



**22 April 2016**

Productivity Commission  
Locked Bag 2, Collins Street East  
Melbourne, VIC 8003

**BY EMAIL:** [super@pc.gov.au](mailto:super@pc.gov.au)

Dear Commissioner

### **Superannuation Efficiency and Competition**

The Financial Services Council welcomes the opportunity to make a submission in relation to the Productivity Commission's (PC) review of efficiency and competition in the superannuation industry.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and public trustees. The FSC has over 125 members who are responsible for investing more than \$2.5 trillion on behalf of 11 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 FSC is a strong proponent of measures to increase competition in the superannuation industry. There is a strong body of economic theory and empirical evidence that demonstrates that market-based competition, underpinned by informed consumers with the freedom to choose between products, delivers better outcomes for consumers.

The FSC is concerned, however, that there are clear barriers to competition in the superannuation industry. The FSC recommends that the PC assess these barriers as part of the first stage of its review, in addition to developing criteria for assessing the system's efficiency. Any assessment of the competitiveness of the system would be flawed if it occurred whilst these barriers remain.

The FSC also recommends that, in developing criteria to assess the efficiency of the superannuation system, the PC has regard to the complexity inherent in both the MySuper and Choice markets, as well as the experience of overseas pension systems. Australia has a world leading system that is delivering increasing adequate retirement incomes and is fiscally sustainable. This is rare in the developed world.

Should you wish to discuss this submission further please contact me .

Yours sincerely,

**BLAKE BRIGGS**  
Senior Policy Manager

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## Introduction

The FSC is a strong proponent of measures to increase competition in the superannuation industry. Competition puts downward pressure on fees whilst simultaneously creating an incentive for providers to improve the quality of the product and services being delivered.

The FSC understands the Productivity Commission to be undertaking a system level review. Its examination of the superannuation system will determine whether the policy parameters are conducive to competition throughout the sector and develop criteria to measure the degree of competition.

The FSC supports this review. Enhancing competition in the superannuation industry would improve outcomes for consumers by introducing the discipline of market forces currently sheltered business models and subsequently effecting trustee decision-making.

In the context of the superannuation industry, increased competition would be expected to:

- Lower fees and increase net returns to consumers;
- Promote product innovation;
- Increase the quality of services trustees provide consumers; and
- Increase the quality of services provided to trustees.

The members of superannuation funds that are not currently subject to competition would stand to gain the most from reforms to introduce competition. Trustees of superannuation funds currently protected from the discipline of market forces are under no pressure to attract and retain members.

An open and competition superannuation market would place pressure on trustees to continually lower operating costs and increase net returns for consumers, whilst simultaneously raising the quality of services their fund provide. The discipline of the market can achieve these outcomes more effectively for consumers than simply relying on the 'best endeavours' of well-intentioned trustees.

The FSC submits, however, that the current legislative framework, however, prevents the superannuation industry from operating in a competitive market. Whilst most consumers are free to choose their own superannuation product in the 'choice' market, many consumers are unable to participate in the choice market if their choice is removed by an enterprise agreement that is negotiated by a third party, such as a trade union, employer or employer organisation.

Current legislation also restricts competition by limiting the number of MySuper products an employer can choose from to be the default fund for their workplace where a modern award contains a superannuation term.

Of the 122 modern awards created by the Fair Work Commission:

- There are 16 awards that only name a single MySuper product that an employer must select to be the default fund for their workplace; and
- In another 27 awards an employer's selection is restricted to only two or three funds.

The FSC is advocating for the introduction of competition at two levels in the superannuation industry – at the level of the individual consumers and at the workplace level. This requires:

1. Providing all consumers the freedom to choose their own superannuation fund; and
2. Allowing employers to choose from any of the APRA-approved MySuper products to be the default fund for their workplace.

Reforms to promote competition at these two levels align with fundamental principles of competition policy – that better outcomes are achieved for consumers when they are empowered to choose between competing products in an open and transparent market.

The proposed framework would ensure that superannuation trustees would be required to compete for default status at all workplaces and, in the event a consumer was not satisfied with the choice made by their employer on their behalf, each consumer has the freedom to make their own choice.

### Dispelling misleading arguments

The FSC is concerned by ongoing attempts by industry superannuation funds to lobby against the removal for their effective monopoly in the default market. The Productivity Commission should bring the same skepticism to its current review that it has traditionally brought to other monopoly providers who have claimed they are a ‘special case’, deserving of protectionist policies.

The history of the deregulation of the Australian economy has demonstrated that consumers are better off when barriers to competition between service providers are broken down and consumers are empowered to make informed decisions. Arguments supporting anti-competitive arrangements ignore the counterfactual – how much better off consumers would be if an incumbent is subject to competition.

In this context it is important to dispel myths and misleading arguments around the incumbent industry superannuation funds that benefit from the current, anti-competitive arrangements.

The performance of industry superannuation funds vary greatly. Whilst some of the 15 large industry funds, represented by lobby group Industry Super Australia (ISA), purport to perform well, these arguments are misleading and hide the performance of poorly performing industry funds.

It is important for the Productivity Commission to recognise that the data often publicised to support claims of industry fund ‘outperformance’ hide the performance of the 28 industry superannuation funds that are not members of their lobby group. These funds are often subscale, expensive and offer low quality servicing.

The misleading claims of universal industry fund ‘outperformance’ are appropriately being criticized as misleading by leading analysts in the superannuation industry, including the Australian Prudential Regulation Authority (APRA) and Chant West. Analysis by Rice Warner Actuaries shows that the average fee for a small industry superannuation fund, those not covered by ISA’s analysis, is 141 basis points – 31 basis points above the industry average.

Evidence in this submission confirms that many industry superannuation funds that are subscale and inefficient, however, are still guaranteed new members and contributions under the current legislative framework. As a result many consumers are being left worse off where they are defaulted into one of these poorly performing funds, making the status quo unsustainable.

This submission provides evidence that the current legal framework entrenches also principle-agent risks that bestows the right of fund choice for a workplace on a trade union, who, unlike most employers, may have a conflict of interest as a result of their affiliation with an industry fund and commercial interest in that fund.

Whilst the Productivity Commission is charged with the responsibility for examining the efficiency and competitiveness of the superannuation system as a whole, the importance of the default market to the broader system should not be understated. The default market is responsible for the

allocation of over \$9 billion per annum and, many industry funds having upwards of 80 per cent of their funds under administration in the default product.

The flow of default contributions are significant in determining whether industry superannuation funds are exposed to competitive pressures across their operations, as well as their trustees' decisions on whether or not they should merge with more efficient funds.

An assessment of the efficiency of the superannuation system, and the outcomes it delivers for consumers, would therefore be deeply flawed if reforms were not first implemented to address the anti-competitive arrangements in the default market.

## Overview of the superannuation industry

Australia's superannuation industry is a hybrid of defined benefit (DB) and defined contribution (DC) schemes. A majority of employees are covered by DC arrangements, with their employers making contributions of 9.5 per cent of their income, increasing to 12 per cent, to a fund on their behalf.

The superannuation system became compulsory for most employed Australians in the early 1990s, and as a result most assets are held in accumulation phase. The industry, however, is undergoing a period of transition as the baby-boomer generation begins to retire, shifting the balance between inflows of contributions and outflows of benefits for most trustees.

A feature of the 'immaturity' of the Australian superannuation system is that a large portion of the assets held for consumers are invested in growth assets – equities, private equity, property and infrastructure. These asset classes, by definition, are more expensive to manage than defensive asset classes, such as bonds or cash, an important distinction between the Australian system and overseas jurisdictions that often mandate investments in areas such as government bonds.

