

# Productivity Commission

Productivity Commission Issues Paper on Superannuation: Assessing Competitiveness and Efficiency

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## Executive Summary

### A world leading superannuation system

A world leading ('A-grade') superannuation system is robust, focussed on retirement income, delivers good benefits, is sustainable and is characterised by a high levels of integrity.

The Melbourne Mercer Global Pension Index (2016) affirms Australia's position as a leading market for pension fund management.

### AustralianSuper

Over 2.2 million Australians trust AustralianSuper to invest more than \$120b on their behalf in order to achieve their best possible retirement outcome.<sup>1</sup>

AustralianSuper is pleased to provide a submission to the third stage of this inquiry. We generally support the comments made in the submissions of Industry Super Australia (ISA) and the Australian Institute of Superannuation Trustees (AIST) in response to the issues paper.

### Balancing competition with consumer protections

Australia's superannuation system must place net returns as the highest order priority.

A combination of regulatory settings and the role of the regulators, with trustee fiduciary responsibility and accountability to members has generally served members well and is likely to drive future improvements.

However not all funds are the same and sustained membership of a poor performing fund will have a materially adverse impact on a member's retirement income.

The recommendations of this inquiry should focus on improving net performance and putting more members, more often, in better performing funds.

In this regard, a fund's purpose, business model, culture, values, use of scale, institutional objectives and governance are of more consequence than competition for the bulk of members are defaulted into a fund.

In relation to the Commission's invitation to comment on the system's specific objectives, we submit the following:

#### **Objective 1: 'The superannuation system contributes to retirement incomes.'**

The success of our superannuation system should primarily be measured by the extent to which it maximises net returns for members.

#### **Objective 2: 'The superannuation system meets member needs, in relation to information, products and risk management, over the member's lifetime.'**

The product disclosure regime in superannuation is designed to help consumers assess financial products and make informed decisions. Our submission notes the steps taken in the sector and by many funds including AustralianSuper to help address information asymmetry.

#### **Objective 3: 'The efficiency of the superannuation system improves over time.'**

Costs are one of the most important determinants of the long run efficiency of the superannuation system. Research has found that larger funds, particularly in the not-for-profit sector, have significantly lower operational expense ratios to net assets. Our submission illustrates the many ways in which the fund continues to improve efficiency and reduce costs while improving outcomes for members.

#### **Objective 4: 'The superannuation system provides value for money insurance cover without unduly eroding member balances.'**

Insurance cover provided through superannuation provides accessible, cost effective and affordable cover for most working Australians with approximately 70 percent of life insurance cover in Australia

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<sup>1</sup> As at 1 July 2017

held within superannuation<sup>2</sup>. Our submission argues that setting default cover at the appropriate level is vital to providing affordable value without eroding balances.

**Objective 5: 'Competition in the superannuation system should drive efficient outcomes for members.'**

In a hybrid distribution model where many people do not choose a fund, consumer protections and clearly articulated and enforced fiduciary responsibilities are more effective than competition in delivering member benefits.

For those members who exercise choice, the structure of the industry, including the number of providers and the ease of switching providers is encouraging competition. The rapidly increasing number of members who exercise choice is providing a sharp source of competitive pressure for providers.

Ultimately, our submission argues that all settings and all participants should prioritise net benefit to members above all other considerations.

If you have any questions or would like further information please contact Kelly Shay  
or Louise du Pre-Alba  
the first instance.

Yours sincerely,

**SAWSAN HOWARD**  
**Head of Corporate Affairs**

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<sup>2</sup> RiceWarner 2016, Insurance through Superannuation.

## **Objective 1: The superannuation system contributes to retirement incomes by maximising long-term net returns on member contributions and balances over the member's lifetime, taking risk into account.**

The success of Australia's superannuation system should be measured by the extent to which it maximises net returns for members. Doing so improves member outcomes, reduces age pension expenditure and increases available investment capital. Long term net returns to members is the key driver of retirement outcomes for system beneficiaries and underpins the ability of our superannuation system to deliver on its objectives.

Analysis of the latest SuperRatings data demonstrates that industry funds continue to dominate performance tables and that at a time when inflation hovers around 2% per annum, many Australian super funds continue to far exceed expectations, with accrued earnings of well over 100% since the end of the GFC.

The current hybrid model ensures appropriate consumer protection for those who do not make a choice or rely on their employer to choose, while also providing choice for those who choose to actively engage with their superannuation.

From an AustralianSuper perspective we believe that, like many high performing industry funds, the strength and consistency of our performance contributes to retirement incomes by maximising long-term net returns on member contributions and balances. In terms of long term net performance over the last 10 years to FY2017, we have simultaneously performed well and significantly reduced investment fees on all options.

AustralianSuper actively seeks to capture the opportunities to minimise fees be it through using our scale to drive economies of scale in external manager mandates, internalising management of investment strategies where we have delivered net performance materially better than external managers.

## Assessment Criteria:

### E2. Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?

Where funds are run only to benefit members, there is little distinction between the fees charged to members and the costs to the fund. At AustralianSuper, like many profit to member funds, we have proactively improved our service and products to members while implementing strategies to reduce costs.

As a result the administration fee of \$1.50 per week per member has been left unchanged since January 2009. An example of the impact of this is for a member starting with a balance of \$50,000 on 30 June 2008 and no contributions thereafter, administration fees as a percentage of a member's balance has fallen by more than 30% over the 10 years from 13bps to 9bps.

In terms of investment costs the ultimate fee charged to a member reflects all costs incurred from managing members' investments. For AustralianSuper there are no additional fees beyond the actual costs incurred. AustralianSuper members have benefitted from the fund's efforts to lower investments costs across the board. Over the last 10 years to FY2017, investment fees on all options have declined considerably. For most of the fund's Pre-Mixed options, investment fees have dropped by more than 20% since FY2008. Investment fees for the fund's popular default Balanced Option have fallen by 21% over the decade. The majority of this decline is due to the 29% reduction in total base fees across the whole fund.

