

**Submission to the Productivity Commission Study into the
competitiveness and efficiency of the superannuation system**



September 2016

Introduction

This submission is made by:

- Independent Fund Administrators & Advisers Pty Ltd (IFAA), a Brisbane based administrator of industry superannuation funds and managed investment schemes. IFAA has approximately \$9.5 billion in funds under administration;
- QIEC Super – a profit for members industry fund established specifically for the benefit of all participants in the non-Government education sector, child and other care and community services in Queensland;
- Club Super - a profit for members industry fund established specifically for the benefit of employees in the sporting and recreational clubs and associated industries in Queensland.

IFAA, QIEC Super and Club Super appreciate the opportunity to make comment on the issues raised in the draft report.

It is acknowledged that this study is the first of a three stage review process by the Productivity Commission, arising out of the Government's response to the Financial System Inquiry:

1. A study to develop criteria to assess the efficiency and competitiveness of the superannuation system (to be finalised by November 2016);
2. An Inquiry to develop alternative models for allocating default members to Funds (to be finalised by August 2017);
3. An Inquiry to review the efficiency and competitiveness of the superannuation system (to commence after July 2017, after bedding down of the MySuper system). This will utilise the criteria developed in stage 1.

The Productivity Commission study outlines the following as the system level objectives for assessing the competitiveness and efficiency of the superannuation system:

- The superannuation system maximises net returns on member contributions and balances over the long term.
- The superannuation system meets member preferences and needs, in relation to information, products and risk management, over the member's lifetime.
- The superannuation system provides insurance that meets members' needs at least cost.
- The superannuation system complements a stable financial system and does not impede long-term improvements in efficiency.
- Competition in the superannuation system that drives efficient outcomes for members.

These objectives are noted as being high level. The general nature of several of these objectives and the reference to meeting members needs, will be very hard to measure at a system level, given the needs of every individual are likely to be different.

At the outset we state our unambiguous support for efficiency and competition in the superannuation industry. However, we have serious reservations about the premise for the 3 stage review process and the potential outcomes and consequences of this process.

It is considered that competitive pressures that currently exist within the industry drive efficiency, which optimises outcomes for members. IFAA client Funds aim to offer competitive fees but also superior service through a value proposition / customer intimacy strategy, which enhances member

engagement. Through the provision of high levels of personalised service, including access to advice, it is contended that members make more informed decisions, contributing to better retirement outcomes.

It is recognised that keeping fees competitive is important in acting in the best interests of members. However, the focus on fees should be balanced against net returns and the services received by members. Lowest cost does not necessarily deliver on either of these objectives and we consider that net outcomes and provision of quality services should be of equal or greater importance.

IFAA, QIEC Super and Club Super have concerns that if after stage 3, the Productivity Commission concludes that the superannuation system is somehow not sufficiently competitive or efficient, the Government may decide to impose some form of competitive process for default Fund selection. It should be noted that under the current default Fund model, in some cases, selection of a default Fund (negotiated in good faith by the industrial parties) can qualify the members for a higher level of employer contribution, or provide access to customised insurance that specifically caters for the needs of members in that particular industry. This is considered to be in the best interests of those members.

A periodic competitive default fund selection process is likely to lead to Funds focussing on short term outcomes, to maximise their prospects in any selection process. This may well be contrary to the best interests of the members, as Trustees should have a long term focus in managing superannuation monies. In addition, a periodic competitive selection process implies a focus on Funds with the lowest fees, which may not provide the member with access to the above-mentioned benefits, including superior insurance or access to a broad range of asset classes when investing. Lowest cost products are also unlikely to offer superior service, which is again unlikely to be in the best interests of members. This outcome would be at odds with two of the Productivity Commission's stated system objectives, which are that the superannuation system should meet member needs and preferences, including for insurance. These implications need to be seriously contemplated in any consideration of a competitive process for default fund selection.

This is aside from the very significant implications which are likely to eventuate for the viability of Funds who do not attain default fund status under any such model. The potential closure of many Funds and merging millions of membership accounts in remaining Funds, is fraught with risk, with consequent impact on system stability. This potential outcome would seem to undermine one of the Productivity Commission's stated system objectives, that the superannuation system should complement a stable financial system.

Additionally, any associated large scale reduction in Funds in the industry as a result, would also reduce choice available to members and significantly reduce competition in the system, which is again contrary to one of the primary objectives the Government is trying to achieve. It may also result in a small number of large players, with consequent concentration risk.

The fact that competitive default fund selection processes may have been adopted in some overseas jurisdictions does not mean the same solution is necessarily appropriate in the Australian superannuation system. The structural and regulatory differences in retirement income systems between countries, is inevitably very significant, and the transplanting of policy settings should be considered with extreme caution.