The strength of the Australian system, however, is that observed through a net-returns perspective, our system has a better return profile than many overseas pension systems. Deloitte conducted research on this subject for the FSC that formed part of our submission to the Financial System Inquiry, and has been attached for your information.

The dominance of DC schemes in Australia also brings with it a high degree of consumer expectation for services – consumers are able to observe the periodic contributions being made on their behalf and have the capacity to become directly involved in managing their investments, as well as ancillary services, such as their insurance coverage. In many ways this capacity for direct engagement with consumers is a strength of the superannuation system as it promotes informed decisions underpinned by quality advice from trustees or financial planners. It also encourages consumers to take a holistic view of their financial affairs.

The DC arrangements, however, also inherently bring with them the cost of this enhanced servicing, as well as the cost of compliance with ongoing tax obligations and regulatory imposts derived from legislation or the financial industry regulators, APRA and ASIC.

Where consumers and employers are free to choose between competing superannuation trustees in the current superannuation system is both effective and competitive. There are a large number of trustees who compete on price or their quality of service, reflected in the discounting that occurs through corporate mandates, which has put downward pressure on fees and increased the quality of services. These competitive pressures readily flow through to service providers to trustees, such as fund managers and insurance companies, where there is also evidence of strong competition.

The FSC is concerned, however, that a large and important sector of the superannuation industry – the default market – is not subject to competitive pressures and operates as an effective monopoly for the incumbent industry superannuation funds. Barriers in industrial law prevent consumers from choosing their own fund, and prevent employers from freely choosing between APRA-authorized MySuper providers to become the default fund for their workplace.

These anti-competitive arrangements also protect the service providers to industry superannuation funds, which are also owned by industry funds, from being required to compete for their business. The barriers to competition at both levels have the potential to significantly affect the outcomes achieved for consumers.

## Barriers to competition under current law

The default superannuation market determines the superannuation fund that is chosen for a consumer who does not, or is not allowed, to choose their own fund. In such circumstances the current law provides that through enterprise agreements or modern awards a trade union, employer or the Fair a Work Commission (FWC) has the power to make the choice on the consumer's behalf, depending on the circumstances.

This section details how these arrangement are anti-competitive as they restrict consumer choice and employer choice, or even remove that choice entirely.

These anti-competitive arrangements are derived from the inclusion of superannuation policy in industrial relations law. Whilst the industrial framework suppresses competition in the labour market, such fixing the price of wages and conditions of employment, its extension to the financial services industry has the effect of placing similar anti-competitive arrangements on competition between superannuation funds.

It is an unusual and anachronistic arrangement that continues to allow the industrial system to suppress competition between providers of financial products. Furthermore, the industrial system operates so as to favour the providers of financial products that are affiliated with industrial organisations – trade unions and employer organisations (registered organisations) – over other financial services providers.

The current industrial framework is also subject to conflicts of interest that arise from the financial interest of registered organisations in the industry superannuation funds that they own.

The financial relationships may create an incentive for registered organisations to promote their industry superannuation above other funds, including protecting them from the possibility of competition from other industry funds. This may be to the detriment of consumers where 'their' fund is an industry fund that is subscale, inefficient, or otherwise underperforming the industry.

These anti-competitive arrangements and conflicts of interest are examined in more detail below, including the negative impact these arrangements have on outcomes for consumers. It is important to recognise, however, that they are entrenched under current law.

Achieving and assessing a genuinely competitive superannuation market first requires law reform to allow all superannuation funds, regardless of whether they are industry or retail funds, to compete in an open and transparent market and to allow both consumers and employers to make free and informed choices.

### Modern awards

Superannuation terms in modern awards currently name a limited number of superannuation funds that an employer can choose to be the default fund for their workplace.

The award system is anti-competitive because:

1. It limits the number of funds that an employer can choose; and
2. The selection process privileges industry funds and excludes retail funds.

These anti-competitive arrangements are considered in more detail below.

### The 'old' award selection process

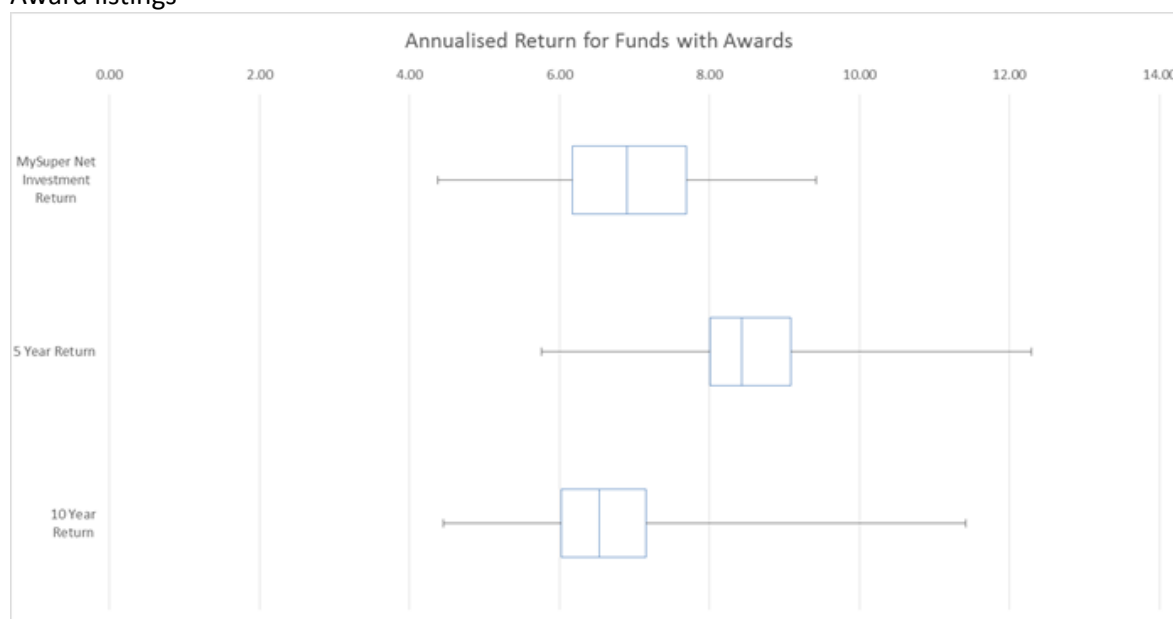
The current superannuation terms in modern awards were set by the Fair Work Commission (FWC) under the 'old' selection process. Under the old process superannuation terms were set by 'normal' industrial Commissioners, who have no experience in competition policy or financial services, based on submissions by the only parties that have appearance rights before the Commission – the registered organisations that own industry funds.

Registered organisations predictably nominate their affiliated industry funds for default listing, and actively opposed retail funds, who have no right to appear before the Commission under industrial law. This process is inherently conflicted as registered organisations have a financial incentive to nominate affiliated industry funds that they own and receive financial benefits from, including for opaque payments exposed by the Royal Commission into Trade Union Governance and Corruption that are currently subject to scrutiny by the Australian Prudential Regulation Authority (APRA).

The old system has resulted in industry funds comprising 88 per cent of all current MySuper listings across the 122 modern awards. Retail funds comprise less than 5 per cent. The remainder is made up of stand-alone corporate and government funds.

FSC analysis of APRA's superannuation return data demonstrates the significant variance in performance by different MySuper products that are listed in modern awards. Chart 1 displays the annualised investment performance of MySuper products that have listings in modern awards.

Chart 1. Annualised Net Investment Returns or Whole of Fund returns for default products with 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 5 years, and the last 10 years – there is significant variance in the performance of the default products selected.

Chart 1 shows that there are very 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.