<b>Pre-Mixed Option</b>	<b>Change in Fees (FY2017 v FY2008)</b>	<b>DIY Option</b>	<b>Change in Fees (FY2017 v FY2008)</b>
<b>High Growth</b>	-25%	Australian Shares	-50%
<b>Balanced</b>	-21%	International Shares	-21%
<b>Socially Aware</b>	-35%	Property	-35%
<b>Conservative Balanced</b>	-22%	Diversified Fixed Interest	-22%
<b>Stable</b>	-16%	Australian Shares	-50%
<b>Capital Guaranteed</b>	-94%		
<b>Indexed Diversified<sup>3</sup></b>	-37%		

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<sup>3</sup> The Indexed Diversified Option was only introduced in FY2011. The change shown reflects the reduction in fees since FY2011.

## Objective 2: The superannuation system meets member needs, in relation to information, products and risk management, over the member's lifetime.

The product disclosure regime for financial products, including superannuation, is designed to help consumers' assess financial products and make informed decisions.<sup>4</sup> It encourages the 'provision of relevant and useful information at the point of sale of a financial product which consumers can effectively use to assess the features of a product and decide whether a product meets their needs'.<sup>5</sup>

The product disclosure regime aims to make reliable information available to investors and their professional advisers. This is based on the premise that, 'if investors are provided with sufficient information to assess the merits of an investment, it is not necessary for a government regulator or self-regulatory body to undertake "merits" analysis of that investment'.<sup>6</sup> The product disclosure regime should ensure that more reliable information is made available and help investors accurately assess the quality and value of a given financial product.<sup>7</sup>

However, we need to be cognisant that many consumers are unable to fully comprehend superannuation product information.

This is likely to lead to poorer individual product choices by consumers. Individual consumers suffer a loss of utility<sup>8</sup> when they are unable to purchase the most suitable product for themselves. For example, they may select a conservative rather than growth-oriented product, or not save enough to provide for their retirement.

AustralianSuper is committed to meeting member needs in relation to information and products and services as an enabler of informed decision making. Our key focus is not more information, but simple, clear and timely information delivered through cheaper channels that result in greater understanding.

Many superannuation funds are taking steps to proactively send content that is relevant and sufficient in order to engage, educate and inform members. In recent years, AustralianSuper has taken significant steps to:

- a Simplify product design and defaults to make decision making easier;
- b Simplify communications to ensure the content is engaging and simply explained, free of the jargon that we have used in the past;
- c Invest in digital communications to reach and engage members through cheaper, more timely and efficient channels;
- d Use trigger-based communications and data analytics to proactively engage members through a context that is relevant for the member and
- e Invest in behavioural finance techniques to guide member decision-making in their interests.

### Assessment Criteria:

#### E6. Is the system providing high-quality information and intra-fund financial advice to help members make decisions?

From a quantity perspective, there is an abundance of information available within the superannuation system. Australians have access to a multitude of information types including research, information and statistics provided through a variety of different sources such as regulatory bodies, independent research and superannuation fund publications. The purpose of this information is to provide Australians with comprehensive information to make informed decisions throughout their lifetime. However, in reality few would know how to access and interpret this information.

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<sup>4</sup> Commonwealth Treasury, *Financial Products, Service Providers and Markets – Implementing CLERP Consultation Paper* (Second CLERP 6 paper) March 1999, para 4.3.

<sup>5</sup> Second CLERP 6 paper, para 4.3.

<sup>6</sup> Butterworths, above n 18, para [7.1.0040]; ASIC Policy Statement 168 *Disclosure: Product Disclosure Statements (and other Disclosure Obligations)* and Policy Statement 182 *Dollar Disclosure*.

<sup>7</sup> Butterworths, above n 18, para [7.1.0040].

<sup>8</sup> In this case, an opportunity cost (lost opportunity).

Lack of sufficient member data remains a key impediment to member engagement preventing the provision of higher quality information.

A fund's ability to engage with defaulted members, who are often younger and prefer digital communications, is restricted by the lack of this information. Within certain other groups (seasonal workers, casual or part-time workers) this problem is also especially acute. Together these groups make up a large share of members who become "uncontactable" or "lost" to the fund.

AustralianSuper provides options for members to seek intra-fund advice over the phone (free) or in-person (at low cost). The fund's advice strategy seeks to make advice more freely available digitally.

### **Application of Behavioural Finance**

'Raised awareness' is at the heart of any decision-making process. In fact, according to the Transtheoretical Model of Change<sup>9</sup>, the first stage of the change process is 'consciousness raising' which is about seeking information about a particular issue.

AustralianSuper uses learnings from behavioural science to continually scan for opportunities to improve communications with members. The focus of this is to provide members the information they need, in its most succinct and relevant format, and facilitate decision making to improve members' welfare. For example, we use a range of principles from behavioural economics such as Prospect Theory<sup>10</sup> and Implementation Intention<sup>11</sup> to produce a range of compelling messages in an experimental design used in the 'consolidation' campaign to members. The significance of targeted information and education is an embedded learning at AustralianSuper. We understand individual differences and needs and are developing and utilising automation solutions that are able to provide in-depth insight about what members need.

These insights coupled with learnings from behavioural science help develop and tailor educational content and materials that assist members in engaging with their financial affairs and demonstrate those behaviours that improve their retirement experience.

### **E7. Is the system providing products to help members manage risks over their life cycles and optimally consume their retirement incomes?**

There are a significant number of products available for members to manage risks over their life cycle.

AustralianSuper has conducted significant modelling of its Balanced option to understand, based on the demographics and account balances of AustralianSuper members, the most effective way to meet their needs and mitigate risk. This is a function of its diversification, access to growth assets and allocation to illiquid assets such as infrastructure and direct property. As member balances increase, AustralianSuper will continue to review the need and demand for other risk mitigants such of sequencing overlays or longevity products for members.

The Government is in the process of consulting on the proposed MyRetirement product. AustralianSuper has made a submission to this consultation. In summary, we support the policy intent of optimising retirement incomes. At current account balances and given current policy settings, the vast majority of AustralianSuper members will access the Government Age Pension to manage their longevity risk.

