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Deputy Chairman  
Productivity Commission  
Locked Bag 2, Collins Street East  
Melbourne, VIC 3003

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Dear Ms Chester

**Superannuation: Alternative Default Models**

The Financial Services Council welcomes the opportunity to make a submission on the Productivity Commission's (PC) Issues Paper on Alternative Default Models in the superannuation industry.

The Financial Services Council (FSC) has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than \$2.7 trillion on behalf of 13 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world. The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC supports enhancing competition in the superannuation industry to improve the efficiency of the system and improve outcomes for consumers.

The FSC would welcome the opportunity to meet with the Commission to discuss our submission in more detail. If you have any questions in relation to this submission please contact the FSC

Yours sincerely

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## Introduction

Australia has a world leading superannuation system, however it can be improved through reforms to enhance the competitiveness and the efficiency of the system. The FSC supports reforms to promote competition in the superannuation system.

The Productivity Commission's suggestion of a baseline of no default is the purest form of competition and, with informed and engaged consumers, has the potential to deliver strong results for consumers. Any model proposed by the Commission as a result of this review should move the industry towards the baseline, however the current level of consumer disengagement means that the baseline option cannot be implemented in the near-term.

The FSC supports a competitive market design that moves the industry closer to the baseline option by allowing all consumers to choose their own superannuation fund, and allowing any Australian Prudential Regulation Authority (APRA) approved MySuper product to be nominated as a default fund where an employer decides to offer a default in their workplace.

We therefore welcome the refreshing approach the PC has taken in its deliberations thus far. The FSC supports a 'market-based competition' model where employers should not be compelled to offer a default fund. It would be significant enhancement to the current system for employers to expect their employees to nominate their own fund as it would promote consumer engagement and reduce principal-agent issues in the system.

The FSC proposes that the safety net for consumers could be strengthened through an enhanced MySuper approval process should the Commission have concerns in relation to the strength of the MySuper safety net and consumers' behavioural biases. An enhanced MySuper approval process, as detailed in this submission, would focus on member outcomes and be an ongoing assessment, rather than the narrow, point in time assessment APRA conducts when it is granting a MySuper authorisation.

This assessment of MySuper performance will ensure the population of MySuper products will improve over time so that employers and consumers who select a MySuper product are protected. It also allows employers to negotiate tailored MySuper products for their employees where this affords the employer a competitive advantage in the labour market.

The market-based model would be applied to all default consumers, however consumers would be entitled to remain with their existing default fund until their business is won by a competing fund. This would simplify transition and avoid any unnecessary cost, market disruption or complexity.

The current industrial system was not designed with a view towards competition and market design. The industrial and highly protectionist overlay on the superannuation system acts to limit competition and stifle innovation, and has resulted in the proliferation of subscale and inefficient superannuation funds, as well as discouraging consumer engagement.

There are market failures in the current model that must be addressed through regulatory reform. Major principal-agent issues exist, where trade unions, employer associations and the Fair Work Commission (FWC) are all entitled to make decisions on behalf of consumers, sometimes in the context of serious conflicts of interest.

The industrial and protectionist overlay on the superannuation system reduces competition and has resulted in the proliferation of subscale and inefficient superannuation funds, as well as discouraging consumer engagement. As detailed in this submission, the full implementation

of the existing model would have a significant cost and disruption for the industry and consumers.

The FSC submits that the proposed auction model is not a solution to these market failures. The auction model:

- Encourages gaming by creating an incentive to design products targeted only at the selection criteria;
- Reduces the system's ability to accommodate default consumers' diverse needs;
- Introduces new market failures and principal-agent risks; and
- Creates a barrier to consumers becoming engaged in their own financial affairs.

The auction model would take the superannuation system further from the baseline model than is currently the case, with implications for consumers, innovation and financial system stability. The Commission should instead prefer a market-based approach that empowers consumers. Allowing people choice in an open market based competitive system should substantially lift their engagement with super.

### Context of the Review

There have been four prior reviews that have covered the default superannuation market structure in the previous six years:

- Cooper Review of 2010
- Productivity Commission inquiry in 2012
- Treasury's 'Better regulation and governance, enhanced transparency and improved competition in superannuation' review in 2013
- Financial System Inquiry of 2014

It may be useful to the Productivity Commission to place the current review in the context of prior reviews that have shaped the current policy debate.

The Cooper review recommended the creation of comparable MySuper products that could all freely compete in a contestable default market.<sup>1</sup> Whilst the then Government implemented the MySuper reforms, it failed to reform the default market to allow for competition and as such this policy area has remained contested between incumbent industry funds and those prevented from competing in the market.

The terms of reference for the subsequent Productivity Commission inquiry into the superannuation default market never contemplated a default market free from the anti-competitive industrial framework. The terms of reference explicitly stated that "the Government believes that default funds should continue to be included in modern awards." The terms of reference simply directed the Commission to "design criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards by Fair Work Australia."<sup>2</sup> That review therefore prevented the Commission from genuinely considering market design issues with the default market.

The 2012 Productivity Commission review considered a range of issues, such as whether the (then) proposed MySuper framework would improve consumer outcomes, and whether

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<sup>1</sup> Recommendation 1.3 of the Cooper Review

<sup>2</sup> Terms of Reference, *Process for the selection and ongoing review of superannuation funds to be included in modern awards as default funds*, 2012

employers would be effected by 'excessive choice' of MySuper products. The environment has changed from the time of the review as MySuper has been shown to be improving consumer outcomes, the number of MySuper products is smaller than anticipated, and would decrease further in a competitive market, and interaction between employers and funds is simpler as a result of SuperStream and other technological improvements.

The election of a new Government in 2013 resulted in Treasury commissioning a discussion paper on options for improving the governance, competitiveness and transparency of the system. This review received 90 submissions from the industry and interested parties, canvassing a range of issues, including the default superannuation market and the benefits of requiring trustees to appoint independent directors. Legislation to improve the comparability of superannuation products by implementing standardised product dashboards and require disclosure of trustees' portfolio holdings were introduced to the last parliament, but lapsed when it was prorogued.<sup>3</sup> These reforms are expected to be implemented by the current parliament and are important to promoting consumer engagement in a competitive market.

The Financial System Inquiry (FSI) also examined the default superannuation market and recommended that all consumers should be entitled to exercise choice of fund, even where covered by an enterprise agreement, that trustees should be required to appoint a majority of independent directors to their boards, and that the Commission should conduct a review of the default market. Following the FSI the Government sought to raise standards of governance amongst superannuation funds by introducing legislation that would require all funds to appoint independent directors<sup>4</sup> and to extend the choice regime by introducing legislation to allow consumers covered by enterprise agreements to choose their own fund.<sup>5</sup> These reforms were opposed by the industry superannuation sector and their lobbying also prevented the bill's passage through parliament before it was prorogued prior to the last election.

This context demonstrates that many of the issues that are being considered by the current review have been examined in detail over previous years. Important reforms, such as extending the choice regime, allowing comparable MySuper products to compete in the default market, and requiring trustees to appoint independent directors, in part to facilitate industry consolidation, have failed to be implemented as a result of ongoing industry and political opposition.

The FSC recommends that the Commission be mindful of the clear evidence indicating that such reforms are in the best interests of consumers as it undertakes its review.

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<sup>3</sup> Superannuation Legislation Amendment (Transparency Measures) Bill 2016

<sup>4</sup> Superannuation Legislation Amendment (Trustee Governance) Bill 2015

<sup>5</sup> Superannuation Laws Amendment (Choice of Fund) Bill 2016

## Summary of Recommendations

**Recommendation 1:** The criteria outlined in the Terms of Reference should underpin the Commission's assessment of each competitive model, in conjunction with the 'no default' baseline, which enables a comparison against full consumer choice. The Commission should also be cautious of implicit and explicit biases in its discussion paper that are inaccurate.

**Recommendation 2:** The Commission should prefer market-based model that reflects the baseline, but with improved consumer protections and with the employer option of offering a default MySuper. This model would promote consumer engagement, support industry consolidation by allowing consumers to switch from underperforming funds, and retain a safety net through the option on an enhanced APRA MySuper assessment process.

**Recommendation 3:** An auction model cannot be designed in a way that effectively addresses theoretical issues, and the FSC has not observed research that demonstrates how this could be achieved.

**Recommendation 4:** The Commission should recognise that an auction model would be at significant risk of gaming by market participants, is exposed to political risk, and would fail to provide products suited to the diverse needs of both employed and retired Australians.

**Recommendation 5:** The Commission recognise that the Fair Work Commission and enterprise agreement framework is not competitive and delivers sub-optimal outcomes for consumers by directing some consumers into poorly performing MySuper products.

**Recommendation 6:** The Commission recognise the current Fair Work Commission and enterprise agreement framework was not designed to achieve competition. The full implementation of the existing model would also have a significant cost and disruption for the industry and consumers.

**Recommendation 7:** The Commission recognise the process for selecting group life insurance through superannuation is effective and the selection should remain the responsibility of the trustees of the fund.

**Recommendation 8:** The focus should be on reviewing the Insurance Management Framework (IMF) mechanism and ensuring trustees review their IMF on an ongoing basis.

## Desirable features of a competitive market

When discerning between models, and identifying the advantages and disadvantages of each, the Productivity Commission should consider the appropriate principles upon which to assess a competitive market outlined in the terms of reference to the inquiry. Condensing very complex issues into simplified high level criteria is too simplistic and lacks transparency.

The original criteria of terms of reference should be applied, considered and assessed when designing and assessing these models. We believe the following issues need to be compared and contrasted, including outlining explicit or implicit assumptions in the analysis, when determining advantages and disadvantages:

- Competition;
- Barriers to entry and exit;
- Impediments to innovation;
- Financial stability and integrity, including capital, risk management, governance and ability to remediate;
- Market concentration;
- Allocative, Technical and Dynamic Efficiency;
- Switching Costs;
- Optimal consumer engagement and behaviour;
- Optimal consumer outcomes maximisation of net returns;
- Optimal consumer outcomes maximisation of other consumer benefits;
- Minimisation of cost;
- Feasibility, including transition costs, and complexity to administer;
- Principal-agent issues; and
- Transparency of related party parents or subsidiaries.

Each model and proposal should be assessed against the PC's proposed baseline of full consumer choice with no defaults, with the presumption that the baseline model achieves the best outcome against these criteria (excluding evaluation of transition costs).

## Appropriate weighting across the criteria

The remainder of the analysis should demonstrate how close the other models are to the baseline model and the quickest and most effective way for industry to get there, or the rationale for moving away.

Competition and efficiency criteria form the majority of the criteria proposed and should be the primary criteria used to assess the superannuation system in this review. Competition has been shown time and again to enhance consumer choice and maximise consumer outcomes in product and service markets.

Restrictions to competition should only occur if:

- (i) a market failure is identified that is not the result of improper market design or regulation that already restricts competition;
- (ii) if the restriction to competition can be shown to have an overall benefit to consumers; and
- (iii) the improvement can only be achieved through a regulatory intervention.

Many of the criteria presented that are not related to competition and efficiency criteria are subsidiary criteria and rather reflect the result of market design. For example, in evaluating consumer engagement and behavioural biases, it would be remiss of the PC to conclude that

consumers will never be engaged with the superannuation system. The current system of having a default model by definition creates an incentive for consumers to be disengaged.

### Incorrect Implicit or Explicit Assumptions that underpin the PC's analysis

#### Consumers don't exercise choice

We believe consumers are prevented from exercising choice under the current system and are actively incentivised to not make a choice. The current extent of consumer disengagement should not be a proxy for the number of people who are naturally disengaged.