In a further 27 modern awards an employer's choice is restricted to only two or three funds, severely limiting the capacity for competition between MySuper products that can be chosen. There are only 7 modern awards where there are 10 or more MySuper products available to be chosen from.

The FSC is concerned that this limitation of competition is adversely effecting outcomes for consumers. Further, consumers who have been defaulted into a poorly performing industry superannuation fund through their modern award may be significantly worse off in retirement as a result of the decision made by the FWC their behalf to limit an employer's choice.

The FSC recommends that the law is reformed to allow all employers to choose a better performing MySuper product from the population of APRA-approved MySuper products.

Concerns that employers may make poor choices on behalf of their employees ignore the fact that the above data demonstrates that the status quo is unsustainable. By leaving the selection of default funds to the FWC and registered organisations the existing framework has driven consumers into underperforming superannuation funds, leaving them worse off in retirement.

The FSC is concerned, however, that the underperformance of some industry superannuation funds is hidden from public debate by the use of global 'industry fund' performance data. The Productivity Commission should reject the flawed argument that consumers are always better off with any industry fund as such data commonly only includes the large 15 funds who are members of Industry Super Australia (ISA) and excludes subscale and inefficient industry superannuation funds that are not members of ISA.

By deliberately excluding the 28 industry funds who are not members of ISA, advocates of the current, anti-competitive framework are able to hide the poor performance of their subscale colleagues and mislead examinations of the superannuation system, such as the Productivity Commission's current inquiry.

**Recommendation:** The Productivity Commission recognise that the current listings in modern awards result in some consumers being default into industry superannuation funds that perform significantly worse than the market. The Commission should also recognise that employers may be prevented by law from choosing a better performing MySuper product for their employees.

#### *The 'new' award selection process*

A 'new' selection process for selecting superannuation terms was legislated by the previous Government. The new process was to require two stages:

1. An 'expert panel' in the Commission creates a list of approved MySuper products (which have previously been approved by APRA for a MySuper license); and
2. A 'normal panel' of industrial Commissioners chooses which MySuper products from the list should be included in the superannuation terms in each award, based on submissions from only registered organisations.

Two members of the 'expert panel' were subsequently stood down by the President of the FWC on the basis that they had apparent conflicts of interest, including one 'expert' being a director on an industry fund that itself would make applications to the panel and another being employed by a fund manager that provided services to superannuation funds.

The FSC subsequently raised concerns in relation to the composition of the expert panel and ultimately took legal action against the FWC on the basis that the constitution of the expert panel was not consistent with the requirements of the *Fair Work Act 2009*. The Full Bench of the Federal Court of Australia issued an order that as a result of these conflicts, and because the President of the

FWC was unable to reconstitute the panel with the remaining commissioners available to him, the review process was inconsistent with the requirements established in the law and unable to proceed.

As a result the President of the FWC stopped the review indefinitely. The conflicts of interest that exist in the FWC process are systemic and anti-competitive. It is not possible to remedy the conflicts in the existing legislative framework in such a way as to legitimise a review through the FWC.

In particular, the FSC notes two observations of a Justice of the Full Federal Court that considered this matter:

PERRAM J: It struck me 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>1</sup>

PERRAM J: 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>2</sup>

The FSC is also concerned that the new process contains the same barriers to competition and conflicts of interest that exist in the old process - only sponsoring organisations are allowed to make submissions during the 'second stage' of the review and retail funds have no right to appear.

Further, the second stage continues to only involve 'normal' industrial commissioners who are not chosen for having any expertise in financial services or superannuation competition. The FSC is also concerned that they may also be conflicted as a result of commonly being employed from the ranks of the registered organisations who are entitled to appear before them.

This 'second stage' of the new process is inconsistent with the recommendations of the Productivity Commission following its last review of the default superannuation market. Claims that the new process is consistent with the Commission's earlier work are simply wrong. They also ignore the fact that the prior review's terms of reference never contemplated the role of the FWC being abolished and required that superannuation remain a part of the industrial system, thereby retaining the conflicts of interest inherent in the link between superannuation and the industrial system.

Furthermore, claims the FWC acts as a 'quality filter' are unsupported by evidence. There is no correlation between the performance of superannuation funds and the number of award listings they receive. There is, however, a relationship between the industrial coverage of the relevant union and the award listings of the associated industry fund.

The implications of this are critical for the future of the role of the FWC in the superannuation system. If the FWC process is retained, consumers will continue to be defaulted into some industry superannuation funds that underperform the market simply because the registered organisations that own the fund have coverage for that modern award.

**Recommendation:** The Productivity Commission recognise that the 'new' process retains conflicts of interest that are inherent in the industrial system and that, without removing the FWC from the selection of default funds for workplace, consumers will continue to be defaulted into poorly performing industry superannuation funds affiliated with trade unions who have industrial coverage. The FWC's process and its impact on competition should be included in the scope of the PC's review.

<sup>1</sup> Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 36

<sup>2</sup> Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 50

## Enterprise agreements

Competition in the superannuation industry is also suppressed by a gap in the choice of fund laws allows enterprise agreements to expressly remove an employee's right to choose their own superannuation fund.

Where these terms exist an employer can only contribute, on an employee's behalf, into to the fund named into the agreement.

Enterprise agreements are either negotiated:

1. Between a trade union and an employer; or
2. Between a trade union and an employer organisation, which then creates a template agreement that is rolled out across a sector.

In both circumstances it is common for the trade union to insist on the industry fund they own to be the fund named in the agreement to the exclusion of all other funds. There is no requirement that the fund they nominate be shown to perform well relative to other funds, and no requirement for the employer to run a tender to encourage competition between trustees in order to secure fee reductions or superior servicing for their consumers.

As with awards, there is also a financial incentive for registered organisations to nominate the fund they own in agreements and to prevent other funds competing for the consumers that will be covered by the agreement. As a result there is a potential conflict between the interest of consumers and the interests of a trade union who promote their fund, even where it underperforms.

<p><b>Recommendation:</b> The Productivity Commission recognise that enterprise agreements are anti-competitive where they remove a consumer's right to choose their own fund. Enterprise agreements and their interaction with superannuation should be included in the scope of the PC's review.</p>
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## Impact of legislative framework on industry consolidation

The FSC is concerned that the current lack of competition in the default system is effecting the broader dynamics of the superannuation industry by preventing industry consolidation.

In spite of the strong growth in the industry to over \$2 trillion under administration, there remain over 116 trustees offering APRA approved MySuper products. Recent analysis by independent ratings agency, Chant West, shows that there are 87 MySuper products managing less than \$5 billion. By comparison, there are only 16 trustees managing more than \$10 billion, and a further 13 trustees managing between \$5-10 billion. There is a strong body of evidence that the lack of scale in the superannuation industry detracts from the outcomes that are delivered for consumers.

Recent Chant West analysis in Chart 2 shows the variance in fees charged by trustees of different size, demonstrating that larger funds charge less for their services, but also delivered a higher quality of servicing for that lower cost.