AustralianSuper believes members need to be exposed to growth assets in retirement as the longevity of income payments is closely linked to capital growth. Effective portfolio construction underpinned by strong net cash flow allows the fund to manage risk and optimise retirement income outcomes.

### **E8. Are principal-agent problems being minimised?**

AustralianSuper concurs with ISA that member outcomes and sectoral performance differences are the key guides to assessing principal-agent problems and fund governance.<sup>12</sup>

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<sup>9</sup> Prochaska, J.O., C.A. Redding, and K.E. Evers, The Transtheoretical Model and stages of change, in Health behavior and health education: Theory, research, and practice, K. Glanz, B.K. Rimer, and K. Viswanath, Editors. 2008, Jossey-Bass: San Francisco. p. 97-121.

<sup>10</sup> Kahneman, D. and A. Tversky, Prospect theory: An analysis of decision under risk. *Econometrica*, 1979. 47(2): p. 263-291.

<sup>11</sup> Gollwitzer, P.M., Implementation Intentions: Strong Effects of Simple Plans. *American Psychologist*, 1999. 54(7): p. 493-503.

<sup>12</sup> ISA Submission to the Productivity Commission, May 2016



ISA's submission to the Productivity Commission in May 2016 referenced independent empirical research to identify a number of trustee agency issues that undermine the efficiency of the choice and SMSF sectors. In the submission ISA highlighted agency issues of retail funds including 'retail funds paying significantly higher fees to related party service providers, a failure to realise economies of scale, lower allocations to higher returning illiquid assets and retaining members in poor value legacy products and the use of vertically integrated financial advice business to sell their products'

With respect to principal-agent problems, we note that retail funds are inherently conflicted through their business model, particularly by their use of often expensive related service providers. Retail funds typically need to trade-off the demands of shareholders with returns to clients. As a result, they tend to have lower performing MySuper investment options. As long as industry agents have conflicted duties in superannuation, then these conflicts will persist to the detriment of members.

As noted in ISA's submission to the Commission dated 03 August 2017, cross-selling is a significant risk under the Inquiry's proposals. Moreover, cross-selling is a major driver of poor consumer outcomes in financial services, as observed by the Sedgewick Review.<sup>13</sup>

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<sup>13</sup> Stephen Sedgewick AO, Retail Remuneration Review: Issues Paper, 17 January 2017

## Objective 3: The efficiency of the superannuation system improves over time.

Costs are one of the most important determinants of the long run efficiency of the superannuation system. APRA (2012) found that larger funds, particularly in the not-for-profit sector, have significantly lower operational expense ratios to net assets. This finding suggests that larger funds are able to spread fixed costs associated with administration and IT infrastructure over a larger asset base.

Furthermore, not-for-profit funds with larger account balances per member have significantly lower operational expense ratios. Not-for-profit funds with larger member balances are also able to reduce variable costs, such as those associated with member interface and insurance claims management. While they benefit from spreading fixed costs over a larger asset base, retail funds do not materially realise reduction in variable costs from administering larger member balances.<sup>14</sup>

AustralianSuper is committed to continuous improvement and product and service innovation for members, businesses and advisers. We are building out our technology, data and digital infrastructure to be better able to tailor our offer to the varying customer needs depending on their profiles.

We use feedback from NPS, complaints, surveys and research to adapt our products to improve their suitability and efficiency for members. We are investing in our mobile app, mobile friendly website, call centre capabilities including click-to-chat and CRM to reduce costs to serve and further enhance customer experience.

### Assessment Criteria:

#### E9. Does the system overcome impediments to improving long-term outcomes for members?

The key impediments to improving long-term outcomes for members include information asymmetry, account proliferation and people defaulting or remaining in poor performing funds.

In relation to information asymmetry, AustralianSuper has developed a range of tools and services to assist members to achieve their best possible retirement. We have identified five actions (the '5Cs') that members can take to have a material impact on their balance:

- CHOOSE a good performing fund.
- CONSOLIDATE all super accounts (including any lost accounts) into one account
- CONTRIBUTE more if and when possible
- CHECK insurance to ensure the right level of cover
- CONTINUE membership upon changing jobs and into retirement

AustralianSuper acknowledges that account proliferation is an issue and commends the work of the ATO and other stakeholders which has resulted in a reduction of accounts from 33 million in 2010 to 27 million in 2016<sup>15</sup>. During this period the workforce increased by 1 million workers<sup>16</sup>. In our submission to Stage 2 of this inquiry AustralianSuper provided recommendations to reduce account proliferation including increasing transfers of lost accounts to the ATO and requiring a contribution from an employer or employee before a superannuation account is opened for a member.

AustralianSuper believes the Productivity Commission should proactively investigate strategies to reduce the number of people defaulted into or remaining in poor performing funds. Strategies for consideration may include:

- Triggering the Significant Event Notice requirements when an investment option/fund delivers sustained poor performance.
- APRA publishing a net benefit league table which easily allows members to identify poor performing investment options/funds.
- Any other material action that the Productivity Commission may identify.

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<sup>14</sup> Working Paper: Effect of fund size on the performance of Australian superannuation funds Dr James Richard Cummings - March 2012

<sup>15</sup> APRA Super Fund Level Publications (Jun-16)

<sup>16</sup> ABS Labour Force, 6202.0 (Employed persons)

### **Introduction of new methods of service delivery**

AustralianSuper is constantly looking to create the optimal offer for members. This is a function of meeting current and future needs in a competitive, compelling and sustainable way.

AustralianSuper expects to continue to lower our cost to serve members through scale related benefits including contracted price reductions from vendors and moving to more digital ways of serving. The pace of digital transformation evident in the financial services sector will be a contributing factor of future cost reduction.

Based on changing member needs and preferences, AustralianSuper has introduced new channels to assist members including a mobile app, click to chat and webcasts.

The mobile app allows members (accumulation and draw down) to check their balance, transactions, insurance cover as well as change investments and update details.

Click to chat allows members to conveniently communicate with a service agent in real time from our website.