First, and as elaborated on further in the submission, there are regulatory obstacles to consumers exercising choice as a result of the industrial relations legislation. Second, the existence of a default mechanism creates an incentive for consumers to not exercise choice and exacerbates any behavioural biases. Thirdly, legislation in some instances removes consumers' right to become engaged and instead delegates decision-making power to trade unions or the Fair Work Commission, even in circumstances where the consumer is not a member of the trade union.

#### Funds are not competitive, especially with fees

The fundamental proposition that funds are not competitive with respect to fees is premised upon the amount of dispersion between the lowest fee MySuper product and the highest fee MySuper product. We believe a focus on fees is not an appropriate policy metric and elaborate on this below.

However, we also challenge the proposition that fees are not improving in MySuper products due to existing, albeit limited, competition.

MySuper has contributed to the reduction in fees in the retail superannuation market. Average MySuper asset fees amongst FSC members have fallen from 1.61 per cent in 2011 to 0.82 per cent in 2013.<sup>6</sup> Industry wide the average MySuper fee is 0.85 per cent. MySuper has also resulted in many retail funds becoming more competitive in both fee charges and returns generated than industry funds.

Further, focusing on investment management fees, the FSC conducted research to ascertain the relative level of fees charged in Australia compared to other parts of the world. Specifically, we conducted a survey of several large global fund managers on their fees charged for the same products in Australia and other jurisdictions. Collectively, the surveyed manager's funds under management (FUM) in Australia total around \$110 billion and \$7.1 trillion globally.

The methodology was as follows. In order to gain an accurate comparison we collected the actual fees charged (and not the published rates) on products that are sold in multiple jurisdictions. This means we compared the same product sold around the world. The products used were: global equities, global property securities, emerging markets and global bonds.

The jurisdictions compared were Australia, US, Europe ex UK, UK, Asia ex Japan and Japan. As fees can change based on the size of the investment, the fee rates collected were based on a \$100 million mandate.<sup>7</sup> The results showed:

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<sup>6</sup> Rice Warner Actuaries, 2014 Superannuation Fees Report, at 24

<sup>7</sup> FSC Submission to Stage Two of the Financial System Inquiry

- global equities rates are almost 11 bps or 20% lower on average in Australia than the other jurisdictions;
- global property securities are 6 bps or 12% lower on average in Australia than the other jurisdictions;
- emerging markets are 13 bps or 17% lower on average in Australia than the other jurisdictions; and
- global bonds are about equal to other jurisdictions on average. These results, comprising data from some of the world's largest fund managers, show that investment management fees charged in Australia are among the world's lowest (if not the lowest).

Extracting the greatest benefits from MySuper, however, can only be fully achieved if all MySuper products are able to compete for default superannuation contributions.

### Government influence over fees and returns

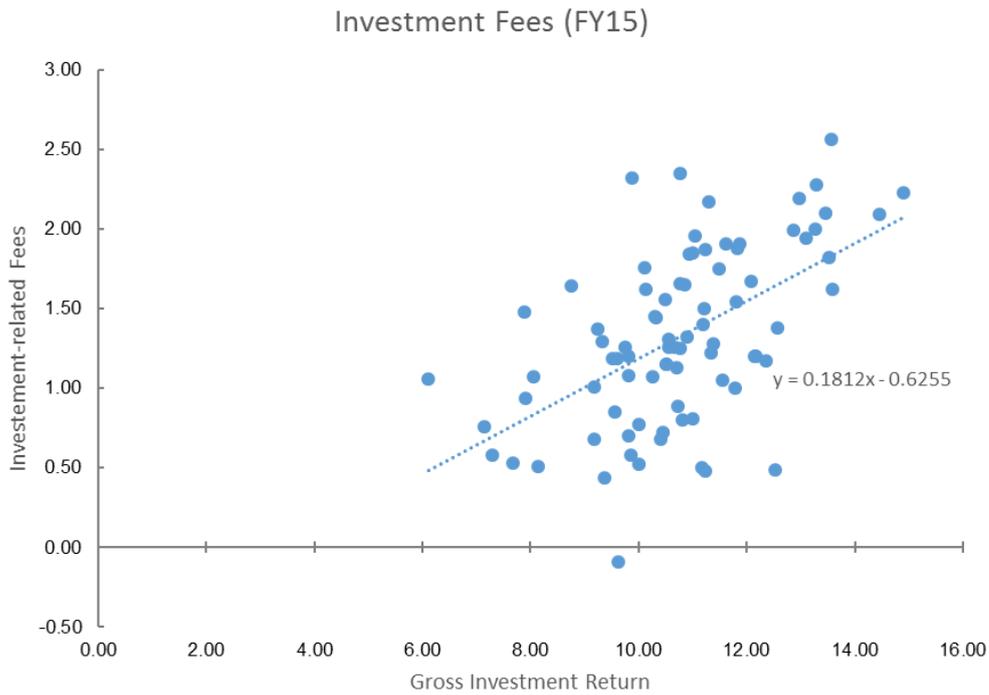
#### *Fees need to be considered in their sub components*

Fees need to be considered by their sub components, specifically administration fees and investment management fees. Economies of scale may be expected to produce a reduction in administration fees. Further, economies of scale may not be present when looking at the product level compared to the whole of fund level due to legacy system issues that may have arisen from fund mergers.

Most importantly, it is unclear that economies of scale would necessary lead to lower investment management fees as they are generally more closely related to issues around asset class liquidity, and asset market efficiency and sophistication.

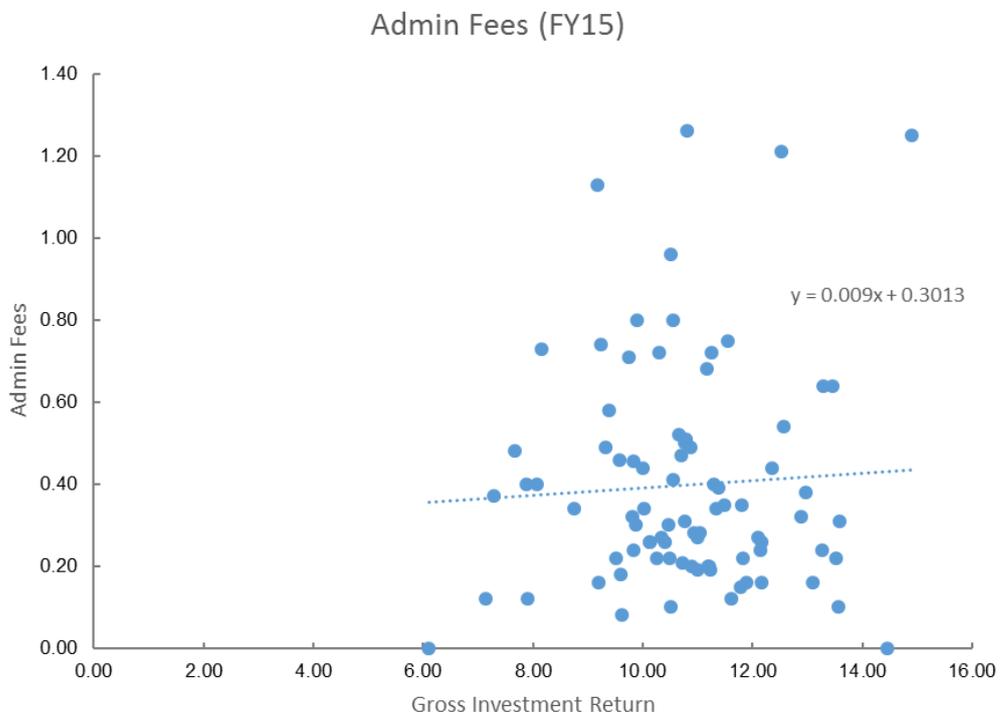
What we do know is that higher investment returns should be correlated with higher investment management fees in an efficient market. To test this we have looked at annual administration and investment management fees for 2015 against gross returns for MySuper products. As expected, investment management fees are positively correlated with gross investment returns – that is a higher investment return is associated with higher investment management fees (Figure 1).

**Figure 1: MySuper 'single investment strategy' Investment Fees vs Gross Returns 2015**



However, there is no meaningful correlation between gross investment returns and the administration cost of a fund (Figure 2).

**Figure 2: MySuper 'single investment strategy' Administration Fees vs Gross Returns 2015**



*Net returns are a superior metric aligned to consumer outcomes than fees.*

The FSC submits that it would not be in consumers' interests to design a default model that minimises fees only.

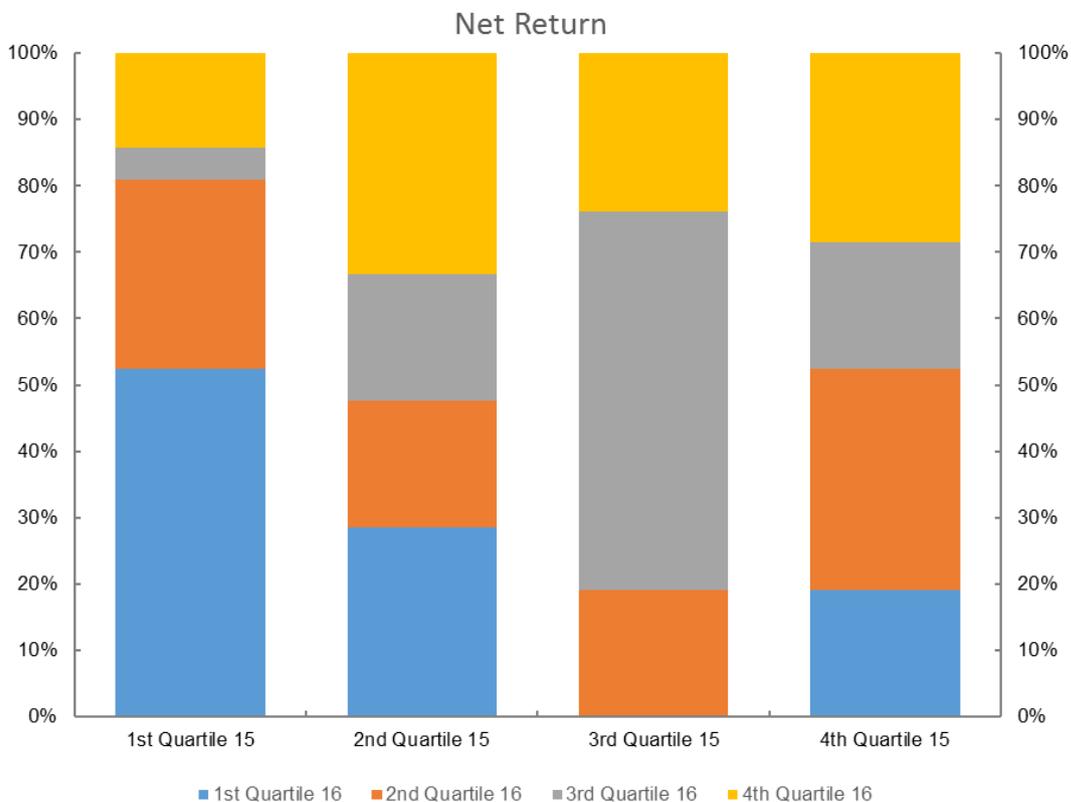
Another way to consider whether the focus should be on fees or net returns would be to consider whether selecting a fund based on net returns or fees would lead to a better outcome. Historical MySuper data provides some indicative evidence, albeit noting this is a limited sample and noting that we do not believe historical experience can predict future experience. ASIC has consistently outlined its view that past performance claims warrant appropriate disclaimers, for example in *Regulatory Guide 234: Advertising financial products and services (including credit): Good practice guidance*, ASIC notes:

*"Past performance information should be accompanied by a warning that past performance is not indicative of future performance."*

*"Forecasts about the future performance of a financial product should be based on reasonable assumptions and should also state that the forecasts are not guaranteed to occur."*

FSC analysis of APRA data in Figure 3 considers whether a top quartile fund on a net returns basis in 2015 would remain a top quartile net return fund in 2016. The data set is over a one-year period, however it shows that 52 per cent of top quartile funds on net returns remain in the top quartile between years. 81 per cent of top quartile (based on net returns) remain in the top two quartiles in terms of performance as measured by net returns.