Chart 2. Chant West analysis of the relationship between fund size and fees



## MySuper fees – by size

Weighted average MySuper fees (% pa) on a \$50k balance

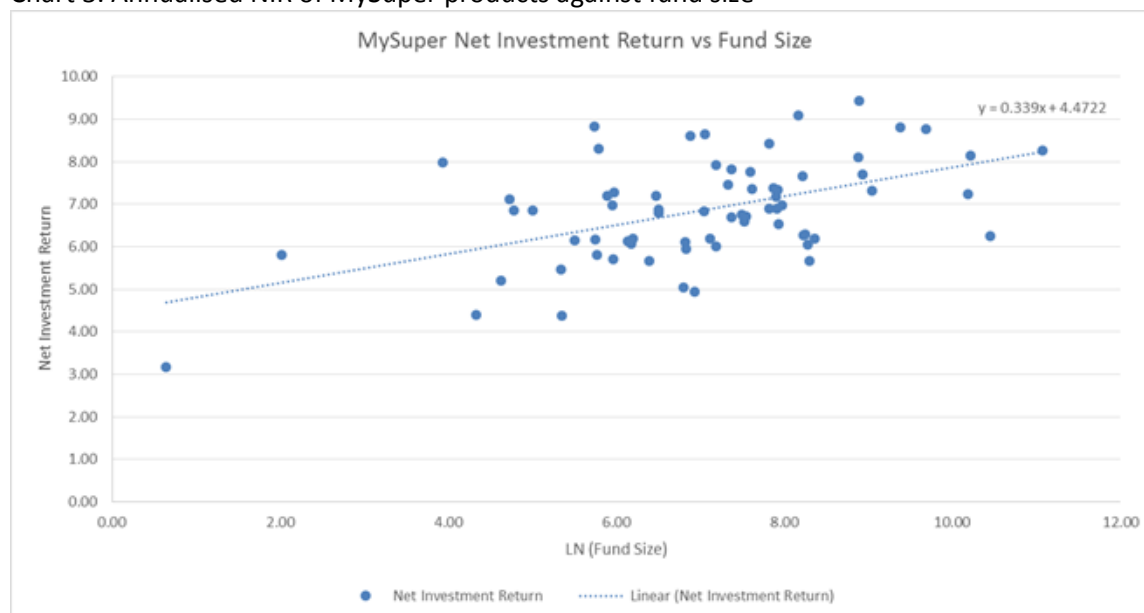
Product Size	No. of Products	Admin. Fee (bps)	Invest. Fee (bps)	Total Fee (bps)	75% Within Range (bps)
> \$10 b	16	26	60	86	72 – 110
> \$5 b - < \$10 b	13	46	57	103	84 – 121
< \$5 b	87	46	59	105	81 – 123
Total	116	33	59	92	80 – 130

Scale matters:

- Admin fees: larger funds have lower fees with better services
- Investment fee: larger funds more sophisticated for the same fee

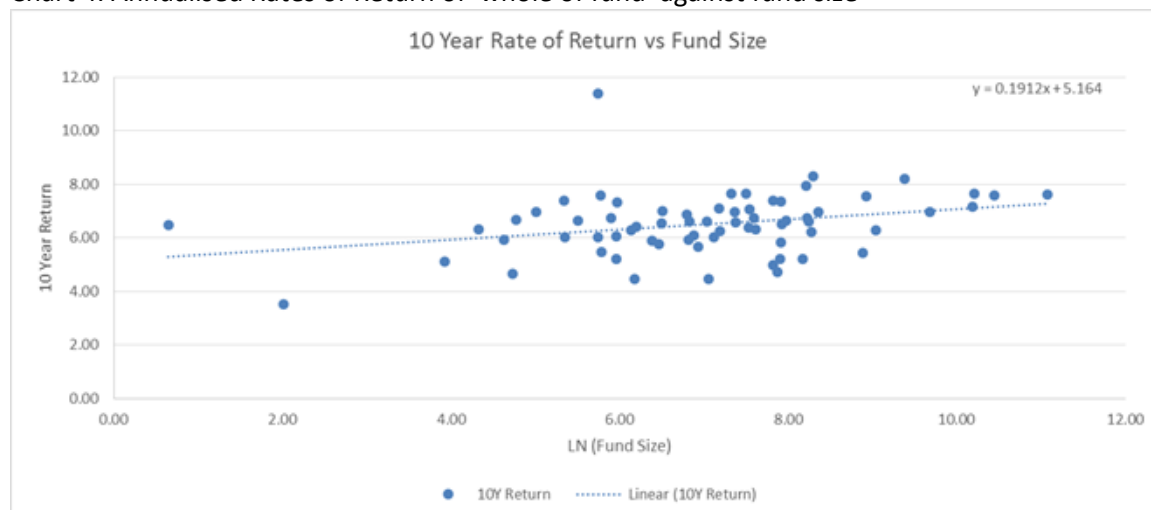
FSC analysis has confirmed the relationship between fund size and net returns. Charts 3 and 4 below reflect APRA’s annualised Net Investment Return (NIR) and Rate of Return data against the size of trustees, for both MySuper products and ‘whole of fund’.

Chart 3. Annualised NIR of MySuper products against fund size



Source: FSC analysis of APRA data

Chart 4. Annualised Rates of Return of 'whole of fund' against fund size



Source: FSC analysis of APRA data

The FSC's analysis demonstrates that there is a clear correlation since both the commencement of MySuper in 2013, and over the past 10 years, between the size of a superannuation fund and the Net Investment Return or Rate of Return that is achieved for consumers.

### Scale and the default system

The FSC submits that the absence of scale in the superannuation industry is directly related to the legal framework for the selection of default superannuation funds.

The default market creates a barrier to consolidation of the industry as the guaranteed flow of contributions that subscale industry funds receive through modern awards and enterprise agreements provides those trustees with liquidity. Trustees are under less pressure to consider the benefits that a merger may deliver their consumers if they are able to meet outflows with the incoming contributions of new members.

Further, there is a potential conflict between the interests of sponsoring organisations and the interests of consumers that may create a disincentive for trustees choosing whether or not to merge their fund with another. The registered organisations that appoint directors to industry superannuation funds enjoy the financial benefit, outlined in the previous section, which comes with retaining their ownership of a subscale fund, even though the consumers may benefit from the fund merging with another to achieve scale.

Introducing competition into the default market would assist industry consolidation. If subscale funds are exposed to competition, but are unable to reduce their fees and improve their service quality to retain members who may otherwise switch to more efficient funds, the trustees of those smaller funds would have lower certainty they can meet their liabilities over time. This uncertainty would create pressure on trustees to consider merging with another fund.

The liquidity pressures that competition would deliver also bring APRA's prudential role to the fore and provide a basis for the regulator to engage with trustees to overcome any conflicts of interest that may be preventing mergers.

## Benefits of industry consolidation to consumers

Rice Warner Actuaries was previously commissioned by the FSC modelled the benefits that industry consolidation would likely deliver for consumers. Rice Warner concluded that consolidation of the industry would generate material cost reductions and reduce fees for consumers.<sup>3</sup>

Rice Warner's analysis shows that competition in the superannuation industry could result in average fees falling by 15 basis points, from 110 basis points to 95 basis points, should the proposed reforms drive scale so that all funds were over \$5 billion.

Industry consolidation that drives the minimum fund size to \$20 billion would also result in average industry fees experiencing a 25 basis point reduction to 85 basis points.

Table 1 below reflects how the more considerable the scale derived from competition, the greater the fee reductions for consumers.

Table 1. Expected reduction in fees as a result of the scale in the superannuation industry

Minimum Size (\$b)	Number of APRA regulated funds 30 June 2014	Estimated Reduction in costs (bps)
1	97	9
2	78	11
5	48	15
10	28	20
20	14	25

Source: Rice Warner Actuaries

Rice Warner also estimates that the reduction in fees would be significantly greater amongst small, subscale superannuation funds. Members of small, inefficient superannuation funds managing under \$1 billion currently pay, on average, 141 basis points per annum in fees; 31 basis points above the entire industry average.

Consolidation of inefficient superannuation funds would result in members paying fees of only 94 basis points; a substantial 47 basis point reduction.