Webcasts allow us to conduct education sessions that can reach more remote parts of Australia that we otherwise could not have reached in person.

## Objective 4: The superannuation system provides value for money insurance cover without unduly eroding member balances.

Insurance is an important part of the superannuation system. The purpose of insurance is to protect members' incomes and the future of those who matter to them. AustralianSuper believes that there is an opportunity to improve insurance within the superannuation system but strongly believes it is an important safety net for working Australians and helps alleviate pressure on social security.

Insurance cover, provided through superannuation, provides approximately 70 percent of life insurance cover in Australia.<sup>17</sup> Group life provides access to cover, ease of cover and efficient delivery of benefits as a proportion of premium when compared with other models of distribution.

Industry Super Funds provide improved value for money cover by not paying commissions and charging only the cost to provide the benefit to members.

Section 52(7) of the SIS Act sets out a range of Insurance Covenants that must be observed by Registrable Superannuation Entities. The covenants are specific regarding benefit design, suitability, cost and the erosive impact of premiums. AustralianSuper does not believe that any further legislation is required in this area. However AustralianSuper, along with other funds, recognises that reforms are required to ensure common standards across funds. The Insurance in Superannuation Working Group has been formed to develop a Group Insurance Code of Practice. This is due to be published during 2017 and will contain specific industry requirements in areas such as:

- i. Maximum premiums (to protect against undue account erosion);
- ii. Common cover cessation rules;
- iii. Common claims handling service standards and
- iv. Improved disclosure regarding Premium Adjustment Models.

AustralianSuper believes the Code of Practice as currently envisaged will drive major improvements across the system that will help further improve value for money in relation to insurance cover.

AustralianSuper recognises how important affordable insurance is for members, and believes that, for most people, this can best be achieved by buying insurance through their super fund. AustralianSuper uses its size and scale to provide the best possible insurance cover for our members. We dedicate significant resources to ensure we have the best possible offer that holistically considers the importance of insurance in members' lives.

AustralianSuper sets automatic insurance levels based on detailed analysis of insurance needs, member preferences and, importantly, affordability. One of AustralianSuper's 10 insurance principles is that default insurance levels should be the minimum amount of affordable cover required to provide for the basic needs of members or their dependants. The appropriate balance of cover and cost takes into account that, for most members, the cost reduces their retirement savings. To achieve that balance, insurance premiums should not exceed 1% of salary over the member's lifetime to retirement or erode the ultimate retirement balance by more than 10%.

This principle has been applied in setting the new default cover levels to be introduced by the Fund on 28<sup>th</sup> October 2017. AustralianSuper provides insurance that is value for money, sustainable for members because of the unique pricing structure it has in the contract with the insurer, TAL. The overall insurance price can be broken down into five elements:

1. The cost of claims
2. Insurer operating expenses
3. Stamp Duty
4. Insurer profit margin and,
5. Overall competitiveness

Each of these elements are discussed below.

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<sup>17</sup> RiceWarner 2016, Insurance through Superannuation.

## 1. **Cost of claims**

This is the largest component and is determined annually to reflect the overall cost of claims over time.

Given that AustralianSuper is self-rated (prices reflect only the Fund's own claims experience) and the Fund's long claims history, insurers are unlikely to materially differ in their pricing of this element.

If, for example, an insurer were to under-price the cost of claims then they would suffer a loss but would reprice upward at the next opportunity. The opposite would occur if the insurer were to over-price. However, over time, the allowance for the cost of claims will approximate the actual cost. As such, the AustralianSuper price is the sustainable market price for that element.

## 2. **Insurer operating expenses**

Insurer operating expenses reflect the resources deployed to manage the insurance program and their efficiency. Expenses are separately negotiated under the current TAL contract. So the question as to whether a more competitive price could be obtained for this element is fundamentally a judgement as to the quality and efficiency of resources - primarily its people.

AustralianSuper regularly reviews TAL's performance, service standards and efficiency. The key driver of operating costs is claims management costs which are influenced by the Fund so are not a major point of potential competitive difference.

## 3. **Stamp Duty**

Stamp duty is a known quantity. Under the current TAL contract it is dealt with on a pass through basis - so the ultimate premium is equal to the underlying cost. As such, stamp duty is not a point of material potential competitive difference.

## 4. **Insurer profit margin**

The profit margin is negotiated at contract renewal and the Fund determines what is a reasonable margin by considering the capital TAL need to employ against the AustralianSuper business and comparable risk adjusted market rates of return on capital. In essence, the profit margin is market based.

## 5. **Overall Competitiveness**

On the basis of the above analysis, it would not be possible to deliver sustainably lower prices for members through any alternative mechanism.

## **Assessment Criteria**

### **E11. Do funds offer value for money insurance products to members?**

#### **Funds' use of member information to inform product design and pricing**

AustralianSuper analyses its membership by age, gender, occupation and salary level.

Default insurance cover levels are set based on analysis, across these dimensions, of insurance needs, member preferences and affordability.

#### **Insurance needs:**

These are determined by analysing across age, family status (single no children, single with children, couple no children, couple with children), work status (full time, part time, not working) and income level, the costs of:

- i. Housing;
- ii. Raising children;
- iii. Replacing unpaid domestic duties and
- iv. Other income replacement (particularly in the case of income protection).

### **Member preferences**

We conduct member research and broader community research into preferences for insurance, particularly relative to retirement savings. These vary by age, gender, income and occupation.

For many members, the insurance that they hold within their superannuation accounts is the only insurance cover that they have.

According to research that the Fund conducted in Oct 2015 through Lonergan Research "Few workers hold insurance outside of super" (7% death, 4% TPD and 4% income). On the other hand, three in ten (31%) workers are relying on the insurance provided by their super provider. This is lower amongst the youngest (22% of 18-24 year olds) but increases with age (36% of 25-34 year olds). If those who neither agree nor disagree with the statement that they rely on the insurance provided by their super provider are included, then close to 3 in 4 (72%) workers are actively or passively relying on the insurance provided by their super.