**Figure 3: Do top quartile net return funds remain top quartile funds year on year (2015 vs 2016)**



Note: This chart divides 'single investment strategy' (i.e. excluding lifecycle) MySuper products into quartiles based on 2015 net returns. The bars show the percentage of fund in a quartile in

2016 based on their 2015 ranking, grouped by the original quartile. 1<sup>st</sup> quartile 15 relates to top quartile, highest net return MySuper products, 2<sup>nd</sup> quartile 15 relates to second quartile and so on. This chart should not be used to suggest that past performance is indicative of future performance, and is a limited and indicative trend analysis only as it depends on only a year on year comparison.

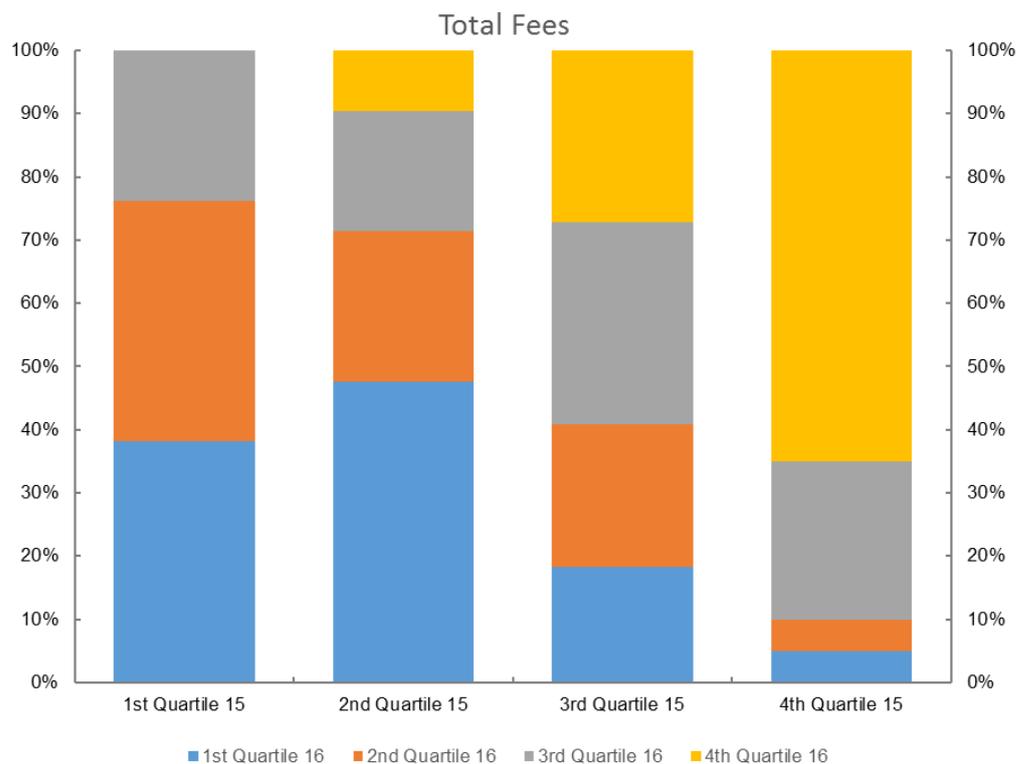
However, the same analysis on a total fees basis shows that only 38 per cent of funds remain in the top quartile in terms of total fees from year to year (Figure 4). Further, the average net return for these funds, at 8.5 per cent, is lower than the average net return for the top quartile of funds on a net return basis at 10.7 per cent in 2015 (median is 10.6 per cent (for net return) v 8.9 per cent (for total fees)).

We believe that past performance on fees or net returns is not an indicator of future performance. However, it is surprising to see that there is less autocorrelation between fees relative to net returns on the limited empirical basis we have to assess MySuper products. These trends, if they continue, would demonstrate that the introduction of MySuper is enabling high performing funds to consistently stand out from their competitors. Consumers should be empowered to switch from poorly performing funds to better performing funds. They would also indicate that net returns is a superior metric to total fees on an empirical basis.

Conducting an auction based on the premise of fee reduction would therefore be short-sighted based on current data should these trends continue.

In addition, an auction or tender model may result in funds squeezing margins at the expense of the services and benefits provided to customers. This includes meeting regulatory requirements in a bid to be one of the lowest cost funds. This would not be sustainable for funds over the long term and could lead to significant sustainability issues for the industry as a whole (as happened with the group life market a few years ago as a result of insurers competing on price and continually, and often unsustainably, lowering their premiums).

**Figure 4: Do top quartile lowest fee funds remain top quartile funds year on year (2015 vs 2016)**



Note: This chart divides ‘single investment strategy’ (i.e. excluding lifecycle) MySuper products into quartiles based on 2015 total fees. The bars show the percentage of funds in a quartile in 2016 based on their 2015 ranking, grouped by the original quartile. 1<sup>st</sup> quartile 15 relates to top quartile, lowest total fees MySuper products, 2<sup>nd</sup> quartile 15 relates to second quartile and so on. This chart should not be used to suggest that past performance is indicative of future performance, and is a limited and indicative trend analysis only as it depends on only a year on year comparison.

### Principal-agent issues

When choice of fund is taken out of the hands of the consumers, agency issues are introduced.

We note that principal-agent issues between consumers and employers and financial advisors are heavily regulated. However principal-agent issues arising between consumers and trade unions or the Fair Work Commission are abundant and largely ignored by regulation:

- In relation to employers who directly interact with superannuation fund providers the agency issue has been dealt with via legislation. Section 68A of the *Superannuation Industry (Supervision) Act 1993* specifically prohibits a trustee or related party from offering an inducement to an employer to win superannuation business. There is no evidence that this legislative solution to the agency issue has been breached. A recent ASIC inquiry found no evidence that this law had been broken in the superannuation industry<sup>8</sup> and this result was recently confirmed by APRA during a House of Representatives Standing Committee on Economics hearing.<sup>9</sup>

<sup>8</sup> ASIC 2015

<sup>9</sup> House Standing Committee on Economics, 14 October 2016

- In relation to financial advisers, the best interest duty has been introduced, along with a ban on conflicted remuneration, to ensure that an advisor must only recommend a superannuation product where it is in the best interest of the consumer.
- Legislation enables trade unions to influence or determine default fund selection through enterprise bargaining and the Fair Work Commission process. This occurs even where consumers are not members of the union. The anti-competitive nature of this arrangement is not covered by competition law due to a general exclusion applied to the *Fair Work Act 2009*, and conflicts of interest arising from union ownership of industry superannuation funds are ignored.
- The FWC process has been shown by the Federal Court to be a deeply flawed process, whereby the Commissioners responsible to act as agents for consumers are likely to have conflicts of interest.<sup>10</sup> Further, the ‘Experts’ appointed to make a value based judgement of which MySuper products should be listed in each award are not involved in the second stage of the review, in favour of traditional industrial commissioners with no financial services expertise. Finally, superannuation funds have no right to appear before the second stage of the FWC review, entrenching the advantage of industry superannuation funds which are owned by trade unions and employer associations.

#### Employers capability to select a default product

It is incorrect to treat employers as a homogenous group when determining their capacity to engage with superannuation funds on their employees’ behalf.

Large employers often have the scale and resources to conduct tenders for tailored MySuper products and secure MySuper offerings with lower fees or benefits that are tailored to meet the needs of their employees. APRA’s MySuper data publications demonstrate the number of tailored products in the market and the benefit arrangements employers can secure for their employees.

The FSC acknowledges that not all employers have the expertise or resources to choose a MySuper product for their employees. For this reason the FSC prefers a model that does not require employers to choose a MySuper should they decide not to. Similar to a requirement for an employee to provide bank account details before employment commences, an employer could expect a new employee to provide their superannuation account details when they commence employment.

The FSC recognises a strong safety net is important when promoting consumer choice and engagement, and the Commission may wish to consider the option of an enhanced MySuper approval process that better reflects member outcomes than the current MySuper authorisation process. This ongoing assessment of MySuper performance will ensure the population of MySuper products will improve over time so that employers who select a MySuper product are doing so from a high quality population.

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<sup>10</sup> J Perram of the Federal Court observed “the qualification provisions are likely to generate problems of the very kind which have arisen. Most of the people who are qualified will also be disqualified.” Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 36

### Auction models cannot be designed to maximise consumer outcomes

The implicit assumption that Governments are capable of designing an auction model that caters to the needs of a diverse range of consumers is flawed.

There are clear limitations to a fee based auction. Expanding an auction or tender to consider other criteria introduces additional complexity and inefficiency. In particular, the government has to select a set of parameters upon which to optimise. There is no set of criteria that could in the real world be dynamically efficient without perfect information.

Also, an auction model will do nothing to improve member engagement, and could actually drive further disengagement, given employees who do not choose will simply be allocated to a fund (by a government body).

The FSC is also concerned that a Government designed auction would hamper innovation and would lead to a concentrated market with less consumer engagement.

**Recommendation:** The criteria outlined in the Terms of Reference should underpin the Commission's assessment of each competitive model, in conjunction with the 'no default' baseline, which enables a comparison against full consumer choice. The Commission should also be cautious of implicit and explicit biases in its discussion paper that are inaccurate.

## Baseline

We are supportive of the Commission using a baseline of active choice, whereby consumers must choose a superannuation fund product and provide it to the employer in order to receive superannuation contributions.

At a high level, the FSC submits that policy decisions should enable the superannuation system to move towards the baseline over time. The FSC is concerned that solutions, such as the auction model, have limited advantages and take regulatory settings further from the baseline.

The FSC has some high level observations on the baseline model:

- Appropriate filters via APRA for minimum product specifications and requirements would still be required. This would mean the MySuper filter could, as the PC recommended, become a 'Standard of Approval' and aggregation sites listing products could be provided by the private sector or the Government.
- This model would have lower barriers to entry, encourage allocative, technical and dynamic efficiency, maximise consumer choice, competition and innovation, be administratively simple and cost efficient to implement, and would alter incentives in a way that reduce current behavioural biases leading to disengagement from consumers.
- This model would reduce the burden on employers in terms of no longer having to select a default fund and drive greater member engagement.
- Recent technological advances, in particular Single Touch Payroll and SuperStream, will facilitate this model being operationally available at a low implementation and administration cost.
- This model could be complimented by appropriate 'nudges' via redesign of relevant ATO employee/employer forms.
- The model could initially be trailed with new entrants to the workforce which would reduce transition costs and financial stability risks.

## Single Touch Payroll and SuperStream

The practical implementation of the baseline model would be challenging, however it would assist the Commission to be aware of important technological reforms that have improved employers' and consumers' interactions with funds, including Single Touch Payroll and SuperStream.

These improvements have allowed more efficient processing of contributions to, and between, funds that reduces administration costs.

### *Single Touch Payroll*

Employers currently manually report Pay As You Go (PAYG) withholdings to the ATO. Under the new Single Touch Payroll this information will be automatically reported to the ATO through Standard Business Reporting (SBR) software.

Reporting of superannuation contributions will also be automatically sent to the ATO when payments are made to super funds. Employers will also have the option to pay their PAYG withholding at the same time they pay their staff.

Single Touch Payroll is expected to commence on 1 July 2017.

### *SuperStream*

SuperStream is the way businesses must pay employee superannuation guarantee contributions to super funds. With SuperStream money and data are sent electronically in a standard format.