Observations

The initial observation to be made is that the Productivity Commission study is extremely comprehensive in its scope. The report proposes in section 7.3 a comprehensive list of 27 criteria to assess the achievement of the 5 objectives. The report goes on to list an even more comprehensive list of 115 indicators which will be used to measure the criteria. The risk of the criteria and indicators having such breadth and depth is that when these are applied (in stage 3), the results are likely to be so complex that it will be difficult to draw clear conclusions. We consider some simplification may be appropriate.

The Productivity Commission's 3 stage study / inquiry is the latest in a long list of Government initiated inquiries / major reforms to the superannuation system in Australia. Just in the last decade, this has included:

- Simpler Super reforms;
- Henry tax review
- Cooper review
 - which resulted in Stronger Super reforms (MySuper, Superstream, Prudential Standards)
- Financial System Inquiry
- ASIC reforms (RG 97 investment cost transparency, SIS s.29QC comparability, dashboard)
- Greatly increased APRA reporting

While a number of these initiatives have added value to the industry, they evidence a relentless change agenda. For some of the initiatives, whether the overall net benefit has exceeded the cost, is doubtful. It should also be noted that each new set of obligations applies in addition to existing requirements, evidencing the ever increasing complexity of the regulatory system, with associated cost impacts.

It is considered there are two major impediments to achieving optimal efficiency and competitiveness in the industry. Firstly, is the overwhelming complexity and interaction of the various elements of the system. This complexity has been acknowledged in Appendix H of the Productivity Commission's draft report, and is considered to be a major factor in inhibiting member comprehension of superannuation. The Financial System Inquiry concluded that a majority of individuals are not actively engaged with the superannuation system. We consider that a significant contributor to this is the system's complexity.

A number of the recent or pending regulatory reforms (MySuper, APRA publishing of MySuper data, dashboards, RG 97, SIS s.29QC) appear to be predicated on an assumption that superannuation members are sophisticated investors who will analyse all of this information, compare to the market, and make rational decisions as to where to allocate their superannuation monies. It is contended that the majority of superannuation members are not sophisticated investors, who will not utilise these initiatives to undertake detailed assessments and comparisons. Therefore, these initiatives are for the benefit of a minority, but compliance with the requirements by superannuation funds has / will incur significant additional cost for all members.

The second major impediment is the very extensive and constantly evolving legislative and regulatory landscape, as a result of the ongoing reviews, changing political priorities and consequent Government decisions. Configuring systems, procedures, staff training, disclosures to comply with the ever changing regulatory landscape is a major component of cost within the industry, with these costs ultimately being borne by members. Another impediment to member confidence is the announcement of proposed

changes, as with the Federal Budget, noting there can be extensive delays in legislation being passed, and in some cases the announced changes are modified, or not passed at all.

While it is acknowledged that there is a very valid place for regulation, greater consideration should be given to the costs and benefits of further changes, and ultimately the efficiency of the regulatory system. It is also contended that the existing model is an impediment to innovation, as the regulatory system is so tight that innovations run the risk of breaching obligations, which in turn would bring regulatory attention.

Additionally, the evolving regulatory landscape further contributes to low levels of member engagement, by further reducing the capacity of members to comprehend the superannuation system. This is also likely to discourage the making of voluntary contributions, as a fundamental principle of behavioural finance is risk aversion. When confronted with uncertainty and lack of understanding in the rules governing their superannuation investment, and the ongoing changes to those rules, rational investors are likely to divert their discretionary investing to other sources. Greater stability in the regulatory system is likely to result in more contributions being made to superannuation, thus assisting in the Government's goal of members becoming more self sufficient in retirement. We consider the Commission should consider these aspects as parts of its deliberations.

Other comments on the Productivity Commission study

Commentary in relation to the proposed criteria, are set out below.

1. **Objective: Competition in the superannuation system that drives efficient outcomes for members**

Against this objective, it is noted there are 13 criteria and 56 indicators proposed. We consider there may be scope for consolidation.

Criteria	Comment
<ul style="list-style-type: none"> Is there sufficient member engagement to exert competitive pressure? Do active members and member intermediaries have sufficient countervailing power? 	<p><u>Consider consolidating criteria</u></p> <p>The Financial System Inquiry concluded that member engagement across the industry is at a low level. Our assessment of the major reasons for this, are outlined above. However, there is natural competition inherent between Funds in the industry to attract and retain members, which is enhanced by the publication of data by ratings agencies and regulators. This results in effective competition in the industry.</p> <p>IFAA client Funds invest considerable effort in increasing member engagement through their customer intimacy strategies, and this has resulted in greater take-up of advice and member actions in customising insurance and investments.</p>
<ul style="list-style-type: none"> Are members and member intermediaries able to make informed decisions? 	<p><u>Criteria supported</u></p>
<ul style="list-style-type: none"> Is there low market segmentation along member engagement lines? 	<p><u>Criteria not supported</u></p> <p>Other criteria adequately measure competition in the market.</p> <p>Marketing expenditures across the industry on attracting and retaining members evidences strong competition.</p>
<ul style="list-style-type: none"> Are principal / agent problems being minimised? 	<p><u>Criteria supported</u></p>
<ul style="list-style-type: none"> Do Funds compete on relevant non-price dimensions? 	<p><u>Criteria supported</u></p>
<ul style="list-style-type: none"> Is there rivalry among incumbent providers? Do Funds compete on costs? 	<p><u>Consider consolidating criteria</u></p> <p>There exists very significant rivalry and competition between Funds on price, benefits and service.</p>