Insurance premiums funded by employer contributions are paid from pre-tax money and in most cases Super funds are able to access wholesale premiums, which individual members would not be able to access through personal policies. The Lonergan research shows that more than a third (36%) of Australian workers agree that "paying for insurance from your super is smart."

### **Affordability**

We apply the Fund's overall principle that insurance premiums should not exceed 1% of salary over the member's lifetime to retirement or erode the ultimate retirement balance by more than 10% over a lifetime.

### **Overall design**

The member preferences and affordability perspectives tend to result in default insurance being a lower proportion of needs at younger and older ages (<25 and >55) than in the middle ages. For example, the Lonergan research shows that people at older ages place a greater emphasis of retirement savings than other members.

## **E12. Are the costs of insurance being minimised for the level and quality of cover?**

### **Proportion of APRA-regulated institutional funds switching their insurance provider**

AustralianSuper has used TAL as its primary insurer (covering 95% of its insurance) since 2009. Specific divisions and corporate plans are insured separately.

The number and frequency of switching insurers is not a good measure of cost minimisation, particularly for large funds.

For smaller funds, competitive prices can be achieved through benchmarking of costs amongst a comparable peer groups

For larger funds such as AustralianSuper with 1.4 million insured members, the size of the insurance pool is such that the price of insurance over the long term reflects the actual claims paid, plus an insurer margin. Insurer margins are set on commercial terms.

## Objective 5: Competition in the superannuation system should drive efficient outcomes for members through:

- i. A market structure and other supply and demand-side conditions that facilitate rivalry and contestability
- ii. Suppliers competing on aspects of value to members

AustralianSuper believes that an appropriate market structure is essential for rivalry between suppliers, who genuinely compete on the basis of primary needs of members only. Several existing forces today are driving increased competitive rivalry, with many larger funds in the Industry Funds sector delivering strong outperformance.

On the supply side, the consolidation of players is playing a role in increasing competitive intensity. Larger funds are translating their scale and size into different bases of competition, whether it be lowering the cost base or delivering enhanced services, or both. Conversely, this has resulted in disadvantages for many smaller funds as they are unable to compete on the same bases. This disadvantage is likely to increase over time as industry data indicates the larger funds are continuing to consistently outgrow smaller funds each year, both in funds under management and total member accounts. AustralianSuper believes continued consolidation of players will further drive positive competitive outcomes in the market.

On the demand side, current default arrangements provides a dual mechanism which caters for two types of members. Members who do not seek choice are generally protected from being defaulted into a poor performing fund. Simultaneously, members who do wish to exercise choice are not generally inhibited from doing so. Increased competition driven by supply-side forces has resulted in higher levels of member awareness and engagement, by a range of measures. This includes number of visits, number of log-ins, rate of account consolidation, as well as exercising of choice (switching). AustralianSuper believes continued member engagement, together with supply side factors, have and will further drive positive competitive intensity in the market.

In addition to market structure, organisational incentive alignment also plays a substantial role in influencing competition across sectors. There is significant evidence to suggest profit-for-member institutions demonstrate consistently better results for members than for-profit institutions on the two most critical measures – investment returns and fees.

### Assessment Criteria

#### C1. Is there informed member engagement?

It is useful here to define what member engagement means at AustralianSuper. In essence, engagement can be gauged by the level of activity between the Fund and our members. Every member service inquiry, social media post, website visit, page click, email open, online search or face-to-face forum that an existing or potential member interacts with is engagement.

In order to ensure *informed* member engagement, AustralianSuper is committed to delivering education, products and services to make superannuation easier to understand for members and employers. We proactively reach out to members and employers to support them with superannuation needs to increase member engagement. One of the ways we measure the success of our engagement is through member activity. In financial year 16/17 AustralianSuper members engaged with their superannuation through the following measures:

- 132,000 account consolidation requests into AustralianSuper,
- 1.3 million voluntary contributions,
- Over 1.2 million member and employers calls to the Contact Centre with more than 40% of those calls being complex queries or requiring transactional assistance.
- 11 million visits to our website,
- 8 million logins to the member portal,
- 600,000 uses of our calculators, and
- More than 10,000 advice conversations between Financial Planners and members.

AustralianSuper acknowledges that while there is informed member engagement there is room for improvement. AustralianSuper undertakes a range of strategies to help members make informed decisions about their superannuation.

## **C2. Are active members and member intermediaries able to exert material competitive pressure?**

Members and planners are able to exert competitive pressure with most workers having choice of fund. This freedom is evident by the volume of roll-ins and rollouts our fund experienced in FY17 with movements occurring 322,000 times to or from a mixture of SMSFs, retail funds and industry funds.

## **C5. Are there material anticompetitive effects of vertical and horizontal integration?**

Approximately 90% of administration services are outsourced.

AustralianSuper has not materially insourced member services. The only recent example was insourcing some face to face financial planners (less than 20).

## **C8. Do funds compete on member-relevant non-price dimensions?**

AustralianSuper is driven by our members' first focus to help members achieve their best possible retirement outcome.

To ensure we know members AustralianSuper conducts strategic bespoke insight projects to inform products, propositions and member engagement. We have deep capabilities across analytics, insights and modelling. By collating and analysing currently held member and market data we understand where improvement opportunities lie and provide actionable insights.

We are committed to continuous evolution of the Fund's price and non-price dimensions to meet members' needs.

## **C9. Is there innovation and quality improvement in the system?**

AustralianSuper believes that innovation and quality improvement is an element of the current superannuation landscape and serves competitively as market differentiators for funds.

AustralianSuper is committed innovation and improvement with the primary objective of delivering better outcomes for members. Central to this is ensuring we understand the wants and needs of current and future members.

Our key innovation tool is one of the largest member listening programs in Australia. In the 2016/17 financial year, we heard directly from more than 100,000 members. To incubate innovations, we perform 'test & learn' experiments to create primary data, we test member offers to see if they're viable and listen to the voice of current and future members. These experiments allow for decision making and innovation of new products that creates, or avoids the destruction of, value for members.