SuperStream transmits money and information consistently across the super system – between employers, funds, service providers and the ATO. The data is linked to the payment by a unique payment reference number.

This means:

- Employers can make all their contributions in a single transaction, even if they're going to multiple super funds
- Contributions and rollovers can be processed faster, more efficiently and with fewer errors
- Consumers can be more reliably linked to their super, reducing lost accounts and unclaimed monies.

The deadline for small businesses to be using SuperStream was 30 June 2016. However, the ATO is providing compliance flexibility for businesses that are not yet SuperStream ready.

All medium to large businesses (those with 20 or more employees) are using SuperStream.

### *Assessment of this model against PC criteria*

The FSC's analysis demonstrates this model measures strongly against the criteria set by the Productivity Commission:

#### *Members' best interest*

Allowing a competitive market would maximise the opportunity for product design that would meet the best interests of members, if accompanied by appropriate oversight by APRA.

Earlier engagement by requiring a consumer to choose a fund would provide an opportunity for more education and create space to promote long-term investing.

#### *Competition*

This model would lead to industry consolidation over time that would improve efficiency, but have lower barriers for entry and would maximise competition and innovation in a static and dynamic sense.

Appropriate private sector comparison websites would develop for approved products that would lead to a focus on net returns.

#### *Integrity*

The allocation process could not be gamed or manipulated as employees would choose based on factual comparisons. It is unclear whether consumer engagement (which is currently low due to incentives discouraging engagement) would still be an issue.

This criteria seems inappropriately designed to only consider auction metrics.

#### *Stability*

Transition costs would be low. APRA would still be required to regulate funds and the stability of the financial system.

Introducing more competition would improve trust and confidence and increase transparency and engagement.

There would be no winner takes all dynamic that would reduce financial system stability like an auction.

#### System-wide cost

Administration would be easy and low cost because of Single Touch Payroll and SuperStream, and regulatory costs would be reduced on business (ongoing costs) as the employee would be required to select the superannuation fund [See Box 1 on Single Touch Payroll and SuperStream].

Government would face minimal costs to implement.

**Recommendation:** The FSC supports the use of a 'no default' baseline for comparative purposes and notes that this closely aligns with the criteria set out in the Terms of Reference.

## Market-based competition

The FSC's preferred model is a genuinely competitive market where any APRA-approved MySuper product can be taken to market to compete for default contributions.

The FSC proposes that consumers should be entitled to choose their own fund and, should an employer wish to offer a default fund, employers could nominate any MySuper product for those employees who do not exercise choice. This blends the aspirational 'baseline' target of active choice by all consumers with the need for enhanced consumer protections, in the form of MySuper, for consumers who are currently disengaged.

Over time, as there is an incremental increase in consumer knowledge and rising average balances, we expect to see a larger number of members actively choosing a superannuation product. In turn, a market-based default model would enable consumers to switch from underperforming MySuper products to better performing products, putting downward pressure on fees and encouraging product innovation to attract and retain customers.

Increased competition will promote consumer switching and drive consolidation of the industry, reducing concerns of 'excessive options' of MySuper products and likely reduce the number of MySuper products from the approximately 70 public offer MySuper products currently in the market. The population of public offer MySuper products, originally estimated to be 120 products, is now less than 70 products, and competitive forces would be expected to reduce this number materially over the short to medium-term.

The Productivity Commission, in Inquiry Report "Default Superannuation funds in Modern Awards" was concerned about the option of allowing employers to select the default product in a purely competitive market on the basis that there would be employers "not best placed to make this comparison from the expected full suite of products that will be available in the medium term." This review, however, was attempting to envisage a MySuper framework that had not yet commenced operation.

In practice there are far fewer MySuper products than the Commission anticipated. Further, the number of MySuper products have already reduced from 120 to 70 demonstrating that the industry is transforming in a manner that will simplify choice.

It is important to note, however, that in spite of the narrow terms of reference in the 2012 Commission inquiry, the Commission still made it clear that all MySuper being entitled to compete in an open market should its concerns about the MySuper filter and range of choice in the market emerge as less significant issues than envisaged. The Commission concluded:

In the longer term... the Commission considers that Option 1 [where employers could choose any MySuper product] has the potential to become a more appropriate option. This is because:

- expected industry consolidation will lead to a fall in the number of MySuper products on offer, reducing search costs for employers
- the MySuper authorisation criteria and broader Stronger Super reforms are likely to increase the average quality of MySuper products over time and narrow the quality differential between them.

The Commission therefore proposes that there be a future review of the recommended process, including an assessment of the appropriateness of employers being able to use any MySuper product as a default superannuation product.<sup>11</sup>

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<sup>11</sup> Productivity Commission Final Report, *Default Superannuation in Modern Awards*, page 192

The FSC submits that, now that the Commission is not bound by restrictive terms of reference, preference should be given to a market-based model as this model offers the optimal mix of competitive forces to drive:

1. Industry consolidation;
2. Consumer protection in the form of an enhanced APRA MySuper assessment; and
3. Increasing consumer engagement.

We consider each of these outcomes in turn.

#### Industry consolidation

The FSC's proposed model would support industry consolidation, as the trustees of subscale and inefficient funds would be obligated to merge their fund, or would be encouraged to do so by APRA, if they become uncompetitive. This would particularly be the case for subscale incumbent funds who are reliant on their default status in awards and enterprise agreements for new members and contributions.

There is a growing consensus that industry consolidation is necessary to achieve greater economies of scale in the superannuation industry. A range of industry stakeholders, including the Financial System Inquiry chair, David Murray, the previous Industry Fund Services chair, Cath Bowtell<sup>12</sup>, and the Deputy Chair of APRA, Helen Rowell, have all spoken on the desirability of industry consolidation.

The model proposed by the FSC would promote incremental industry consolidation as the loss of members and contributions by trustees that are reliant on the existing default framework would generate reduced or even negative flows and place those funds at a disadvantage to growing funds that are achieving scale efficiencies. Further, negative flows would threaten the need to sell assets in unfavourable markets, further diminishing a fund's relative performance to its competitors.

Unlike the 'winner takes all' auction models, the FSC's proposed approach would result in industry consolidation at a measured pace. This allows an orderly transition to a more competitive, efficient superannuation industry as trustees would have time to either change their strategies to attract new members, or to consider merger partners. This model also avoids the market disruption that can occur in an auction model where large volumes of assets may have to be sold into an unfavourable market, leaving consumers worse off, should the trustee be unsuccessful in a tender.

#### Consumer engagement

Engaged consumers make better decisions that result in higher levels of retirement savings, on individual and aggregate levels. This results in more Australians living a comfortable retirement, and reduces the reliance of future generations on the age pension and other Government benefits.

The FSC submits that the Commission should prefer a model that promotes consumer engagement. A market-based model would encourage higher engagement as when consumers exercise choice of fund this engagement provides an opportunity for the trustee to provide

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<sup>12</sup> Rose, S. *Default fund choice aired*, Australian Financial Review, 4 June 2015

additional services and information to enable a consumer to take a greater interest in their retirement savings.

The FSC is concerned, however, that the FWC process and enterprise agreement model discourages consumer engagement by delegating decision-making responsibility to trade unions. This is particularly a concern considering only 15% of all employees are members of a trade union, resulting in unions making decisions on behalf of consumers who are not their members, and with no legal obligation to act in the interest of those consumers.

It is inconsistent with the principles of competitive markets, however, that the freedom of consumers to choose between financial products should be subordinate, under legislation, to the decisions of trade union officials and employer organisations.

### Employer choice

The population of employers in Australia is diverse, and as a result their capacity to make informed decisions in relation to default superannuation varies considerably. The FSC recognises that not all employers would consider themselves qualified to select a default fund, whilst other employers view negotiating a superannuation arrangement on behalf of their employees a competitive advantage in the labour market.

The corporate mandate market demonstrates that where employers can negotiate on behalf of their workforce they can secure significant discounts on fees and tailored insurance arrangements that best suit their employees. APRA's quarterly MySuper data provides detailed information on the range of fee discounts that employers extract from both industry and retail superannuation funds on behalf of their employees.

Employers negotiating discounts on behalf of their employees should not be discouraged where this delivers better member outcomes. This process also engenders competition that flows through the industry as consumers compare and contrast their respective funds.

Under the market-based model the FSC proposes it would be appropriate to continue to allow an employer to offer a MySuper as their default fund should they choose to do so. In order to reduce the regulatory burden, particularly on SMEs, it would be preferable, however, to not obligate an employer to offer a default product, but make it as simple as possible for them to do so by making publicly available comparable information about MySuper products.

It would also be necessary to ensure consumers can continue to exercise choice in the event they disagree with their employers default fund.

### Enhanced APRA-MySuper approval process

MySuper product features are prescribed in legislation and providers must receive APRA authorisation before they can take MySuper products to market. There remains, however, considerable variability in the quality of MySuper products, largely attributable to the relatively limited scope of what APRA can take into account when approving a MySuper product.

The Commission has the option of strengthening the MySuper approval process should it have concerns around the strength of the MySuper safety net and consumers' behavioural biases.

The existing APRA administrative filter could be amended to become a multifactor 'member outcomes' assessment. The FSC envisages this authorisation being applied on an ongoing basis, that is, as APRA carries out its prudential regulatory function and receives regular information on the operation of funds. This would allow APRA to continually assess the performance of the funds' MySuper products.

An enhanced member outcomes assessment would serve two purposes:

- The quality of all MySuper products in the market would increase over time, protecting disengaged consumers; and
- It would complement APRA's prudential role for the MySuper authorisation process to drive industry consolidation through the merger of subscale funds.

The FSC submits that scale, fees and longer-term net investment returns should be the main criteria for a member outcome assessment, as outlined below. There are also ancillary criteria that APRA should be obligated to consider.

1. Scale and operational efficiency:

- Trustees submit their s29VN scale assessments to APRA for objective consideration;
- Trustees demonstrate their risk management culture and compliance with SPS 220;
- Trustee has adequate capital capabilities with regard to risks specified in APRA's SPS 114 ORFR requirements;
- A trustee can show administrative efficiency, including call centre efficiency and ability to resolve pricing and administration errors should they arise;
- If APRA concludes that a trustee is failing to improve its operational efficiency relative to the industry, and its scale assessment demonstrates that it is not, and will not, achieve scale over time, APRA can withdraw a MySuper authorisation; and
- APRA would first be required to work with the trustee to help it change its strategy to achieve scale.

2. Fees:

- The Government benchmark fees and net returns in the MySuper sector;
- APRA should be required to issue quarterly MySuper product fee data against an industry wide benchmark, as well as category benchmarks, such as 'active', 'passive' or 'lifecycle stage'; and
- APRA should be required to take into account the fees charged by a trustees in evaluating whether it is achieving its scale objectives.

3. Long-term performance:

- APRA will be authorised to assess the net performance of a trustee's MySuper product<sup>13</sup> against the industry average, as well as category benchmarks, such as 'lifecycle' products or products catering to young or older members;<sup>14</sup>
- If APRA forms the view that a MySuper product has underperformed over the medium term, and is not addressing the underperformance, APRA can withdraw a MySuper authorisation; and
- APRA is required to work with a trustee to identify the causes of its underperformance before withdrawing an authorisation.

4. Ancillary criteria:

- Trustee has a strategy to promote member engagement and increase members' financial literacy;
- Trustee offers retirement products that provide income streams;

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<sup>13</sup> Where a trustee has rebrand a default product as their 'MySuper', APRA should be authorised to take into account the historical performance of the default product. This would empower APRA to tackle underperformance and excessive fees amongst sub-scale funds immediately, likely bringing down industry average fees in the near-term as high cost products are removed from the system.

