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

Dear Sir/Madam

Superannuation: Assessing Competitiveness and Efficiency

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission on the issues paper *Superannuation: Assessing Competitiveness and Efficiency*.

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through our service provider membership, represents over 90 per cent of the 14.8 million Australians with superannuation.

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

Yours sincerely

Glen McCrea
Chief Policy Officer

EXECUTIVE SUMMARY

ASFA considers that a competitive, efficient and dynamic superannuation system is crucial to ensure people retire with dignity – where the superannuation system has an overarching objective of providing adequate incomes to ensure all Australians achieve a comfortable standard of living in retirement, supplementing or substituting the Age Pension.

ASFA's fundamental concerns with the Productivity Commission's (the Commission's) assessment framework remain (notwithstanding some improvements since the Commission's Stage 1 draft report). That said, addressing these concerns is not the purpose of this submission.

Instead, this submission is largely concerned with three major areas that ASFA's membership considers are central to promoting the overarching objective of the system. ASFA's suggested reforms in respect of these areas – which in most cases relate to regulatory settings – would help improve system-level efficiency and competition.

Insurance is an integral element of Australia's superannuation system. Group insurance cover on an opt-out basis provides cover for employees that otherwise would not have it. This supports individuals, and their families, who suffer health-related misfortune, and reduces pressure on the social security system by reducing Australia's substantial underinsurance problem. Notwithstanding the significant benefits of insurance in superannuation, ASFA acknowledges that current insurance arrangements can be improved.

Innovation is central to the competitive dynamic in the superannuation system and is a source of ongoing improvements in member outcomes. Innovation is broader than just product design – it applies to services, products and functions at all stages of the superannuation supply chain. However, the changing and expanding regulatory requirements can represent a considerable opportunity cost for funds and related service providers – which creates the risk that funds and service providers will under-invest in innovative solutions. Specific legislation also constrains innovation in certain areas.

ASFA firmly believes in the need for a prudent regulatory framework for superannuation. However, excessive regulation – and unduly frequent changes in the regulatory framework and requirements – adversely affects efficiency, productivity and innovation. Changes to superannuation and tax settings necessitate capital expenditure, and the complex and prescriptive nature of the regulatory framework imposes material ongoing compliance costs. In addition, the superannuation industry pays levies by which government recovers the cost of regulation. With respect to the latter, ASFA has long articulated its concerns with the lack of transparency around how levies are calculated and spent.

ASFA strongly opposes the Commission's proposed centralised clearing house for the Australian market. It would introduce new and substantial risks and costs to government, employers and funds. In addition, it would not leverage the benefits of SuperStream – to which the superannuation industry has contributed more than \$900 million over five years for development.

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1. INTRODUCTION

ASFA welcomes the opportunity to review the Productivity Commission's issues paper *Superannuation: Assessing Competitiveness and Efficiency* and provide this submission. In drafting the submission, ASFA consulted with its membership.

ASFA considers that a competitive, efficient and dynamic superannuation system is crucial to ensure people retire with dignity – where the system provides an adequate retirement income to ensure all Australians achieve a comfortable standard of living in retirement, supplementing or substituting the Age Pension.

The Australian superannuation system is widely considered to be one of the best in the world. The \$2.3 trillion in superannuation assets represents the accumulated retirement savings of Australian workers and retirees. The retirement incomes (and lump sums) generated from superannuation savings allows individuals to achieve a much higher standard of living in retirement than otherwise would be the case.

For the Australian Government, the superannuation system helps the long-term sustainability of the Commonwealth budget. The projected growth in Australia's superannuation assets over coming decades – and the associated retirement income – will limit the Commonwealth's Age Pension expenditure. Indeed, the trajectory of Australia's expenditure on public-provided pensions is among the lowest in the OECD.¹ Further, insurance arrangements in superannuation reduce pressure on Australia's social security system.

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

ASFA supports reforms to the superannuation system that are in the best long-term interests of fund members, and which as a corollary would help improve system-level efficiency and competition. This includes reforms that would improve insurance offerings in superannuation, help promote innovation throughout the superannuation supply chain, and reduce the costs and barriers associated with regulation.