Based on changing member needs and preferences, AustralianSuper has introduced new channels to assist members including:

- A mobile app, that allows members (accumulation and draw down) to check their balance, transactions, insurance cover as well as change investments and update details)
- Click to chat, which allows members to conveniently communicate with a service agent in real time from the website, and
- Webcasts, which allow us to conduct education sessions that can reach more remote parts of Australia that we otherwise could not have reached in person.

As member needs further involve we will not only seek to introduce new services but involve them in the design of these services to ensure it meets their needs and lift their interaction with their superannuation



## **Policy Impediments: What are the material policy or regulatory impediments to the competitiveness and efficiency of the superannuation system?**

### **Superannuation Guarantee regulations**

The Superannuation Guarantee requirements still allow businesses to submit SG contributions up to 28 days after the end of each quarter. There is no legal requirement for businesses to notify funds that an employee has left their employment or that a new employee has joined – until the next SG file is delivered. This means that if, for example, a member leaves employment in January, the fund may not know until end April. This time lag not only leads to complex backdating of transactions but, importantly from an insurance perspective, the fund cannot actively engage with members at that important time of their lives when they change jobs or leave work and need to make important insurance decisions.

A move to compulsory monthly SG and greater enforcement of the SG timetable would significantly assist the industry in terms of improved member engagement, better product design and reduced cost.

### **Product design and tax constraints for disability benefits**

The SIS legislation draws a distinction between total and permanent incapacity and temporary incapacity. Payments under these two conditions for release are also taxed very differently and the Payment Rules are unduly restrictive, for example limiting variations in temporary incapacity (income protection) payments over time. Funds could design products more suited to member needs if these two conditions for release were combined. This would allow insurance and corresponding release of benefits on a flexible basis (any combination of periodic and lump sum payments) provided the member is “disabled”, with an appropriate definition of “disabled” which allows for the fact that the disability may be temporary, permanent, total or partial.

## **Scale Economies: What methodology would you use to estimate unused scale economies and pass through of realised scale economies, and why?**

AustralianSuper benchmarks against relevant comparable funds in Australia and internationally. If significant disparity is found we investigate to identify any systemic or structural impediments to achieving similar results.

We highlight to the Commission that AustralianSuper’s investment fees on all options have declined considerably over the last 10 years and the administration fee of \$1.50 per week has remained unchanged since 2009.

Insurance is a good example of where scale economies can benefit members. AustralianSuper has managed to capture the scale benefits of having 1.4 million insured members by delivering insurance prices on a basis that required less capital for the insurer and therefore lower cost per member. This is encapsulated within the “Premium Adjustment Model” which involves insurer premiums being adjusted to reflect claim rates that are higher or lower than expected. For smaller funds there are often too few claims to deliver statistically credible insurance pricing data, so prices often have to rely on the experience of other funds in the insurer’s portfolio and/or reflect proportionately higher insurer capital requirements.

Greater scale in claims management enables insurers to employ more specialist staff such as rehabilitation consultants and mental health experts which is not feasible for smaller funds.

## Benchmarking

On the system-level benchmarking:

In the context of the approach set out in the Stage 1 Study to compare long-term net investment returns to a set of passive, liquid reference portfolios, the following questions are addressed: Which reference portfolios would most meaningfully inform the analysis? What is the best way to ensure that equivalent taxes are netted out of returns to a reference portfolio? What fee levels should be applied to the reference portfolio? What are the most appropriate listed asset class benchmarks to use to calculate the returns to these reference portfolios?

### Which reference portfolios would most meaningfully inform the analysis?

The Productivity Commission indicates that it wishes to compare the system's long-term net returns to a reference portfolio based on average asset allocations across the system for the relevant period.

Two particular reference portfolios could be considered:

1. A portfolio using the asset allocation of the average/median default fund, with index returns for each major asset class, adjusted for taxes. This sample reflects the investment strategy that the industry as a whole has taken over the course of time, and provides a strong benchmark against which any particular fund's performance, cost and risk can be assessed; or
2. A simple portfolio comprising of listed asset classes. This approach provides a simpler, replicable index against which funds can be assessed.

There are advantages, disadvantages and considerations for both options.

For the portfolio using the asset allocation of average/median fund, the Productivity Commission should be cognisant of:

- i. The information largely exists through information disclosed either to regulators and/or survey providers such as Chant West or SuperRatings;
- ii. The asset allocations include illiquid assets such as Property, Infrastructure, Credit and Private Equity. These asset classes would need to be either linked to a reliable index series (which exist in many cases) or proxied to the returns of liquid asset classes;
- iii. It is not necessarily the correct approach to use a constant average allocation through time, as these asset allocations are subject to trends over time, such as a decreasing allocation to Australian equities, where the average allocation has fallen from 55% to 44% from 2006 to 2016 (based on the SuperRatings) and
- iv. Asset allocations disclosed can fluctuate over shorter periods of time, and some form of averaging (e.g. 1, 3 or 5 year rolling periods) should be used, rather than frequently reassessing.

For the portfolio using a simple passive/liquid asset allocation, the Productivity Commission should be cognisant of:

- i. The simple/passive portfolio does not reflect how the industry has invested in practice. As a result, it will not be representative of the cost, risk or illiquidity which funds are taking on and
- ii. Whilst the average/median portfolio requires data, the simple portfolio also requires a series of assumptions, including what the appropriate reference portfolio is, which asset classes to use, how to set the appropriate level of risk.

Finally, in selecting the most appropriate reference portfolio, there is inevitably a potential for Hindsight Bias, so the choice should be consistent with what would have been selected at the appropriate time.

### What is the best way to ensure that equivalent taxes are netted out of returns to a reference portfolio, and what fee levels should be applied to the reference portfolio?

With respect to fees, we recommend ensuring that the fees netted from the reference portfolio reflect the estimated cost of investing the asset allocation passively and managing the investment options of a typical fund.

This should be applied with consideration for:

- i. The costs of administering a passive portfolio, such as
  - a Levies from government and regulatory bodies (e.g. APRA levy);
  - b Back office costs (e.g. custody, tax, accounting);
  - c Middle office costs (e.g. performance reporting, compliance, risk management).