<sup>14</sup> Categories should reflect the risk appetite of the membership, so that defensive portfolios catering to older members are not seen to be underperforming aggressive portfolios designed to cater to younger members.

- Consistent liquidity considerations across trustees when determine product sustainability;
- Trustees have appointed a sufficient number of independent directors, have robust governance procedures and APRA is satisfied with a trustee's compliance with its governance standard;
- A MySuper provider must have digital access and transaction ability for their consumers;
- APRA must be satisfied that a MySuper provider as adequate capital to address operational issues or structural risk.

Under this proposal APRA would have an obligation to work collaboratively with a trustee to improve their performance if they are underperforming against any of the criteria. APRA would then have the authority to cancel a MySuper authorisation where a trustee fails to meet any of the first three criteria and has demonstrated incapacity or unwillingness to address its poor performance.

The effect of cancelling a MySuper authorisation would be that a trustee cannot accept new default members. To ensure stability for consumers, however, the trustee can continue to receive contributions on behalf of existing default members. The impact on liquidity that would result is intended to encourage merger activity amongst subscale funds.

#### Assessment of this model against PC criteria

The FSC's analysis demonstrates this model measures strongly against the criteria set by the Productivity Commission:

##### *Members' best interest*

Informed and engaged consumers are in the best position to determine which product suits their personal needs and a competitive model that works towards that outcome should be preferred. The market-based model proposed would encourage all consumers to construct an investment strategy that best-suits their needs, such as their risk appetite, insurance requirements and life expectancy, and would result in higher net returns for more consumers.

Consumer choice would be underpinned by an enhanced APRA approval process for MySuper products. This safety net ensures the population of MySuper, for those who are disengaged, are of a higher quality, which increases over time, than is currently the case.

##### *Competition*

The proposed market-based model of competition allows new entrants to the default market, such as retail funds, to compete with incumbent funds, subject to the APRA MySuper-approval process. This model also allows new entrants to the superannuation industry to compete, subject to the necessary prudential hurdles being cleared, such as capital requirements.

The competition this would generate between incumbent funds, excluded retail funds and new entrants would generate the competitive tension that would put downward pressure on fees, increase net returns and support product innovation. Such developments would be necessary for funds to attract and retain members.

Competition could be facilitated by APRA publishing data on the performance of MySuper products, as part of its continual MySuper assessment, to enable product comparisons by consumers and commentators.

### *Integrity*

A market-based model removes many of the risks that arise from gaming as millions of individual consumers will make their own choices about which superannuation product suits their personal needs. To the extent that competition must occur within the rules, APRA will be the ultimate arbiter by retaining control over who receives and retains MySuper authorisation.

The FSC proposed model is also free of political risk, a risk that besets the auction model and industrial model, and may engender 'gaming'. The superannuation industry is politicised, with trade unions holding equity interest in industry funds. Should the Commission determine that it would be appropriate for a government body to assess funds against legislated criteria, there is political risk that a future government may amend the selection criteria so as to suit their constituency. This was the case following the last Productivity Commission review of default superannuation, where the then Government amended the Commission's recommendations to insert a bias towards industry funds that entrenches their dominance in the default market.

The FSC prefers the market-based model to avoid political risk, as consumers themselves are responsible for assessing different funds.

### *Stability*

A market-based model would promote the stability of the superannuation system over the long-term more than other models being considered. It would extend the regulatory oversight of the prudential regulator, depoliticise the sector by putting power directly in the hands of consumers and deliver tangible benefits for consumers over time.

The benefit to consumers as a result of industry consolidation would also be significant, albeit incremental. The tightening of pressure on subscale trustees would be slow but steady, allowing a managed process of mergers that would promote system stability.

### *System-wide cost*

The FSC submits that the proposed market-based model would minimise system wide costs for employers, consumers and trustees and build upon cost reductions achieved through the introduction of MySuper.

Employers would no longer be obliged to incur the cost of choosing a default fund at their workplace, reducing compliance cost and risk for employers. However employers who choose to select a default fund, as it offers them a competitive advantage in the labour market, may do so.

Trustees would have lower costs in not requiring to comply with the two sets of MySuper assessments; APRA and the Fair Work Commission. Current systems to comply with APRA reporting and assessment requirements would be utilised to ensure that any additional expense coming out of the enhanced MySuper authorisation would be minimal, and more than offset by the scale advantages extracted from this model driving industry consolidation.

There would be no significant change for consumers as all consumers are required to interact with one superannuation trustee or another when commencing work, or switching funds, however this model nudges them towards greater engagement with their fund when that interaction occurs. Consumers would, however, benefit from the increased competitive offerings proving them with better value and potentially higher net retirement savings as a result.

### Transitional arrangements

The FSC does not envisage that transitional arrangements would be complex under the market-based model. This model will apply to all default consumers, however default consumers can remain as a member of their existing fund indefinitely, removing any transitional issues.

Current default funds can continue to receive contributions and new members until such time as that business is won off them by more competitive funds. This would introduce incremental liquidity pressures on uncompetitive trustees over the medium-term, but not major disruption in the near-term. Fund mergers would occur in an orderly manner overseen by APRA.

APRA's enhanced MySuper assessment would be an ongoing process where APRA works with uncompetitive trustees to change their business strategy or consider merger options prior to the loss of their MySuper authorisation. Should APRA take the significant step of cancelling a trustee's MySuper authorisation, the trustee could continue to receive contributions on behalf of existing members, but not receive new default members.

Employers would not face any administrative issues as they can continue to use their existing default fund until such time as they choose a new default provider, or decide not to nominate a default fund for their workplace. Where an employer stops nominating a default fund, an employer would instead require an employee to provide their funds details, along with their other financial details, when they commence employment.

**Recommendation:** The Commission should prefer a market-based model that reflects the baseline, but with improved consumer protections and with the employer option of offering a default MySuper. This model would promote consumer engagement, support industry consolidation by allowing consumers to switch from underperforming funds, and retain a safety net through the option of an enhanced APRA MySuper assessment process.

## Auction Model

The auction model has come to the fore in this debate as a result of flawed analysis that was adopted by the Financial System Inquiry (FSI). This submission focuses on the current debate around the Chilean auction model, but notes that there are other models in operation overseas. Through analysing the Chilean model the FSC has sought to extrapolate shortcomings in that model that equally apply to comparable models in other jurisdictions.

The FSC's primary conclusion is that an auction operates effectively when attempting to achieve a single outcome for a simple product, such as the lowest possible cost.

Superannuation, however, is a complex product that offers a range of services and features which offer different degrees of value to different consumers based on their personal circumstances. It is impossible to design a set of criteria for all default consumers that would accommodate this complexity, and as a result different cohorts of consumers would be worse off under an auction model.

The underlying rationale for the Chilean auction model, as was canvassed in the FSI's interim report, is that fees in Australia are too high because members are disengaged and do not put pressure on funds to reduce fees.

The FSC engaged Chant West to examine the Chilean auction system in detail. The Grattan report claims Chile's default fees are less than one-third of MySuper fees. This is not correct.

The problem is the Grattan report originally compared only Chilean administration fees with total MySuper fees (administration plus investment fees). The Chant West analysis shows that Chilean default and MySuper administration fees are at similar levels.

The biggest difference is with investment fees. Chile's fees are much lower because it invests in a very different way to MySuper funds. Essentially, funds in Chile (including its default fund) manage about 57% of assets in-house at very low cost. Most of this is domestic and most of it is in fixed income securities. Overall, about 60% of Chilean assets are invested in fixed income assets.

By contrast, less than 5% of MySuper assets are managed in-house and only about 20% of assets are invested in fixed interest securities. Given these differences, you would expect MySuper investment fees to be higher.

It is also worth noting that Chilean funds do not offer the range of services provided by Australian funds, such as insurance coverage and management of claims, which is a valuable service to consumers but carries additional cost.

The FSC has attached the Chant West research into the Chilean system for reference and submits that the Productivity Commission should take significant care not to rely on previous flawed analysis when considering the auction model. Grattan has recognised its analysis was incorrect and responded accordingly to the FSC, however, publicly Grattan has only gone so far as to 'tweet' a correction, and update its slide deck with information it purports is now accurate. Grattan continues to publicly advocate for an auction model.

## Theory based disadvantages

Economic theory raises a number of clear issues with the proposed auction model that would be difficult, if not impossible, to overcome when seeking to achieve a competitive model relative to the 'no default' baseline:

*It would raise barriers to entry*

A 'winner takes all' auction would require significant resources for potential providers, as well as impose major regulatory barriers to entry, such as enhanced prudential obligations to minimise potential financial sector instability. These barriers would prevent all but the largest financial institutions from seeking to enter the default market.

*It would lower dynamic efficiency over time*

The balance between consumption and saving over time would be distorted by the criteria set by the Government to win the auction. This criteria would inherently approximate the needs of consumers, and emphasise some product attributes over others.

As a result the FSC is concerned that product providers would design their products to win the auction, potentially neglecting the diverse needs of different cohorts of consumers and leaving consumers worse off. It may also result in emphasis on product features that some consumers do not need, but would still be required to consume, whilst neglecting product features they would benefit from.

*It would lead to less or no innovation*

Product providers would design products based on the criteria set by the Government and likely favour low cost, vanilla products that are readily understandable and competitive. This is a form of gaming the criteria that is an inherent risk in any auction.

The FSC is also concerned the Government is not traditionally a source of innovation in markets, and may either not recognise innovation when it occurs, or alternatively fail to appropriately weight the risk and benefits arising from attempts at innovation.

*It would reduce financial stability and create too big to fail institutions.*

The significant flows of contributions to the successful bidders would potentially create systemic risk in the financial system and result in the creation of financial institutions that are too big to fail.

It may also result in system risk should all non-successful bidders face liquidity issues immediately after an auction and be forced to sell assets into unfavourable markets, or hastily merge on terms unfavourable to consumers.

<p><b>Recommendation:</b> An auction model cannot be designed in a way that effectively addresses theoretical issues, and the FSC has not observed research that demonstrates how this could be achieved.</p>
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*Selection criteria would ignore consumer differences*

The FSC's primary concern with an auction model is that any selection criteria developed and implemented by a Government body would necessarily approximate the needs of a diverse body of default consumers.

There are significant demographic differences within the default market, such as ages, income, cost of living and non-superannuation assets. The criteria developed for an auction model would be blind to many of the differences between consumers in the default market and lead to homogeneity of products between providers participating in the auction.

Consumers would be worse off under this model as consumers would be defaulted into products that may not reflect their individual needs and circumstances. Whilst a consumer may still be eligible to choose to switch out of the default option, the design of the model discourages consumer engagement by creating an administrative barrier to exercising choice,

and an implicit assumption that the Government has chosen for them, and the Government makes the best decision.

The FSC is concerned that this introduces a new structural impediment to consumers arranging their financial affairs in the way that best suits their individual needs.

The FSC agrees with the analysis of the different needs of consumers put forward by the Chair of the Productivity Commission at a recent Senate Economic Committee Inquiry:

Mr Harris: Again, this is a question of relative versus absolute performance. It depends on what their aims are, doesn't it? We have, in the course of this default fund process, which is in its early stages, been around to see a number of individual funds as well as the representatives of different elements of this debate on superannuation. In the course of those discussions with individual funds it has quite often come up that, depending on the objectives of those funds, they have perhaps a lesser performance. The answer might be that it is an ethical fund, for example, or one that has particular religious objectives. There are such funds whose performance would obviously be less than those of some other funds because they are meeting, nevertheless, the terms of what they have said to their members, which is: 'This is how we will try and deliver product.' So, relative performance is hard to judge. I am sure that there are poor-performing funds on all sides if you have a particular benchmark about what is good. But it is not necessarily a simple question of what is good; it is what you promised your members you would do.<sup>15</sup>

The complexity in understanding the needs of individual consumers was put clearly by the Deputy Chair of the Commission:

Ms Chester: It is. And it is made even more difficult when you think of it purely from a member's perspective—for example, someone who is doing their superannuation through SMSF. That individual member knows their personal circumstances—do they own the family home, do they have other private savings and what is their tax position. So it is very difficult for us to have a fuller view as to whether someone's outcomes through their super—when they are making the decisions themselves—are truly optimal, unless we knew everything about them.<sup>16</sup>

The FSC recommends that the Commission emphasises the advantages of encouraging consumers to exercise choice. The Commission should be cautious of an auction model that causes consumer disengagement.