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<sup>3</sup> Rice Warner, *Superannuation Fees Report 2014*, page 15-21

## Opaque related-party arrangements in the default market

Another anti-competitive feature of the default superannuation framework is the manner in which it suppresses competition between service providers to the industry superannuation funds that enjoy an effective monopoly in that market.

The FSC believes there is a role for both stand-alone superannuation funds and vertically integrated financial conglomerates in a competitive superannuation market. Within the default superannuation market, however, a single related party structure affiliated with industry superannuation funds dominates the market in a manner the FSC is concerned undermines competition between service providers and has a negative impact on the outcomes delivered for consumers.

Industry superannuation trustees have established a network of service providers that not only have complex cross-ownership arrangements, but also have overlapping directorships. For examples, subsets of industry superannuation trustees own:

- Industry Funds Management;
- Industry Super Property Trust;
- Frontier Investment Consulting;
- Industry Super Holdings;
- The New Daily; and
- Industry Fund Services.

Industry superannuation funds, until recently, also collectively owned the fund administrator SuperPartners.

Industry superannuation funds have not only invested members' retirement savings as equity stakes in these related party service providers, but also pay these providers for their services. The FSC is concerned that this structure suppresses competition specifically in the context of industry funds' monopoly status in the default market. The absence of competitive pressure between service providers in the default market may therefore result in higher fees and lower returns for consumers.

The FSC is concerned that members of industry superannuation funds are effectively paying two sets of fees for the same service:

1. The headline fee the service provider charges the industry funds; and
2. The cost of using members' retirement savings to provide capital to the service provider to maintain its operations.

There are many examples of industry superannuation funds repeatedly being required to inject capital into the service providers they own in order to support their operations. These capital injections come directly from members retirement savings, however as they are treated as equity investments in the service provider, the 'return' of this investment is hidden amongst other investments, and not reported to consumers.

This 'hidden cost' to consumers may result in consumers paying inflated costs relative to other service providers. The cross-ownership arrangements between service providers also alleviates pressure for the service providers to raise the standards of service or lower their fees for consumers.

### SuperPartners

The case of SuperPartners provides an example of the related party arrangements of industry superannuation funds reducing members' retirement outcomes. Until recently five industry superannuation funds collectively owned SuperPartners, an administration service provider.

SuperPartners undertook a project in 2008 that was intended to deliver a new IT system for its affiliated superannuation funds by 2010. The project was repeatedly delayed and the costs overran to a significant \$250 million – almost equivalent to an entire year of revenue for SuperPartners from all its customers.<sup>4</sup>

Following a strategic review by external consultants the industry superannuation funds not only wrote down the equity investments in their holdings of SuperPartners, but also sold SuperPartners to a private sector provider on terms that have not been made publicly available, prior to the IT project ever being completed.

The SuperPartners example demonstrates how the decision to establish an industry superannuation owned service provider, rather than contract with competing, private sector providers, may have resulted in consumers paying more in costs related to that provider than would otherwise have been the case. Consumers were expected to incur the expense of supporting a failed attempt of industry superannuation funds to establish their own administrator, as well as through the fees paid to SuperPartners for the services it did provide industry superannuation funds.

The FSC submits that, in the event that industry superannuation funds are subject to greater competitive pressure in the default market to attract and retain members, their trustees would be less likely to invest in initiatives such as SuperPartners. The losses that risky ventures may generate would have a greater impact on the trustee's competitiveness in the market and their capacity to attract and retain consumers.

**Recommendation:** The Productivity Commission examine how to introduce competition amongst service providers catering to trustees who participate in the default superannuation market.

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<sup>4</sup> Patten. S., *Botched IT project costs super funds millions*, Australian Financial Review, 26 November 2013



## Measuring superannuation efficiency should be multi-dimensional

Superannuation trustees' role is to invest and grow a consumer's retirement savings until they retire. The Government is also consulting on introducing reforms that will extend a trustee's responsibility to manage the draw-down of an individual's savings through their retirement.

The FSC understand the Productivity Commission's review is an assessment of how to measure how efficiently the superannuation achieves its objective of growing a retiree's superannuation savings and whether it is subject to adequate competition whilst doing so.

The current framework inherently puts scale, fees and net investment returns at the front of considerations of the performance of superannuation products. Whilst the FSC agrees they are important, there are also system level features of the superannuation industry that deliver tangible benefits to consumers. This include insurance coverage, retirement products, diversity of choice, financial planning capacity, capital reserves, member engagement initiatives and supporting IT infrastructure – all of which come at a cost to consumers, but deliver a tangible benefit.

The FSC therefore recommends that measuring the efficiency of the superannuation system should be a multi-dimensional assessment of the factors that contribute to delivering adequate retirement incomes for Australian retirees.

This includes understanding the contributory role of interrelated features, such as asset allocation decisions, drawdown patterns, investment performance, fees, financial advice and insurance coverage. As a result the FSC recommends the Commission taking a multi-dimensional approach to assessing the performance of the superannuation system and how efficiently providers deliver both their core functions and additional services to consumers.

### Like-for-like comparisons

The FSC is concerned that assessment of the superannuation system often begin with a comparison of the performance of individual superannuation products. The FSC cautions that this assessment has been fraught with difficulty when undertaken in the past and detracts from a more appropriate focus on system level analysis.

There are a range of products available for consumers, including:

- MySuper products with a single, diversified investment strategy;
- MySuper products with a lifecycle investment strategy;
- Diversified products tailored to the risk appetite of the investors;
- Single asset class investment options; and
- Single security investment options.

Whilst some products are available to all consumers, such as MySuper products, many products are only available to consumers who have received financial advice. As a result of the diversity of products it is not appropriate to compare the performance of one product with the performance of other products.

Unfortunately it has been common for industry stakeholders to make misleading comparisons, such as comparing the performance of a MySuper product with the aggregated performance of all the products offered on a retail platform. In particular, APRA's historical 'whole of fund' data lumped together all investment options as if a consumer was invested in all the options a superannuation trustee offered. Commentators often used this data for comparative purposes and to influence

consumer decision-making, as if it formed a reliable basis on which a consumer could make an informed decision.

## Business models

Within the superannuation industry there are a range of different business models. These include:

- Industry funds that can have as much as 80 per cent of their membership in their single, diversified MySuper product;
- Master trusts that offer a diverse range of investment options directly to consumers or through platforms, and often have over 60 per cent of their members engaged and invested in choice options; and
- Self-manage superannuation funds that afford an individual broad discretion in how to invest their retirement savings.

The FSC is concerned that the complexity of the difficult models may lead to a focus on MySuper products, rather than the system as a whole. A focus on MySuper, however, would ignore the better retirement outcomes that can be achieved should a consumer seek financial advice and exercise choice of fund. Investment strategies that are tailored to an individual consumer's circumstances can outperform a MySuper product and result in a better quality of life for the consumer in retirement.

Superannuation trustees that focus on the collective outcome, however, have built their business models on a single investment strategy. These trustees benefit from consumers being disengaged and may underinvest in choice options and other measures to promote consumer involvement in their own retirement savings.

For this reasons the FSC recommends the Productivity Commission examine the benefits that can be delivered for consumers should they become more engaged in their superannuation and make informed decisions. The Commission should avoid arguments that would inherently support one business model over another, but instead focus on the needs of consumers.

## Fees

The superannuation industry has aggressively sought to reduce fees for consumers and, as demonstrated in research by Rice Warner Actuaries, superannuation fees have been falling for an extended period of time.

Rice Warner Actuaries compiles an annual fees report, with the most recent snapshot of industry fees reproduced in Table 2 below.