- ii. The costs of obtaining the passive allocation; such as
  - a For listed asset classes: Whilst relatively small, the cost of index management is generally not allowed for in published market returns of listed asset classes;
  - b For unlisted asset classes: benchmark returns are generally disclosed on a “net of fees” basis so should have no fee removed.

With respect to tax, the rate in the accumulation phase is simplistically 15% on income and 10% on capital gains. However, there are numerous factors that should be taken into consideration to determine the impact of tax on an option’s return within accumulation and pension phase. These factors and their impact vary year on year, but can be categorised as follows:

- i. Income vs capital gains/losses;
- ii. Impact of franking credits
- iii. Source of income (domestic or foreign)
- iv. Tax exempt income and
- v. Other relevant tax provisions which vary from time to time

Given the difficulties of estimating the tax rate, we recommend that post-tax returns are compared using the simple excess return of the Fund’s crediting rate relative to the Median fund.

### **What are the most appropriate listed asset class benchmarks to use to calculate the returns to these reference portfolios?**

In the context of the approach set out in the Stage 1 Study to benchmark long-term net investment returns at the asset class level, and given the available data, what is the best way to estimate long-term net returns at the asset-class level for the system, and why? Which listed benchmarks should be used for each asset class? How can the Commission best assess the investment performance of unlisted investments?

The best way to estimate long-term net returns at the asset-class level is by identifying benchmarks that are the best representation of what the median fund is invested in. Where possible, we ensure that each benchmark complies with the CFA SAMURAI requirements:

- i. Specified in advance: Benchmark is known to all at start of evaluation period;
- ii. Appropriate: The benchmark should accurately reflect the manager’s performance style ;
- iii. Measurable: You must be able to measure the results ;
- iv. Unambiguous: A good benchmark’s components should be known;
- v. Reflective: Of manager’s current investment expertise;
- vi. Accountable: Manager should agree that the benchmark is an appropriate measure and
- vii. Investable: You should be able to replicate and invest in a benchmark.

Index returns for unlisted asset classes, such as property, infrastructure and private equity can be obtained from third-party benchmark providers.

## Current default arrangements

Australia's current default superannuation system invests over \$400 billion of savings on behalf of at least 7 million people and default funds have materially outperformed the system average for as long as data has been recorded.<sup>18</sup>

The cumulative evidence from two decades of performance data demonstrates current default arrangements have delivered the most efficient component of the system, charging lower fees and delivering better net returns than other sectors<sup>19</sup>.

These outcomes are consistent with the Productivity Commission's own conclusions about investment performance.

It is widely agreed that the existing default arrangements do not create any concerns about stability in the superannuation system that could lead to significant systemic risks.

## Challenges of the current system

The fundamental challenge of the current superannuation system is simply articulated by one of Britain's most distinguished economists Nicholas Barr, "The more complex the financial product, the less likely people understand and the less likely people are to make choices in their own best interest. Choice should be optimised not maximised. This is an argument that gets overlooked or over-ridden for ideological reasons. This is not an ideological argument. It is a technical argument. How you do it should be technical."<sup>20</sup>

This is also the case when it comes to the current default arrangements. Clearly there is a need for greater financial literacy and support but where that is not enough, or when people simply do not engage, choice should be optimised not maximised.

When optimising choice, it is essential that the key measurement be long-term net returns.

## Challenges for small business

AustralianSuper represents over 220,000 businesses, of which approximately 80 percent are small businesses<sup>21</sup>. This is consistent with national statistics that nine out of ten Australian businesses are small businesses accounting for 33 per cent of Australia's GDP, employing over 40 per cent of Australia's workforce, and paying around 12 per cent of total company tax revenue.<sup>22</sup>

The overwhelming majority of these businesses have, at best, only 1 employee to manage their account payable, human resources and payroll operations. For most small businesses superannuation is not their core function and many are not fully aware of the obligation to nominate a default fund, the selection process or how to measure if it is the best option for their employees. This is consistent with the MYOB business monitoring report that identified dealing with payroll compliance as a pain point for 29% of surveyed small businesses.<sup>23</sup>

Our experience is that the overwhelming number of small businesses are not aware of their obligations to nominate a default fund and that they must choose that fund from the list provided in the relevant Award where that exists. Unsurprisingly, the majority of small businesses believe that if they offer employees choice of fund they do not need to have a default fund.

We believe this is a shortcoming of the existing default arrangements and more can be done to improve the accountability and integrity of default funds.

AustralianSuper proactively engages with and supports businesses to meet their superannuation obligations through a range of mechanisms. AustralianSuper acknowledges the work done in this area by the ATO and

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<sup>18</sup> ISA 'Living in an Empirical World' 28 October 2016

<sup>19</sup> ISA Submission to the Productivity Commission, May 2016

<sup>20</sup> 'Competition is not appropriate for super', Australian Financial Review, 11 July 2017

<sup>21</sup> Defined as a business that has an Australian Business Number (ABN) and or employs less than 20 people

<sup>22</sup> Small Business Counts, Small Business Statistical Report, Office of the Australian Small Business and Family Enterprise Ombudsman, 2016

<sup>23</sup> MYOB Business Monitor National Report, December 2016

other stakeholders but there is still a long way to go. We believe the ATO should continue to have a responsibility to assist employers to understand their superannuation obligations and monitor non-compliance.

## Challenges for all businesses

The Australian Securities and Investments Commission's (ASIC) recent submission to the Productivity Commission highlighted that 'although employers currently have the legal responsibility to make a decision in relation to the default fund superannuation product, employers are required to neither select a fund that is in the best interests of their employees nor to put their employees' interests ahead of their own in selecting a fund.'<sup>24</sup>

A rigorous selection process for funds to become an eligible default fund would assist employers to choose a default fund with confidence that it is in their employees' best interests.