#### Empirical based disadvantages

##### *The initial evaluation of Chile's auction model system was wrong*

The Grattan Institute report found Chile's fees were about one-third of Australia's default MySuper fees, but the report wrongly compared Chilean administration fees with the total of administration and investment fees for MySuper options (Chant West 2014). Further, any apparent differences were attributed to different investment allocations between Australian MySuper funds and Chilean funds, and Chilean fee levels are unsustainable (Chant West 2014).

##### *There is no positive evidence (or any evidence at all) on the long term effects on competition, dynamic efficiency and innovation impacts of auction models for pensions systems*

We do not believe current auction models for pension systems are comparable to Australia. However, we note that in many cases they are relatively new policy developments. Many

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<sup>15</sup> Senate Economics Committee, 20 October 2016, page 21

<sup>16</sup> Senate Economics Committee, 20 October 2016, page 22

theoretical concerns remain untested because of a lack of time elapsing to see the negative impacts of these models. In particular we believe innovation and consumer choice will be lower, as will net returns because of inappropriate asset allocations which are more static.

*Evidence on the qualities of auctions or tenders in other markets is not applicable and easily differentiable (e.g. compared to spectrum auctions)*

Auctions have been used in other markets to achieve policy based outcomes. Usually, these auctions work best when there is one policy objective. For example, in the case of spectrum, governments were concerned that there could be overcapacity and so took property rights out of market control to limit access to a network. In order to maximise revenues to government an auction is used to then sell off licences. However, this is an entirely different policy situation to the current state of the superannuation industry.

We believe these examples are distinguishable from the superannuation industry. There are multiple policy objectives that make this model incomparable to lessons from auction theory in other policy settings. Attempting to introduce a cap on fees via an auction model, which is effectively what nationalisation of the right to manage superannuation in the hands of the government, would lead to inefficient outcomes.

*Cross country comparisons have flaws that undermine relevance to Australian policy.*

International comparisons should be used with some caution as differences across countries reflect different stages of development of the country, geography, tax and expenditure policy settings, comparative advantage, unique resource endowments, the openness of the economy, productivity levels, societal choices, regulatory settings and measurement issues.

In the case of the Chilean auction model, there were only five pension funds and fees were considered to be high. The potential for market disruption and transition costs were much lower given the small industry size. The tender did result in lower fees, but saw only one new fund enter the market. Australia's superannuation system comparatively has much more competition, relatively different levels of service, different asset allocations, different regulatory settings, and is clearly not comparable with Chile.

For example, OECD data is inconsistent as different international pension systems report fees differently, preventing direct comparisons from being established. Further, OECD data does not take into account different levels of member servicing in the different jurisdictions – Australia largely operates on a full service model. Member servicing is a significant contributor to the cost basis for a superannuation fund and, in many instances, should not be discounted where they are important to an effectively functioning system. Government run pension funds, such as the two Norwegian funds, 'Government Pension Fund – Norway' and the 'Government Pension Fund – Global', do not provide any degree of member servicing. Those funds are administered through an arm of Norway's Central Bank and are not required to have any notable interaction with the public, for which it is ultimately intended to provide.

*Practical implementation issues*

*How regulation will impact innovation including Fintech*

We do not see how a Fintech ventures could enter the market successfully. These companies would face a reduced incentive to undertake research and development aimed at innovating the funds management industry. Incumbents would also face less incentives to innovate due to reduced competition and higher barriers to entry. No mechanism design can overcome this.

*Market dislocation and gaming*

Shifting to an auction model where there are already a large number of competition products would be financially devastating for the losers and their consumers. As noted, we believe an auction model could be gamed via tacit collusion, cost padding, and other well established principles. Over time, this model would not maintain a low level of costs.

*It is impossible to know what to maximise across vastly different consumer preferences*

It is unclear how Government would make decisions as to what product features and services should be included in a tender, nor is it clear how Government would assess unsolicited product features as part of a tender process.

**Recommendation:** The Commission should recognise that an auction model would be at significant risk of gaming by market participants, is exposed to political risk, and would fail to provide products suited to the diverse needs of both employed and retired Australians.

## Current Industrial Model

### General assessment of industrial model

There are clear policy-related barriers to competition that impede the efficient functioning of the market under the existing FWC and enterprise agreement framework:

- Under the FWC's 'expert panel' process, Australia's 122 Modern Awards will contain a limited list of mandatory default funds selected by the FWC; and
- Enterprise agreements remove the capacity for approximately 800 000 consumers to choose their own superannuation fund by requiring an employer to pay into a particular MySuper.

These instruments are negotiated or based on submissions from the trade unions who are owners of industry superannuation funds and have a disproportionate influence over the selection outcomes:

- Modern Awards are set by the FWC following a two stage review, the second stage affords trade unions and employer associations, but not superannuation funds themselves, the right to appear before the FWC to make submissions on which MySuper products should be listed in each award; and
- Enterprise agreements are directly negotiated by trade unions and employers, who are usually members of employer associations, and therefore have an interest in ensuring the fund they own is ensured default status in the agreement they create.

Further, the representation rules of trade unions prevent one industry fund from readily competing with another industry fund where the trade union related to the fund does not have the 'right' to represent the industrial interests of those workers.

The policy framework clearly suppresses competition, not only between default industry funds and retail funds, but also between industry funds. Competition between industry funds is suppressed as only trade unions with industrial coverage in relation to a modern award will make submissions on which industry fund should be listed in each award in the second stage of the FWC process. This allows a trade union, which is affiliated with an industry fund, to block the inclusion of another industry fund.

The FSC is concerned that these arrangements give rise to a clear conflict of interest, where industrial parties place their own interests ahead of the interests of consumers.

The Federal Court has provided useful commentary on the current process, which requires an 'Expert Panel' to review MySuper products. Of the three 'Expert Panel' members on the FWC, the FWC President stood down two as a result of potential conflicts of interest giving rise to legal action before the Federal Court.

The Full Federal Court was scathing in its assessment of the current default allocation model. Justice Perram observed that "the qualification provisions are likely to generate problems of the very kind which have arisen. Most of the people who are qualified will also be disqualified."<sup>17</sup>

The Court went so far as to observe that "it's obvious that this legislation has not been thought through in its practical operation. I'm just not sure that it's the role of this court to try and bend it back into the shape of something which works."<sup>18</sup>

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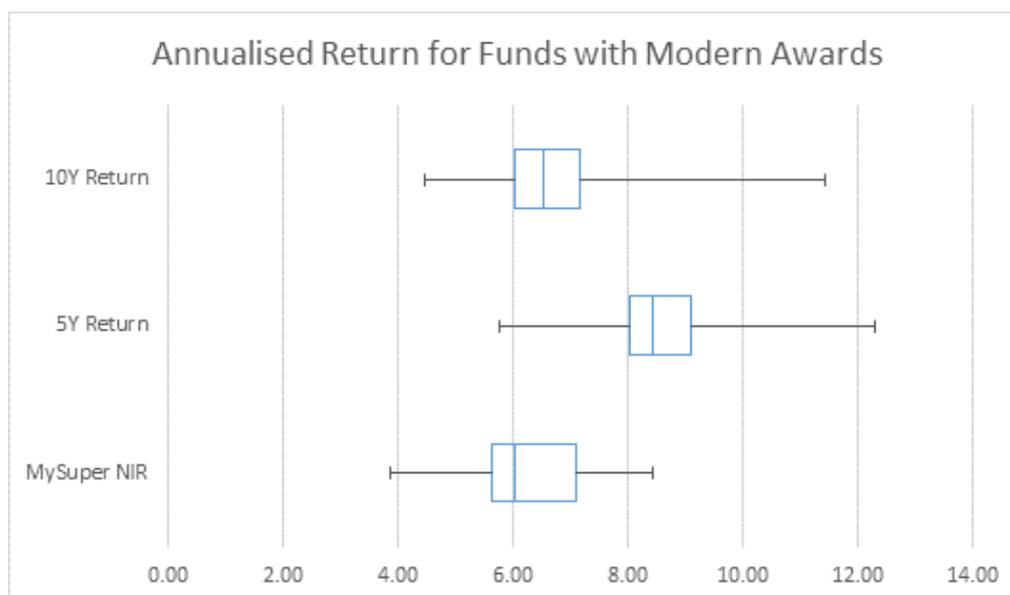
<sup>17</sup> Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 36

<sup>18</sup> Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 50

The existing policy framework is neither contestable nor competitive.

There is significant evidence to show that the poor performance of some superannuation funds listed in modern awards and enterprise agreements is undermining the retirement outcomes for members of those funds. The MySuper data reported in APRA's superannuation return data in Chart 1 demonstrates the significant variance in performance by different MySuper products that are listed in modern awards.

Chart 1. Annualised NIR or Whole of Fund returns for default products with Modern Award listings



Source: FSC Analysis of APRA and Fair Work Commission data

Chart 1 demonstrates that across three different timeframes – since MySuper started in 2013, the last five years, and the last 10 years – there is significant variance in the performance of the default products appointed by the Fair Work Commission to modern awards as default funds.

Chart 1 shows that there are poorly performing industry funds that have listings in the award system. As there are 16 modern awards that only name one MySuper product, an employer in that industry has no choice as to which MySuper product must be the default product for their workplace if/when the “grandfathering” provisions that allow defaults used by an employer in 2008 are removed. Consumers are being defaulted into underperforming products under the current framework.

The FSC recommends that the Commission recognise existing policy is a clear barrier to competition that fails against the criteria of operational, allocative and dynamic efficiency:

- Operational: requiring two stages of MySuper vetting, through APRA and then the FWC, is duplicative and inefficient, and creates barriers to entry from trustees that are not owned by industrial parties (employer groups and trade unions).
- Allocative: the current policy framework has resulted in the proliferation of subscale and inefficient superannuation funds and acts as a barrier to fund merging as they can rely on their default status and the resulting guaranteed inflows to support their liquidity.

- Dynamic: the industrial framework suppresses efficiency gains over time as it removes the pressure to reduce costs, lower fees and innovate to win default consumers.

**Recommendation:** The Commission recognise that the Fair Work Commission and enterprise agreement framework is not competitive and delivers sub-optimal outcomes for consumers by directing some consumers into poorly performing MySuper products.