Table 2. Superannuation fees

Fees by superannuation segment – Year to 30 June 2014						
Sector	Segment	Operating	Investment management	Operating & investment management <sup>1</sup>	Advice	Total fees <sup>1</sup>
				(%)		
Wholesale	Corporate	0.16	0.46	0.62	0.02	0.64
	Corporate Super Master Trust (large)	0.28	0.53	0.81	0.04	0.86
	Industry	0.29	0.63	0.92	0.04	0.96
	Public Sector	0.17	0.59	0.76	0.04	0.80
Retail	Corporate Super Master Trust (medium)	0.66	0.62	1.28	0.10	1.38
	Corporate Super Master Trust (small)	0.79	0.64	1.43	0.11	1.54
	Personal Superannuation	0.87	0.49	1.36	0.29	1.64
	Retail Retirement Income	0.78	0.40	1.18	0.43	1.61
	Retirement Savings Accounts	0.60	0.40	1.00	-	1.00
	Eligible Rollover Funds	0.68	1.51	2.18	-	2.18
Small funds	Self-Managed Super Funds	0.21	0.68	0.89	0.15	1.04
<b>Total</b>		<b>0.37</b>	<b>0.59</b>	<b>0.96</b>	<b>0.14</b>	<b>1.10</b>

<sup>1</sup> Components may not add up to totals due to rounding.

Rice Warner's research also shows that superannuation fees have been steadily falling over time.

The majority of consumers are invested through wholesale products, including corporate super master trusts, industry funds, public sector funds or corporate funds. Whilst fees have broadly fallen across the sector, from an average of 130 basis points in 2004, to 110 basis points in 2014, fees have fallen more dramatically amongst large master trusts, from 114 basis points to 86 basis points.

Table 3 below provides a comprehensive snapshot in the changes in fees across superannuation products over the past decade.

Table 3. Superannuation fees over time

Sector	Segment	Fee rate %						
		2014	2013	2011	2010	2008	2006	2004
Wholesale	Corporate	0.64	0.78	0.79	0.80	0.73	0.78	0.75
	Corporate Super Master Trust (large) <sup>1</sup>	0.86	0.86	0.83	0.87	0.79	0.81	1.14
	Industry	0.96	1.07	1.13	1.26	1.07	1.13	1.18
	Public Sector	0.80	0.76	0.82	0.81	0.69	0.70	0.66
Retail	Corporate Super Master Trust (medium) <sup>2</sup>	1.38	1.30	1.83	1.95	1.87	1.83	2.11
	Corporate Super Master Trust (small) <sup>3</sup>	1.54	1.69	2.21	2.41	2.16	2.04	2.11
	Personal Superannuation	1.64	1.73	1.87	2.07	2.00	2.12	2.30
	Retail Retirement Income	1.61	1.71	1.75	1.85	1.84	1.79	2.04
	Retirement Savings Accounts	1.00	0.70	2.30	2.30	2.30	2.30	2.30
	Eligible Rollover Funds	2.18	2.43	2.40	2.42	2.49	2.53	2.53
Small funds	Self-Managed Super Funds	1.04	1.12	1.00	1.01	0.98	0.87	1.01
<b>Total</b>		<b>1.10</b>	<b>1.17</b>	<b>1.20</b>	<b>1.27</b>	<b>1.21</b>	<b>1.26</b>	<b>1.30</b>

<sup>^</sup> Prior to 2006, corporate super master trusts were only segmented into funds with assets greater than \$5 million and those with less than \$5 million.

<sup>1</sup> Excludes employer plans with less than \$5 million in assets.

<sup>2</sup> Employer plans with assets between \$2 million and \$5 million.

<sup>3</sup> Employer plans with less than \$2 million in assets.

## Fee comparisons

An important starting point for the comparison of superannuation products is the fees charged for that product.

A common flaw with fee comparisons is that comparative data, such as 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.

By comparison, 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 interaction with the public, for which it is ultimately intended to provide.

The FSC notes the FSI’s comparison in its report of the Australian system to the auction model for default contributions in Chile. In many ways the work of Grattan was influential in promoting the Chile model, and promoting this current Productivity Commission review.

The Grattan Institute report found Chile’s fees were about one-third of Australia’s default MySuper fees, but analysis by Chant West found that the Grattan report wrongly compared only the Chilean administration fees with the total of administration and investment fees for Australian MySuper options.

When all Chilean fees are compared to MySuper fees, MySuper products are, on average, cheaper than our international counterparts.

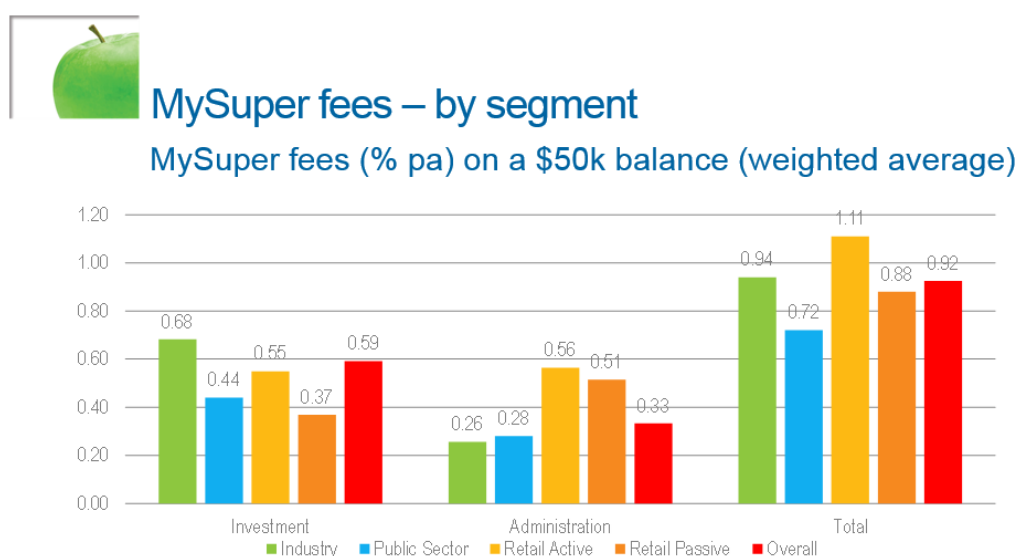
The research report into the Chilean model has been attached to this submission for the Productivity Commission’s consideration.

### MySuper fees

MySuper products are the most comparable in the superannuation market, however even comparisons between MySuper are inherently challenging as they are often designed to cater to different cohorts of consumers.

Chant West analysis shows that in the MySuper market there is considerable variation in the fees charged, as reflected in Chart 5 below.

Chart 5. MySuper fee components



Overall average: 92 bps

It is incorrect, however, to assume that all MySuper products are comparable. For example, ANZ Wealth’s ‘Smart Choice’ MySuper product is one of the cheapest MySuper products in the market, charging only \$50 per annum and 50 basis points. ANZ Wealth’s product is actively managed across asset classes, but passively invested in each asset class and may be chosen by consumers who are focused on minimising the fees charged by their trustee.

ANZ Wealth’s product is significantly different to the MySuper product offered by Australian Ethical Investments (AEI). Being an ethically invested superannuation fund AEI is inherently actively managed as it requires close engagement with the companies in which AEI invests to determine whether they comply with the requirements of the trustee. As a result AEI is a more expensive product, however consumers may have chosen that this is appropriate as it reflects their values, and the investment returns may compete with other trustees through the active management.

The FSC therefore recommends caution in how the Productivity Commission evaluates the performance and efficiency of different MySuper products. Different superannuation products are tailored to the different needs of consumers and, whilst it is superficially appealing to take a ‘one-size-fits-all’ approach to evaluating products, this would be a flawed approach.