2. ASSESSING COMPETITIVENESS AND EFFICIENCY

As ASFA has stated in previous submissions to the Commission, it is a challenging task to measure the competitiveness and efficiency of the superannuation system. From a practical perspective, the complexity of, and heterogeneity within, the superannuation industry means it is difficult to determine system-wide competition and efficiency.

While ASFA acknowledges that the Commission's revised assessment framework – in the final report for Stage 1 – is an improvement on that presented in the Stage 1 draft report (with some rationalisation and refining of the assessment criteria), ASFA's fundamental concerns remain. ASFA has explained in detail in previous submissions its concerns with the Commission's assessment framework (see ASFA's submissions to Stage 1).²

¹ OECD 2016, *Pensions at a Glance*.

² See these ASFA submissions: *Superannuation Efficiency and Competitiveness: Response to Productivity Commission Issues Paper*, (20 May 2016); *Superannuation Efficiency and Competitiveness: Response to Productivity Commission Issues Paper – supplementary submission* (9 June 2016); *Productivity Commission Draft Report: How to Assess*

2.1 The objective of superannuation

While ASFA acknowledges the Commission has refined some of its objectives – in particular, Objective 4 on insurance – ASFA considers the Commission’s set of objectives remain subsidiary to the overarching objective of superannuation.

Superannuation is ultimately about delivering income which affords a comfortable standard of living in retirement. As such, ASFA considers the primary objective of the system should be:

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

ASFA considers there should be a formalisation of an objective for superannuation in legislation. Since a single primary objective cannot possibly encompass the full purpose of the system, subsidiary objectives are required to comprehensively define this fuller purpose. ASFA addressed these issues in detail in its response to the government’s exposure draft for the *Superannuation (Objective) Regulation 2016*.³

2.2 Criteria and indicators

As noted in previous submissions, ASFA supports a ‘balanced scorecard’ approach.

A balanced scorecard needs to focus on direct measures of efficiency and competition to be effective. Notwithstanding some rationalisation and revision, ASFA considers there are too many criteria and indicators – some of which are not well specified and/or ambiguous. Further, the Commission provides little detail on how it will combine the information from the indicators to make an overall assessment of competitiveness and efficiency. It is clear that some indicators would be more important than others, but how much more important is likely to be a matter of significant judgement.

ASFA does not make substantive comments in this submission about the assessment framework, except with respect to the appropriate use of reference portfolios to benchmark investment returns (see Section 3). Details of ASFA’s concerns, as well as suggested changes, are in ASFA’s submissions to Stage 1.⁴

2.3 Data requirements

The issues paper notes that for many of the indicators, the required data either is not available, or is not of sufficient scope or quality for the intended purpose. Thus, the Commission will source additional data, including from surveys of funds and fund CEOs (on matters such as quality of fund governance).

ASFA has some concerns with this approach. Firstly, it will increase the data reporting burden for the industry – which is already subject to extensive data reporting and compliance requirements. Secondly, although surveys can be a valuable tool they have their limitations, and results can be affected significantly by survey design. The Commission’s relatively heavy reliance on survey data means that due attention must be given to survey design.

Superannuation Competitiveness and Efficiency (14 September 2016).

<https://www.superannuation.asn.au/policy/submissions/2016>.

³ ASFA 2017, *Submission to The Treasury, Response to Exposure Draft – Superannuation (Objective) Regulation 2016* (10 February 2017). <https://www.superannuation.asn.au/policy/submissions/2017>.

⁴ See footnote 2.

2.4 Alternative default models

ASFA notes the Commission will not produce a final report for *Stage 2: Alternative Default models*, and that instead, the Commission's work on alternative default models will be incorporated into the broader Stage 3 review.

ASFA made extensive comments on the Commission's proposed models for allocating default members to products in the submission to Stage 2.⁵ With respect to the Commission's remaining work on alternative models, it is worth emphasising that for any potential model, it is important that the Commission consider potential transition costs with respect to current arrangements – including costs to fund members – and consider adequate transition periods that would minimise impacts on members.

3. THE ASSESSMENT FRAMEWORK: BENCHMARKING RETURNS

The Commission's assessment framework incorporates indicators that involve benchmarking long-term net returns against passive reference portfolios. The Commission proposes to benchmark returns at the system level (but also at the asset-class level).

ASFA has a number of comments about the Commission's approach.