The default framework does not protect funds from ‘inefficient competition’

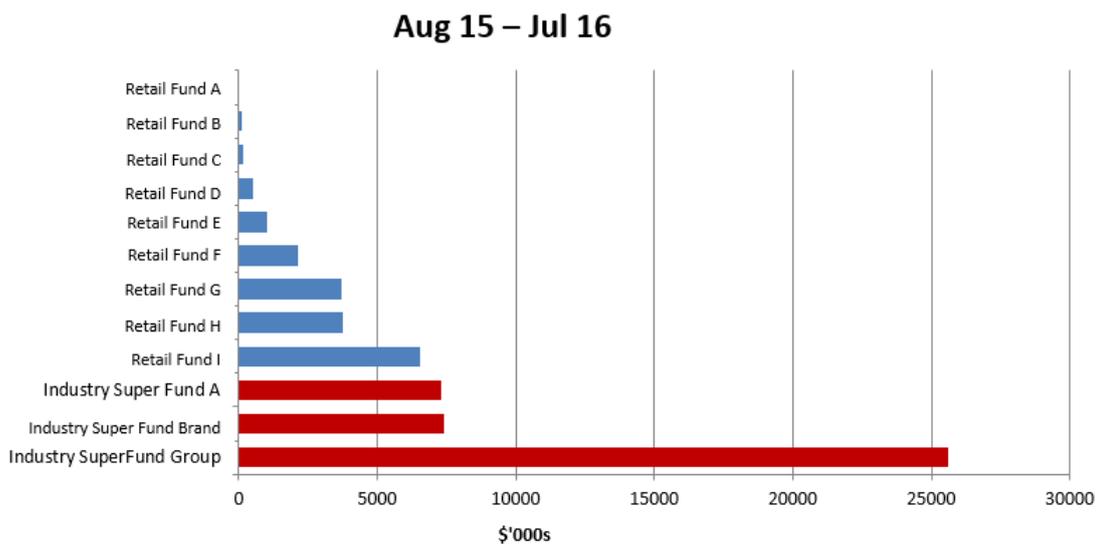
The FSC is also concerned by suggestions that exposing industry funds to competition-enhancing reforms would lead to inefficient competition that is not currently experienced in the industry.

This argument appears to rest on the assumption that the protected status of industry funds provides efficiencies, such as not incurring the expense of advertising and the need to have the same liquidity considerations as some other funds, which they would not experience should they be required to compete.

The argument in regards to industry funds incurring lower expenses on advertising is simply incorrect. Data presented in Chart 2, sourced from Nielsen AdEx, demonstrates that over the past twelve months Industry SuperFund Group, that is, the collection of 15 industry funds who co-brand themselves ‘Industry SuperFunds’, collectively spent \$25 million on advertising.

The \$25 million in advertising expenditure is far greater than all the remaining retail superannuation funds listed in the top 10 combined. It is also consistent with the annual advertising spend of the Industry SuperFunds group over the past three years.

The brand managed by lobby group ISA, also incurred its own expenditure of over \$7 million, a sum greater than any retail superannuation competitor. An individual industry superannuation fund also outspent every other superannuation fund in the market, including any retail superannuation fund.



Source Nielsen AdEx

The FSC submits that in the context of increasing consumer engagement with consumers, advertising is an important activity and should not necessarily be discouraged. This data

exposes, however, the assumption that industry superannuation funds incur lower advertising expenses as a result of being protected from competition under the current policy framework.

The FSC submits that the Commission view with caution claims that industry funds are more efficient for not having to compete for the default market when there is evidence to the contrary.

The FSC also submits that advertising expenditure funded by trustees, but delivered through related parties such as ISA, also be included in the Commission's assessment of the efficiency. The FSC is concerned that this behaviour reflects how guaranteed market share may cross-subsidise activities in the choice market.

### *Assessment against PC criteria*

The FSC's analysis demonstrates this model performs poorly when measured against the criteria set by the Productivity Commission:

#### *Members' best interest*

It is a lottery for consumers as to whether they will be defaulted into a quality, or sub-optimal, MySuper product through the default system. The current system relates to the industrial coverage of the relevant union, rather than the performance of the fund the union owns, and this is not in the best interest of consumers.

Further, preventing consumers or employers to nominate a different fund where the default fund is underperforming is clearly not in the best interest of a consumer.

#### *Competition*

The advantage afforded industry funds in the second stage of the FWC process, as well as the general preferred position of industrial parties when the process is overseen by an industrial tribunal, ensures that competition is suppressed.

Further, competition is also suppressed between industry funds as default status relates to the industrial coverage of the relevant union. This prevents one industry fund seeking to compete with another and is consistent with cartel behaviour.

#### *Integrity*

The current legislative framework lacks integrity. The legislation entrenches gaming in the default market to ensure continued market share of industry superannuation funds. The industrial model was not developed with competition policy in mind.

The Commission should prefer models that are aimed at promoting competition to achieve the best outcome for consumers.

There is also limited transparency in the current model that undermines the integrity of the system as veneer of a merit-based 'Expert Panel' process is undermined by a blatantly anti-competitive second stage influenced by conflicted industrial organisations.

#### *Stability*

The industrial framework lacks stability because the continued reliance of subscale and inefficient industry funds on the guaranteed flows of contributions and members through the default system undermines retirement savings.

Not only does this model undermine consumer engagement, it also risks eroding consumer confidence in the system over time should higher fees and lower returns undermine the effectiveness of superannuation as a policy.

#### *System-wide cost*

The current system generates significant unnecessary cost for superannuation consumers and trustees. The FWC process itself is an unnecessary duplication of the APRA-approval process for MySuper products, which ensures that all MySuper products satisfy a minimum standard.

It also results in some consumers being compelled, under law, to maintain multiple super accounts, including multiple sets of fees and insurance arrangements.

Finally, the ongoing support for subscale and inefficient superannuation funds, and the barrier to industry consolidation, results in a structurally high level of aggregate industry fees than would otherwise be the case.

The FSC is particularly concerned that there continues to be a significant number of subscale industry funds managing less than \$5 billion – Chant West research shows that only 29 of the 43 industry funds as at 30 June 2016 manage less \$5 billion or more in assets – creating a drag on the efficiency of the system and preventing more significant investments in infrastructure assets.

Rice Warner Actuaries has estimated that average fees in the industry would be 15 basis points lower than they currently are should the minimum fund size be \$5 billion, and 25 basis points lower if the minimum fund size were \$20 billion.<sup>19</sup> The average fee for a small industry fund is current 141 basis points, and the industry average 110 basis points.<sup>20</sup>

#### *Transitional issues*

The FSC commissioned research by independent Actuarial firm, Rafe Consulting, in 2014 to examine transitional issues arising from the revised Fair Work Commission process for selecting default products in Modern Awards.

The report considered a range of transitional issues related to the implementation of the FWC process, including:

- The movement of default consumers out of from funds who lost their Modern Award listing to other MySuper products;
- The cost to members as a result of account duplication and buy/sell spreads;
- The impact on employers who would be obligated to choose a new fund from those now listed in Modern Awards as their existing default fund had lost it listing; and
- The cost to Government of managing the market disruption.

Rafe Consulting concluded that, should the FWC process be allowed to be fully implemented, for affected superannuation fund members and employers of participating organisations, the FWC process will result in:

- At least 1.25 million employees having to be redirected to alternate superannuation arrangements;
- A potential cost to these impacted employees of \$185 million;

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<sup>19</sup> Rice Warner Actuaries, 2014 Superannuation Fees Report, at 21

<sup>20</sup> Rice Warner Actuaries, 2014 Superannuation Fees Report, at 5

- A potential losses to these members of \$50 million from asset buy/sell spreads and crystallisation of tax losses;
- Around 100,000 employers will be required to redirect superannuation contributions on behalf of some or all of their employees; and
- A potential cost to impacted employers in the region of \$30 million.<sup>21</sup>

Rafe Consulting also concluded that the potential cost to all superannuation funds was in the region of \$25.5 million.

**Recommendation:** The Commission recognise that the current Fair Work Commission and enterprise agreement model was not designed to achieve competition and delivers worse outcomes for consumers by directing some consumers into poorly performing MySuper products. The full implementation of the existing model would have a significant cost and disruption for the industry and consumers.

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<sup>21</sup> Rafe Consulting, 16 June 2014, Impact of Changes to the Fair Work Act on the Australian Superannuation Sector, Employers and their Employees.

## Allocation of Insurance inside superannuation

Our submission has focused on how default products are allocated in relation to superannuation. In the case of group life insurance provided through superannuation, we believe that the current competitive allocation process is effective and is outlined in this section of our submission.

The provision of death and disability insurance benefits to Australians through superannuation on a default opt-out basis is a critical component of the system. Funding insurance premiums within superannuation has become an important part of affording millions of Australians with cover and provides a safety net to those who would have otherwise not chosen, or been able to take out insurance individually. Group insurance within superannuation, therefore, plays an important role in providing an economic and social benefit to Australia, and is vital in contributing to reducing the burden on taxpayers of publicly funded social security.

The provision of these benefits to members is a complementary feature of the superannuation system that enables an individual to manage the financial risks of an unintended absence from the workforce due to illness or injury either temporarily or permanently, or in the case of premature death provides a financial safety net for their dependents. Ultimately, in the case of temporary disability, insurance benefits can enable a person to continue to save for their retirement while recovering from a health setback as many offerings include replacement Superannuation Guarantee contributions.

Fundamentally the selection of insurance products inside superannuation is intimately related to the superannuation funds itself, including the demographics and needs of the membership and the fund's attraction and retention strategy. The separation of insurance into a distinct competitive process undermines the capacity for a trustee to operate a superannuation fund in the manner that delivers the best outcome for members. This is particularly the case in relation to tailoring superannuation products when tendering for employer mandates where employees may have specific insurance needs.

**Recommendation:** The Commission recognise that the process for selecting group life insurance through superannuation is effective and the selection should remain the responsibility of the trustees of the fund.

## Group insurance within superannuation

### *Obligations on trustees under relevant prudential standards*

Under Australia Prudential Regulation Authority's (APRA) Prudential Standard SPS 250, trustees have obligations to develop a selection process that includes, at a minimum: consideration of the prospective insurer's terms of cover and exclusions, claims philosophy and the reasonableness of premiums to be charged.

The selection process must also undertake due diligence of the selected insurer and must be able to demonstrate to APRA the appropriateness of the selection and any due diligence undertaken.

Furthermore, the trustee must be able to demonstrate that the engagement of the insurer was conducted at arm's length and is in the best interests of members and their beneficiaries.<sup>22</sup>

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<sup>22</sup> APRA Prudential Standard SPS250 section 23, page 6

### *The number of life insurers and reinsurers participating in the market*

When trustees examine and evaluate the marketplace for insurance providers, many elect to invite all of the active group insurers to participate in the tender process. During the challenge faced by the group life insurance industry in 2013, which was caused by the significant increase in claims volume, many trustees found it difficult to get insurers other than the incumbent to compete for new or existing business.

Similarly, direct insurers found it difficult to obtain reinsurance support from the local reinsurance market given the issues experienced by reinsurers active in the group life insurance market in 2013-14. Capital in the market had significantly depleted due to the sharp increase in claims experienced in the group insurance through superannuation sector. The group insurance market experienced a period of 2-3 years where reinsurance capital for new business was hard to secure.

However, with stability now starting to return to the market, a greater number of insurers and reinsurers are now competing for new opportunities. Further, the price rise experienced in recent years (which stemmed from the challenges in 2013) is beginning to be relaxed as trustees work with insurers to embrace benefit design, service and technology changes that aim to provide greater sustainability of premiums and design over the longer-term.

Greater competition in the industry delivers better outcomes for members – this is not solely related to premiums, as trustees are now placing greater importance on better cultural alignment with insurers, particularly on areas such as appropriateness of benefit design, claims philosophy, service models and technology advancements.

It is also worth noting that current consolidation trends and superannuation fund mergers are naturally reducing existing inefficiencies and cost to members, caused where there is the duplication of insurance cover across multiple accounts. Where consolidation occurs, members should be warned of loss to cover, but at the same time be given choice to make an informed decision about their future cover.

### *The role of reinsurers and the important role they play in the group insurance market*

The reinsurance market is critical to ensuring group insurers can best make use of the capital it can access. The insurer - reinsurer relationships now have evolved to a point where there is a much closer alignment of interests. For example, 50:50 quota share arrangements are more common than they were pre-2013 when in many instances, reinsurers held a much larger portion of the risk and therefore suffered more extensive losses than the direct insurers did when the sharp increase in claims costs began to emerge. Reinsurers are now much more focused on sustainable partnerships.