### MySuper discounting

The current legislative framework prevents MySuper providers from effectively tailoring and discounting their MySuper products to win new business from employers. As present legislation restricts MySuper tailoring to only 'large employer' plans, with over 500 consumers. Further, to offer a tailored MySuper the provider must first seek approval for the tailored MySuper product from APRA.

These provisions clearly create a disincentive for superannuation to compete through tailoring their MySuper products to the needs of individual workplaces. This impacts the capacity for fee reductions, tailored insurance products, addition servicing, such as financial advice arrangements, or other special product features.

The FSC recommends that the Productivity Commission examine barriers in existing law to MySuper providers tailoring their MySuper products to win new corporate mandates.

### Choice product fees

The equation for evaluating fees is complicated when choice investment options are included in the equation for assessment as choice options are extremely diverse.

Choice products extend from simple options, such as cash, to complex products, such as offshore hedge funds. The fees charged for each investment option clearly vary significantly, and are driven by a range of factors, such as the cost of managing the investment varies, or because the fund managers themselves are in high demand and as such the market has dictated they can charge higher fees.

The FSC recommends caution in developing any methodology for comparing choice options that are not readily comparable.

### Investment Management Fees

Very few superannuation trustees manage their investment portfolio in-house, as such there is significant competition amongst investment managers for the \$2.6 trillion in contestable savings in Australia.

Global research house Morningstar stated the following in its 2013 Global Fund Investor Experience Report:

"Australia fares very well with respect to fees and expenses. Australian equity, allocation and fixed income funds are some of the least expensive globally, with only the much larger United States charging consistently lower total expense ratios."

To support the Financial System Inquiry 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.

The results showed:

- 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.

Anecdotally, the FSC heard from several fund managers in preparing our submission to the FSI that on most occasions, approval has to be sought from head office to discount fees for the Australian market in order to win business.

## Performance

The performance of a superannuation product, net of fees and taxes, is an important measure of how effectively the superannuation system delivers for consumers. The FSC supports benchmarking of product performance based on 'like-for-like' comparisons as is currently undertaken by APRA.

MySuper products can more readily be benchmarked as they are broadly designed for disengaged consumers. For example, the net performance of a trustee's default product may be benchmarked against both an industry average, provided such comparisons also provide meaningful category benchmarks, such as similar 'lifecycle' products or products catering to young or older members.<sup>5</sup>

Benchmarking product performance between choice products, however, is more difficult. As outlined in previous sections, there are a diverse range of choice products designed to cater to specific cohorts of members who may select that product as part of a comprehensive strategy for managing their financial affairs.

APRA has commenced collecting comprehensive data on choice options offered by trustees and will soon make some of the information it collects publicly available. The FSC recommends that comparison of choice products should first be left to the private sector ratings agencies, such as Chant West, who are well positioned to publish meaning information and analysis for consumers.

The FSC notes, however, that creating meaningful, centralised comparisons between the thousands of investment options available across multiple trustee platforms would be challenging, if not impossible. This complexity has led to some stakeholders arguing that individuals should be prevented from tailoring their investment portfolio with different investment options.

The FSC is concerned, however, that this approach may result in consumers being worse off in retirement if they are forced into a 'one-size-fits-all' approach to portfolio management.

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<sup>5</sup> Categories should reflect the risk appetite of the membership, so that defensive portfolios catering to older members are not, for example, portrayed as underperforming aggressive portfolios designed to cater to younger members, even though such products are clearly not comparable.

## Insurance

MySuper products are required to provide default life and TPD insurance coverage. Choice superannuation products often commonly provide an insurance option with some form of underwriting. Insurance provided through superannuation has long been accepted an important way of raising the level of insurance coverage in Australia and addressing a chronic state of underinsurance.

For example, Rice Warner Actuaries have estimates that the underinsurance gap to be \$4.5 trillion (for Death) and \$11.2 trillion for TPD. They calculated that the annual cost to the Government (of social security payments) due to underinsurance as more than \$1.3billion (Death & TPD combined).

Insurance, of course, comes at a cost to consumers. Trustee directors have effectively negotiated competitive rates for insurance premiums on behalf of their members through 'group insurance' arrangements, however the cost of insurance is also effected by the claims experiences of insurers. The insurance industry is currently working with the prudential regulator and superannuation sector to ensure that pricing is sustainable and delivers the best outcome for consumers.

The issues paper notes that a claims to premiums ratio may be an appropriate indicator to benchmark insurance, however a comparison based solely on a claims to premiums ratio must properly consider the timing of premiums paid and claims incurred, recognising that many claims are not notified until many years after the incident. While assumptions can be made for any claims which have been incurred but not yet reported (IBNR), the accuracy of these assumptions is impacted to how well developed the claim experience is (that is, what percentage of likely claims have been notified)and will differ significantly between different cohorts of members and between funds. Assumptions can be varied to suit different outcomes, and as such some standardisation needs to be considered to render a comparable result.

The FSC recommends that the Productivity Commission recognise the value that insurance delivers for consumers through group insurance arrangements inside of superannuation rather than a focus on minimising cost. There is currently structural adjustments occurring in the industry to better match pricing to claims experiences which are intended to deliver sustainability.

## Trustee services

Superannuation trustees are required to provide a range of additional services that have value to consumers or are required under law, but add to the cost of managing a superannuation product.

These services include:

- A baseline standard of member engagement to promote financial literacy;
- Administration capacity to manage features such as inter- and intra-fund transactions, fair and efficient scheme pricing and consumer interactions;
- The maintenance of a trustee board and compliance with APRA's governance requirements;
- The maintenance of capital reserves to cover operational risk;
- Administration of ATO requirements on behalf of members;
- Compliance with Anti-Money Laundering obligations;
- Compliance with regulatory imposts, such as ASIC orders, APRA reporting and oversight obligations and RBA obligations;
- Implementation of Government policies, such as SuperStream and Single Touch Payroll; and
- Payment of APRA levies to support APRA, ASIC, the Superannuation Complaints Tribunal.

The Productivity Commission should have regard to the range of additional services a trustee provides its members, but add to the cost of managing a superannuation fund and lower net investment returns for consumers.



### *Scheme pricing*

Scheme pricing is an important example of how efficiency can be traded off against effective management of a superannuation trustee.

Retail superannuation funds manage the pricing of their superannuation portfolios through daily unit pricing, a process widely recognised as international best practice as best reflects the market value of assets. Daily unit pricing is inherently fair between consumers as one consumer is not subsidising the investment decisions of another consumer.

Most industry superannuation funds, however, practice crediting rate pricing, that usually involves less frequent pricing of assets held in an investment portfolio and a crude apportionment methodology for tax and other purposes. Crediting rate practices result in one cohort of members subsidising other members, such as where a member leaves the fund whilst the crediting rate is highly valued (because it has not been repriced after a market fall).

The persistence of industry funds in maintaining what is inherently a system that is unfair to consumers is not clear, however it is likely related to the cost of developing the IT systems necessary to implement daily unit pricing – a cost that would be borne by fund members as industry superannuation funds do not hold shareholder capital.

As a result, unfair and inefficient practices help industry superannuation funds reduce their members' fees, but cost members in other ways, such as lower actual returns on their retirement savings.

### *Member satisfaction*

The performance of superannuation trustees can also be measured by the number of complaints about the trustee to the Superannuation Complaints Tribunal (SCT). Helpfully this provides an objective analysis of customer satisfaction.

In the previous 2013-14 reporting timeframe the SCT received 1364 complaints that were within its jurisdiction. The SCT broke down the source of complaints by fund type:

- Retail funds: 34.6% (472)
- Industry funds: 49.4% (674)
- Corporate: 3% (36)
- Government: 12.4% (170)

The Productivity Commission should be aware that retail funds collectively have 25% more members, but 43% less complaints, than industry funds.