<ul style="list-style-type: none"> Is the market contestable? 	<u>Criteria supported</u>
<ul style="list-style-type: none"> Are there material anti-competitive effects of vertical and horizontal integration? 	<u>Criteria supported</u>
<ul style="list-style-type: none"> Are economies of scale utilised and the benefits passed through to members? 	<u>Criteria supported</u>
<ul style="list-style-type: none"> Is there innovation and quality improvement in the system? 	<u>Criteria supported</u>
<ul style="list-style-type: none"> Are outcomes improving at system level? 	<u>Criteria supported</u>

2. **Objective:** *The superannuation system maximises net returns on member contributions over the long term*

Against this objective, it is noted there are 4 criteria and 20 indicators proposed. We consider there may be scope for consolidation.

Criteria	Comment
<ul style="list-style-type: none"> Are net investment returns being maximised over the long term, taking account of service features provided to members? 	<u>Criteria supported</u>
<ul style="list-style-type: none"> Are costs incurred by Funds and fees charged to members being minimised, taking account of service features provided to members? 	<u>Criteria supported</u>
<ul style="list-style-type: none"> Do all types of Funds have opportunities to invest efficiently in upstream capital markets? 	<u>Criteria supported</u>
<ul style="list-style-type: none"> Is the system effectively managing tax for members, including in transition? 	<u>Criteria supported</u>

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

Against this objective, it is noted there are 7 criteria and 23 indicators proposed.

Criteria	Comment
<ul style="list-style-type: none"> Is the system using lessons from behavioural finance to design products and 'lean' against well known biases in how people make decisions? 	<p>Criteria needs clarification</p> <p>It is unclear what is being measured, and how.</p> <p>It is the case with IFAA client Funds that considerable effort goes into researching proposed product changes, against the market, but often also with regard to member preferences, via surveys and analysing actual member behaviour. In this way, Trustees are applying best endeavours to ensure that the Fund offerings best meets member preferences and needs.</p>
<ul style="list-style-type: none"> Are Trustees acting in the best interests of members? 	<p>Criteria supported</p>
<p>Are member preferences and needs being met by:</p>	
<ul style="list-style-type: none"> minimising unpaid contributions and lost accounts? 	<p>Criteria supported</p>
<ul style="list-style-type: none"> Funds collecting relevant information to ensure their product offerings are suitable for their diverse member bases? 	<p>Criteria not supported</p> <p>It is considered that this criteria could be incorporated into the first criteria in this section.</p>
<ul style="list-style-type: none"> the system providing high quality information and financial advice to members to help them make decisions? 	<p>Criteria supported</p>
<ul style="list-style-type: none"> the system providing products and information to help members optimally consume their retirement incomes? 	<p>Criteria supported</p>
<ul style="list-style-type: none"> Member balances being allocated in line with their risk preferences and needs? 	<p>Criteria not supported</p> <p>This criteria appears to have limited usefulness. Most Funds offer switching, which allows members to customise their investment exposure to specifically match their preferences and needs. However, at the default MySuper level, Trustees make decisions on what they consider to be the most appropriate asset allocation / risk exposure based on their intimate knowledge of the demographics of the membership. This default option profile cannot take account of individual risk preferences and needs, which the criteria</p>

	apparently seeks to measure. While it may be considered that lifecycle offerings cater for risk preferences and needs of particular cohorts, even these are based on Trustee assumptions.
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4. **Objective:** The superannuation system complements a stable financial system and does not impede long-term improvements in efficiency

Against this objective, it is noted there is 1 criteria and 2 indicators proposed.

Criteria	Comment
<ul style="list-style-type: none"> Are there material systemic risks in the superannuation system? 	<u>Criteria supported</u>

5. **Objective:** The superannuation system provides insurance that meets members' needs and preferences

Against this objective, it is noted there are 2 criteria and 14 indicators proposed.

Criteria	Comment
<ul style="list-style-type: none"> Do Funds offer insurance products that meet members' needs? 	<u>Criteria supported</u>
<ul style="list-style-type: none"> Are the costs of insurance being minimised given the type and level of cover? 	<u>Criteria supported</u> Refer above