AustralianSuper acknowledges ASIC's work publishing guidance and advising employers on their responsibilities under the *Superannuation Industry (Supervision) Act 1993* (SIS Act), specifically their obligations relating to inducements. ASIC has noted that 'the real prospect remains of employers selecting a fund as a result of inducement, including lawful inducements and on the basis of competition directed to the employer rather than to the quality of the product.'<sup>3</sup>

AustralianSuper supports regulation prohibiting a business from choosing, as its default fund, a superannuation fund that is part of a financial institution from which it receives other financial services.

## Improvements to the Default System

AustralianSuper supports efforts to further enhance the outperformance of the default system, and to incorporate specific net performance measurement into the selection of default products through the Fair Work Commission. We believe that a rigorous selection process for funds to become an eligible default fund would assist businesses to choose a default fund with confidence that it is in their employees' best interests.

As stated in our previous submission to the Productivity Commission, AustralianSuper strongly argues that the outcome of any change to the default system must be to reduce the number of people defaulting into consistently poor performing funds.

AustralianSuper believes the Productivity Commission should proactively investigate strategies to reduce the number of people defaulted into or remaining in poor performing funds. Strategies for consideration may include:

- i. Triggering the Significant Event Notice requirements when an investment option/fund delivers sustained poor performance;
- ii. APRA publishing a net benefit league table which easily allows members to identify poor performing investment options/funds and
- iii. Any other material action that the Productivity Commission may identify.

These proposals are designed to shed light on the poor performers as this will encourage members to consider other better performing superannuation funds. While the immediate effect of these strategies will be on enhancing choice, rather than default actions, the anticipated long term impact would be to reduce the number of poor performing funds and improve the performance of the superannuation industry as a whole.

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<sup>24</sup> Submission 41- Australian Securities and Investments Commission (ASIC) Alternative Default Fund Models – Public Enquiry, November 2016

## Alternative default arrangements and transition issues

In considering changes to default fund arrangements we ask that the Commission conduct a full cost benefit analysis of any recommendation to understand and assess the costs, benefits and risks associated with any alternative arrangement.

AustralianSuper strongly argues that any change to the current default arrangements should only be undertaken when there is confidence that the changed system would work better for defaulting members.

AustralianSuper supports the current system enhanced by the yet to be implemented Fair Work Commission process.

Should the Government favour the Productivity Commission's recommendations AustralianSuper supports a 'heavy filter' being applied to default fund selection to ensure only the best performing superannuation funds are eligible default funds.

The heavy filter works best for employees, businesses and system performance.

## On the first timer default mechanism

The inherent danger of moving to a system of 'first timer default' decision for employees is that employees may be defaulted into a poor performing fund and member disengagement may be perpetuated.

The risk is concentrated on one event and may never be revisited.

Research indicates that the majority of first time job starters do not actively choose their own superannuation fund. If members continue to be disengaged this default has lifelong implications and potentially more damaging than current shortcomings of the system.

Consequently it is essential that there is a significantly rigorous selection process for eligible default funds based on long term net investment performance.

There are a number of practical issues that would need to be addressed which include consideration of:

- i. Those with broken work patterns will have superannuation accounts that close and they should be afforded a further default option;
- ii. Those who depart Australia and return later with depleted accounts will need further default option consideration;
- iii. At a system level, we expect a shift to "once only" default will spark a battle for new starters in particular that will increase direct competition (which may deliver member benefits) but have a marked impact on costs of acquisition per member for each fund (impacting systems costs).

AustralianSuper believes the advantage of once only default must be balanced by:

- i. Ensuring only the best performing superannuation funds, measured by long term net investment performance, are eligible default funds,
- ii. Mandated communication to fund members if the fund they have been defaulted into consistently underperforms, and
- iii. Other safeguards identified to ensure members have the best possible retirement outcomes.

## On merger transparency

AustralianSuper supports the introduction of a formal framework that specifies the process and obligations of trustees when making or considering merger proposals as part of a complete review of the mergers process.

We do not believe that elevating the level of disclosure will create a material risk of discouraging merger activity.

We reiterate from our previous submission that the following measures are also worthy of consideration as mechanisms to assist superannuation fund mergers:

- i. Extend capital gains tax relief for superannuation fund mergers indefinitely - this relief expires on 1 July 2020.
- ii. Tier APRA's operational risk reserve requirements of funds based on their operational capacity, risk management framework, net cash flow, scale and member assets.

- iii. Enable APRA to provide special MySuper authorization for merging funds to establish special purpose MySuper investment vehicles to facilitate small fund mergers prior to their ultimate merger with a large MySuper investment option - this would ensure that members of large MySuper investment options do not subsidise the cost of multiple mergers of small superannuation funds.
- iv. Review the successor fund transfer requirements to provide exceptions to equivalent rights where funds are merging as a result of APRA approved prudential supervision reasons and
- v. Encourage APRA to report annually to the Council of Financial Regulators on their progress and results in the application of the scale/outcomes test in MySuper products.

AustralianSuper understands the complexity and challenges involved in any merger. We support disclosure of merger attempts and recommend that 'merger attempts' be defined as 'when a formal proposal has been made by one board and considered by another board.'

## Conclusion

AustralianSuper welcomes the opportunity to comment on the Productivity Commission's Inquiry into Assessing the Competitiveness and Efficiency of superannuation.

We have a world leading superannuation system, but we should never rest in our pursuit of better outcomes for members and the community.

All funds should continue to innovate, improve performance and drive further efficiencies to meet both their fiduciary responsibilities and the challenges presented by competition, changes in technology and shifts in member behaviour.

AustralianSuper believes that the current "hybrid model" of distribution where members who do not make a fund choice are placed in default funds and a growing number of members are exercising choice, is driving competition and hence improved performance amongst those funds with the capacity and orientation to deliver better outcomes for members.

Our submission describes AustralianSuper's efforts to improve its own performance and identifies a number of systemic changes that would benefit members.

Given the relative success of Australia's superannuation system, the test for systemic changes is necessarily high. They should only be pursued if they can be demonstrated to lead to more members being in funds where their best interests are served.

AustralianSuper has identified a range of improvements in each of our submissions, that we believe would meet this test and improve the system.

Again, we reiterate our steadfast position that at all times, the most important measure of the system's success should be the long term net outcome for members.