" including SuperStream.[23]

Notwithstanding the benefits that already have been realised, there is still much to do to maximise the return on this substantial investment for the benefit of members.

Of the current 800,000 plus employers, there are still 120,000 employers (representing 8% of total contributions) that are not SuperStream ready. Most of these employers are 'small'. As superannuation funds act in the best interest of members it will continue to accept and allocate contributions that are not submitted in the SuperStream standard, absorbing the additional cost of processing cheques and paper. Hence, it is the non-compliant employer that is inefficient rather than the fund, but the fund is paying for the employer's inefficiency. A central clearinghouse is not going to fix this. The government should focus on assisting employers in becoming SuperStream compliant. However, where employers are able but unwilling to comply with the SuperStream standards, employers should be appropriately penalised for non-compliance.

A recent survey revealed an underlying issue that unless fixed, will continue to plague superannuation funds and its members. The ATO identified in its *Superannuation Reform Final Report 2015* that '…smaller employers (1-4 employees) were more likely to do payroll manually (32%) or not know the software package they used (6%). Just under one-fifth (1 in 5 employers) said that no payroll software is used/payroll done manually. Unless the fundamental issue of employer ecommerce capability is addressed, funds will need to continue to process contributions in an inefficient and costly manner.

11.3 Centralised clearing house

The Commission is proposing to explore further the option of a centralised clearing house. Employers would remit all superannuation contributions directly to a single centralised clearing house. In turn, the clearinghouse would direct the contributions (money and data) to the relevant superannuation funds. ASFA strongly opposes a centralised clearing house for the Australian market as it would introduce new and substantial risks and costs to government, employers and funds (and therefore members) and would not continue to leverage the benefits of SuperStream.

The Commission refers to the KiwiSaver model, where Inland Revenue takes on the role of the centralised clearing house. Although KiwiSaver is a practical and efficient model to use for the still reasonably immature New Zealand market that started nearly 10 years ago, it simply is not fit for purpose for a mature and complex market.

[23] http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf.

In 2010, the Super System Review considered many collection and re-distribution options in the context of the Australian market.[24] At the time, KiwiSaver was still in its infancy but the Review dismissed it as a viable option for the Australian market. The main reasons include; the different types of schemes (defined benefit and defined contributions); the size of the market both in terms of number of accounts (30 million accounts) and contributions collected and allocated (around $140 billion annually); and the number of funds in the market – including 585,000 Self-Managed Superannuation Funds.

Most importantly, the costs and risks of transitioning from the current multi-provider model (with mandated payment and data standards) to a single provider model are likely to be significant, without any benefit for superannuation members.

An alternative and proven approach to a more efficient processing of contributions is the introduction of universal money and data processing standards. This is what SuperStream is all about. SuperStream considerably improved the quality and completeness of superannuation data and replaced costly and cumbersome manual processes. Because of the introduction of SuperStream, most (if not all) contributions are currently processed and allocated to members' accounts within three business days upon receipt of money and complete data.

It is worth noting that ATO already provides a Small Business Clearing House. This is a free service that employers can use if they are a business with 19 or fewer employees, or have an annual aggregated turnover of $2 million or less. This service was designed mainly for the small employer segment who would find it difficult to invest in new systems to become compliant with the SuperStream standard.

Another important consideration is that a single provider model – a monopoly – is anti-competitive and generally undesirable for any market particularly where the market solutions, in conjunction with legislation, provides the right level of competition in the market place, increasing services and service quality and efficiency for employers and members.

[24] http://www.treasury.gov.au/ConsultationsandReviews/Reviews/2009/Super-System-Review