Reinsurers are increasingly providing valuable support to insurers, providing access to training and education to supplement the capabilities of group insurers, with a continued training focus on underwriting guidelines. The reinsurers can often leverage their international experience to provide alternative perspectives in managing key claims and underwriting trends.

Reinsurers are increasingly taking part in an ongoing dialogue with trustees, particularly in relation to claims experience updates, this is so that insights can be shared across all parties in a timely manner.

### *The heightened interest from overseas reinsurers operating in the market*

The local reinsurers suffered heavy losses in 2013, causing many to withdraw temporarily from new group insurance opportunities or limit their involvement to incumbent business or preferred benefit designs. This provided opportunities for new reinsurers to enter the market in the period 2013-15, providing capacity (where there was no local reinsurance support in some cases) and increased competition in the Australian market.

In addition to those that have set up local offices, a number of offshore-based reinsurers have elected to participate in the Australian market, either as a secondary reinsurer or sole reinsurer on smaller mandates.

### *The number of market tenders and participation in those tenders*

Since the Stronger Super reforms, there has been a marked increase in the number of superannuation funds seeking to test the insurance market.

This is achieved through a market tender process where all group insurers are invited to participate, either on a full market tender basis, or through to more limited tenders, where specific group insurers are identified that meet key fund criteria (e.g. alignment with culture, capacity, ability to provide appropriate service and technology offerings).

Tender quality has improved dramatically since the Stronger Super reforms with improvement in data standards by trustees and tenders now running for more appropriate periods of time. This gives insurers additional time to understand the history of a fund's insurance arrangements and their member needs, the opportunity for the insurer to hold meetings with trustees to raise any questions and address any knowledge gaps they may have, as well as the pricing of a range of potential product changes under consideration.

In addition, superannuation funds are also participating in reinsurance market tenders where the underlying service proposition provided by the group insurer is sound. This requires trustees working closely with insurers to test the reinsurance market to find the best reinsurance price and supporting product terms to deliver the best outcome for the trustee and its members. In the past 12 months, this heightened competitiveness has seen a significant number of trustees change insurers where longstanding relationships had existed.

### *Issues relating to a government-run processes*

The FSC believes that the proposed idea of a centralised government body to develop and specify mechanisms and metrics for a competitive selection of funds whereby that body is provided with an ability to directly allocate employees to the specific product(s) may be unsuitable for the following reasons.

We believe that trustees are in a unique position to understand their membership intimately and are best placed to design and develop superannuation and insurance solutions which best meet the needs of their membership demographic. Trustees already have a responsibility to act in the best interest of their members under section 52(2)(c) including specific covenants in relation to insurance under section 52(7) of the Superannuation Industry (Superannuation) Act 1993 (the SIS Act).

### *The weaknesses of a government-run tender mechanism*

We are concerned that a government run tender process would restrict the ability of trustees to negotiate competitive insurance arrangements based on default cover being allocated on a compulsory basis. Where cover is automatically allocated, the ability of insurers to offer cover

without the need for members to provide evidence of health may be compromised. Further, larger employers have been able to negotiate insurance design and terms which meets the need of their particular workforce (e.g. resource companies) – this would not easily be possible under a government run tender process, to the detriment of the employees concerned.

The premium rates which members pay may increase or decrease (resulting in the members who need the best available cover at the cheapest rates having to pay more than insured lives which are a less risky proposition) where the existing generally homogeneous group of members with similar occupations is disturbed.

A risk arises that funds may seek to attract (through better and cheaper insurance offers) members based on assets a member holds. A member with higher assets may be in a less risky occupational segment and as such may pay a cheaper premium. This would mean that the potentially higher claim costs associated with a higher risk occupation would be spread across like members who are less able to afford these costs.

#### *The weaknesses of government defined product features*

We are concerned that government defined product features would reduce the ability of both funds and insurers to compete, and potentially stifle market innovation. A default insurance product that is very prescriptive is not likely to enhance competition on the insurance side of superannuation as it may cause a potential withdrawal of capital by insurers and reinsurers, and reduce market capacity if these features are less sustainable than current best practice.

A consistent default fund insurance offer may help drive competition but only in the short- to medium-term. It would not encourage innovation or new market entrants – both of which would better ensure medium to long term competition.

The trustee is already required to have an Insurance Management Framework (IMF) in place under APRA prudential standard SPS250 to manage insured benefits available to beneficiaries.

The IMF requires trustees to take into account the specific needs of their membership, defines their principles for their planned insurance design and considers the impact on the retirement outcomes of their members.

We believe that the IMF is an appropriate oversight mechanism for trustees to design the product features appropriate for their membership cohort, this would not be covered under a government run scheme. The focus should be on reviewing the IMF mechanism and ensuring trustees review their IMF on an ongoing basis, not introducing government defined products.

<p><b>Recommendation:</b> That the focus be on reviewing the Insurance Management Framework (IMF) mechanism and ensuring trustees review their IMF on an ongoing basis.</p>
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#### *Benefits of trustee obligations*

Under paragraph 22 of APRA Prudential standard SPS250, a trustee must develop and implement a selection process for choosing an insurer that considers the reasonableness of the premiums, terms and conditions and performance of the insurer.

The trustee will often use a market tender process to adhere to its prudential obligations. The objective of this process is to ensure the fund membership has access to the best overall value proposition available. Typically, this will involve assessment against a combination of terms

and conditions, service, the insurer's claims philosophy, as well as the cost of the insurance cover.

#### *Allows for competition and innovation in the market*

A trustee run tender process will allow the market to respond with competitive and innovative offerings based on claims insights and respective competitive advantages. These competitive dynamics will drive efficiency throughout the market as insurers continually look to improve operations and services offerings to remain relevant and competitive against their peers. These innovations include insurers investing internally in technology to support a differentiated market offering. These advances in offerings allow a trustee to select an offer which best aligns with the fund's objective and needs, and helps it differentiate from other funds in the market.

#### *Efficient mechanism to achieve value for money*

A tender is generally an efficient process to assess the best value for money offering in the market as each competing insurers will submit pricing terms which can be benchmarked and ranked for trustee consideration. This process can give the trustee of a fund confidence their offering is competitive and in the best interest of its membership.

In addition this process allows the overall market to rebalance on a regular basis to ensure overall sustainability throughout the varying cycles.

#### *Issues related to a separate competitive process*

##### *The problem with multiple insurance providers for separate member cohorts*

The current tender processes proceed on a well-defined membership cohort. We are not confident this would occur if there were multiple insurance providers for a particular member cohort.

Having multiple insurance providers for particular member cohorts could have unintended consequences and create further complexity and additional costs in the system (e.g. Insurer A for existing fund members, Insurer B for default fund cohort who joined in past two years, Insurer C for default fund cohort for new members for next two years). This would severely complicate the disclosure requirements which funds must meet, as well as the process of regular communications with members.

These changes have considerable cost implications and will remove much of the benefits of scale and insurance pooling as a result of administrators of superannuation funds needing to manage complex relationships with multiple insurers. For superannuation trustees, one of the key operational risks of administering a superannuation fund relates to the administration of insurance arrangements and this complexity will likely increase the operational risk profile of a fund. This is likely to result in certain membership cohorts in superannuation funds receiving a much poorer outcome.

When the overall membership of a fund is broken down into member cohorts, it would be expected the cohorts will reflect similar risk traits. As such, the risk appetite of insurers can result in the higher risk cohort receiving poorer terms or pricing. This means that members who may have pre-existing medical conditions, are working part-time, casually or working in high-risk occupations may no longer get access to the same level of insurance cover at an affordable price relative to terms available when pooled together with all cohorts of the fund.

An additional complexity of managing separate cohorts is the general market volatility or cycles experience from an insurance pricing perspective. The repricing cycles and performance of certain funds (due to economic conditions) can impact on the overall portfolio for different insurers at certain points in time which are subsequently reflecting in the pricing terms offered to the market. Having cohorts of members spread across different insurers can see inconsistent outcomes being experienced across these cohorts, as one of the insurers may be experiencing a turnaround in performance or a tightening of risk appetite.

#### *Risks of a more frequent tender process*

Allocating insurance through a separate competitive instrument for default superannuation funds runs the risk of creating an environment whereby there are continual and repetitive tender processes (for example, every two to three years). A separate process lessens the ability for superannuation funds and insurers to invest in product, service and technology innovations as the timeframes to realise these benefits is often over a number of rate guarantee cycles (generally, six to 10 years).

Such investments include technology platforms for members to interact with the fund and insurer on matters relating to underwriting (getting access to additional cover), integrated administration models, data management, claims management (online claims portals) and product transformation (progressive improvements to the policy terms and conditions). These examples will often require a commitment to a longer term relationship to ensure the membership of a fund can get access to the benefits without having adverse pricing outcomes, such as the insurer or fund trying to recover costs over a two-year period.

An additional risk of a repetitive tender process is the dilution of the knowledge and experience of a fund's insurance performance over a longer period. This will often equate to an insurer having more confidence in the insurance risks of the portfolio having a direct flow through to the pricing and rates offered (more confidence in the expected future performance of a portfolio can eliminate additional risk buffers).

In addition, whilst trustees and insurers work continue to recognise the benefits of working more closely to improve claims handling process and information sharing, there is a risk that more frequent retendering will make delayed claims notification more complex as past insurers may not have a relationship with the trustee and there can be difficulties in assigning the claim from a previous period to the correct insurer.

#### *Commercial pressures can impact on sustainability*

Sustainability has become a keystone of the insurance selection process, as insurers look to grow their business through acquiring more lump sum and trustees look at securing more sustainable products for their members.

For superannuation funds with large cohorts, the tender process generally occurs every two to three years. This means that the window of opportunity to win business will be narrower and this will drive more aggressive pricing, increasing the probability of mispricing.

Additionally, if the separate competitive process is restricted to new superannuation fund members only, there is pricing risk associated with an unknown membership demographic.

#### *Complexity of measuring value in non-monetary components of design*

The current competitive tender process attempts to benchmark different offers. Given the complexity of life insurance, this will primarily be achieved through a pricing comparison on a like for like policy terms basis. There is a risk that such a process will anchor terms and

conditions on the existing design and keep the focus on an easy comparable basis, in this case, pricing.

It can be difficult for trustees to compare offers in the market, given the inherent complexities and variability of group risk policies.

Tender consultants are typically engaged to support trustees throughout the insurance selection process. A challenge often faced by tender consultants is that they are not always able to appropriately determine a value against policy terms and conditions of a policy designed to protect the long-term experience of the portfolio. These differences in insurer terms and conditions typically restrict how people get access to cover to reduce anti-selection or adverse claim behaviour. Given this inability to assign value (pricing change) these changes are not always accepted which can lead to long-term sustainability challenges.

These complexities can lead to poorer outcomes or a general reluctance to update terms and conditions to match the current economic environment, in particular when a certain cost-benefit is unable to be attributed to the change until experience has been observed in hindsight (e.g. a change designed to remove anti-selection).

This reluctance to modify terms and conditions or need for immediate pricing benefit (to keep comparison on price) can lead to a higher long-term cost for the provision of group insurance. A lack of product design innovation which is aimed at delivering long-term benefits may affect have a short term pricing impact.

#### *Ambiguity in the allocation of insurance through a separate competitive process proposed*

The Productivity Commission has proposed the concept of allocating insurance through a separate competitive tender process, but it is unclear whether the separate tender process will only be applicable to all existing fund members, or simply new fund members.

If the proposed process is only for new fund members, there will be a significant pricing risk associated with an unknown membership demographic. This is particularly concerning if it is unknown what categories of employees will be defaulted to a particular default fund because of insufficient information around risk pools.