## International comparisons

A genuine system level benchmarking exercise would include an assessment of the Australian superannuation system against overseas pension systems. However, that raises a number of challenges as Australia's superannuation system is more complex than most international pension systems and requires superannuation trustees to deliver higher degrees of member servicing, insurance coverage and administrative support.

Whilst these complexities establish a higher cost basis to our system, the Productivity Commission should not ignore the value of these services to consumers, and the extent to which they are delivered efficiently due to the almost universal coverage of the system.

The FSC compares some of the features of the Australian system to pensions systems overseas and the value these characteristics deliver Australian consumers. Fiscal sustainability and income adequacy are key elements of the efficiency of any pension system to provide benefits and these are elements that the Australian pension system consistently rates highly in regards to.

Stability and transparency are also very important features that the Australian pension system addresses well: "Young people in particular need to believe in the long-term stability of the pension system and the pension promises that are made to them in order to have them endorse the generational contract"<sup>6</sup>.

### *Investment Strategies*

The Australian superannuation system is more heavily invested in growth assets than many other overseas jurisdictions. This bias towards growth assets is the product of:

- Most assets being invested in the accumulation phase;
- No government mandate for investment in sovereign bonds; and
- A higher degree of comfort amongst Australians for accepting risk.

The result of a higher allocation to growth assets, however, is that they are more expensive to manage than defensive assets. Over the medium term this orientation to growth assets is accepted to deliver a better net-return for consumers, and as such is widely recognised as a strength of our system.

The FSC therefore cautions against reliance on research that portrays the Australian pension system as being more expensive than our international counterparts, especially OECD data, as such analysis often neglects different investment strategies, the age profiles of beneficiaries and the net returns that are delivered for consumers.

### *Fiscal Sustainability*

Fiscal sustainability relates to the ability of the current system to continue to deliver entitlements in the future. Pension reserves expressed as a proportion of Gross Domestic Product refers to the level of current assets set aside to pay for future retirement incomes. This is an important indicator of a nation's ability to provide retirement income in the future, with a higher level of assets relative to GDP indicative of higher likelihood of ability to meet future liabilities.<sup>7</sup> In contrast, high levels of government debt will impact on the future ability of a country to provide stated-funded pensions.

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<sup>6</sup> OECD, 2015, "Pensions at a Glance 2015", page 32

<sup>7</sup> Pascuzzo, Patricia, 2014, "An International Comparison of Pension System Performance in Delivering Adequate Retirement Incomes"

Australia's pension system consistently scores highly across a ranking of international pension systems. In 2013, Australia (with a 102.2% asset-to-GDP ratio) was only one of four OECD countries with an asset-to-GDP ratio higher than 100% and only one of six OECD countries that exceeded the OECD weighted average asset-to-GDP ratio of 82.8%<sup>8</sup>.

In 2011, Australia spent 3.5% of GDP on public pensions. Comparatively, "Italy spent the largest proportion of national income on public pensions among OECD countries in 2011: 15.8% of GDP. Other countries with high gross public pension spending are also found in continental Europe, with Austria, France, Greece and Portugal at about 13% to 14% of GDP and Germany, Poland and Slovenia at about 11%."<sup>9</sup>

Australia has not succumbed to the effects of the recent global economic crisis and its aftermath of sluggish economic growth. Our pension system has protected Australia from the large government debt levels in many OECD countries resulting from their inefficient pension systems. In Europe in particular, in nominal freezes of pension benefits has reduced standards of retirement considerably and contributed to falling prices and wage deflation.

### *Income Adequacy*

Income adequacy pertains to the level of benefits that are currently provided by the system, with the term 'net replacement income' encompassing both State-funded income (inclusive of basic income and any applicable safety net benefits) and private pensions.

The measure of income adequacy is referred to as the 'replacement rate' and is "equal to the ratio of the net pension entitlement to life-time average net earnings. Theoretical replacement rates are forward-looking and assume that currently legislated pension rules apply throughout an individual's career until reaching the normal pensionable age in each country."<sup>10</sup>

The OECD average for all 34 OECD countries with both public and mandatory private provisions, the average net replacement rate is equal to 52.9% for the average-income worker.<sup>11</sup> This, however, is often a reflection of the structural fiscal unsustainability of generous, universal Government pensions in European countries that are not undergoing painful structural reform to fund ballooning pension liabilities.

In Australia, the average replacement rate is 44.5%. By contrast, in New Zealand and Chile, countries whose pension systems were highlighted as strong framework examples by the Financial System Inquiry, are forecast to achieve replacement rates of 40.1% and 32.8%, respectively.<sup>12</sup> There are, of course, important differences in terms of contribution rates and contribution rules that may affect adequacy outcomes.

### *Defined Benefits vs Defined Contribution*

Australia's superannuation trustees predominantly manage a defined contribution system, however there remain significant defined benefit schemes in the Australian system that cater to some large corporations and public sector agencies.

The defined contribution system provides for ongoing contributions over a consumer's working life, and provides greater certainty the retirement benefit will be funded when the consumer retires.

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<sup>8</sup> OECD, 2015, "Pensions at a Glance 2015", page 191, figure 10.4

<sup>9</sup> OECD, 2015, "Pensions at a Glance 2015", page 178 – 179, figure 9.3

<sup>10</sup> OECD, 2015, "Pensions at a Glance 2015", page 27

<sup>11</sup> OECD, 2015, "Pensions at a Glance 2015", page 141, figure 6.4

<sup>12</sup> OECD, 2015, "Pensions at a Glance 2015", page 141, figure 6.4

Defined benefit systems are reliant on the sponsoring employer, such as the corporation, remaining solvent over the long term, and hence introduces a greater degree of counterparty risk for future retirees.

Defined contribution systems, however, are often more complex to administer. As a consumer makes contributions over their working life they take a greater interest in the management of their savings as the income upon retirement is of an uncertain quantum, and a consumer can seek to make decisions to maximise their own retirement outcome.

Other, cheaper international schemes are often defined benefit, such as Norway's sovereign wealth fund and other European pension schemes. These schemes have lower operational costs as the organisations administering the fund are often not required to provide consumers any services.

## Recommended measures of efficiency and competitiveness

Taking into account complexities arising in assessing the efficiency and competitiveness of the superannuation system, the FSC recommends that the Productivity Commission focus on system level questions that would measure whether superannuation is delivering on the promise of achieving adequate retirement incomes for Australians.

The questions the FSC proposes that the Productivity Commission recommend as measures of the efficiency and competitiveness of the system include:

1. Are investment returns globally competitive taking into account the risk/return profile of members?
2. Are trustees achieving the investment return targets that are provided to consumers when they join a product?
3. Are consumers and employers free to choose between superannuation products?
4. Is there tailoring and discounting of products to win new consumers and employer mandates?
5. Is the industry consolidating towards the optimal number of competing funds as a result of subscale funds merging with more efficient funds?
6. Are trustees investing in the innovative products and technologies that consumers expect of financial service providers?
7. Are consumers more engaged in relation to their superannuation savings?
8. Fees have fallen across the system relative to current benchmarks?
9. Have legislative and regulatory barriers to competition in superannuation been removed?
10. Are ongoing regulatory costs in the system as low as possible?

Measures of whether the industry is improving against the criteria can be sourced from many existing reporting framework. APRA's extensive data collection capabilities, in particular, provides a firm basis for measuring whether the superannuation system is delivering for consumers and whether competitive forces are being effectively applied and having an impact on the structure of the industry.