ASFA understands why the Commission has decided to use passive reference portfolios to benchmark returns. Passive reference portfolios provide performance benchmarks that are simple, transparent, replicable and easy to apply. These features are attractive, particularly where investment performance is assessed on an ongoing basis.

There are, however, limitations with using passive reference portfolios to benchmark returns, and the Commission should be cognisant of these.

A single reference portfolio – that reflects the aggregate asset allocation in the superannuation system – would be simple and transparent. However, it would only measure the performance of the system with respect to the particular system-wide asset allocation – that is, it would only measure the 'efficiency' of certain investment decisions.

Crucially, it would not be able to measure the extent to funds meet their stated investment objectives. These differ markedly. Members are heterogeneous with respect to their investment objectives, and so are – by extension – funds and the investment products/options that they offer.

These issues apply to reference portfolio benchmarking more broadly, but are more acute for a single system-wide benchmark.

There are broader systemic risks of using a single reference portfolio – if used as the basis for ongoing assessment. In particular, there is a risk that ongoing use of a reference portfolio (to benchmark performance at the system level) might lead to funds using the reference portfolio as a pseudo 'risk-free portfolio', where funds strive to mimic the reference portfolio. This would lead to similar investment approaches among funds, and so reduce competition. It would tend to limit investment returns, where

⁵ ASFA 2017, *Submission to the Productivity Commission, Superannuation: Alternative default models – draft report* (2 May 2017).

funds would focus on replicating the reference portfolio rather than investing in the best interests of members.

3.1 A set of reference portfolios for system-wide performance

With respect to benchmarking system performance, ASFA considers that a better approach (than using a single reference portfolio) would be to use a set of reference portfolios.

As noted above, the variety of investment objectives among different funds, products and investment options dictates that asset allocation and risk profiles vary considerably. In this regard, it is worth noting differences between major segments in the superannuation industry.

- A MySuper member's investment strategy is dictated by the fund trustee.
- In contrast, a choice member's investment strategy depends on their specific objectives and risk appetite (as is the case for self-managed superannuation funds, or SMSFs), which may take account of investments outside superannuation.
- Typically, investment strategies differ between accumulation and retirement phases.

In this regard, a guiding principle for measuring and benchmarking net returns is that 'like should be compared with like'. This principle should apply to how funds/products are grouped to measure net returns, and the choice of benchmarks against which groups are assessed.

ASFA considers the Commission should use a set of reference portfolios. The Commission could use different benchmarks for different groups of products at an aggregate level.

- For MySuper products, an indicator could be applied to the group of products.
- For choice products, it generally would be appropriate to apply an indicator to groups of trustee offered, diversified, investment options which are considered to be a 'balanced' option ('balanced' options generally are regarded as being where the allocation to growth assets is between 60 and 80 per cent).
- For SMSFs, an indicator could be applied to the group of products.
- Separate benchmarks could be applied to the accumulation and retirement segments.

Using multiple reference portfolios would reduce the aforementioned risk of funds centralising investment strategy around a single reference portfolio.

Given the limitations of using reference portfolios in general, the Commission should consider supplementing its outcomes from benchmarking with other metrics of (system) investment performance. This could include an analysis of whether fund-level investment objectives are being achieved. Forward-looking metrics could include an assessment of the quality of funds' investment governance arrangements. In this regard, ASFA notes the Commission's broader assessment framework includes an indicator of 'the in quality of investment committee and investment governance processes' (Criterion E8).

3.2 Construction of reference portfolios

With respect to constructing reference portfolios, it would be appropriate to derive reference portfolios based on the average asset allocations for the different groups (asset matching). ASFA agrees with the

Commission’s proposed approach of concentrating on indices for listed asset classes. This could include standard indices (Table 1), including those proposed by the Commission.

Table 1: Benchmark indices

Asset class	Possible benchmarks
Fixed interest	Australian Broad Investment-Grade Bond Index (AusBIG)
	S&P ASX Australian Fixed Interest Index
	Bloomberg AusBond Composite Bond Index All Maturities
Domestic equities	S&P/ASX 200 Accumulation Index
	S&P/ASX 300 Index
International equities	MSCI World ex-Australia Index
	S&P Developed ex-Australia LargeMidCap Index
Unlisted/listed property	S&P/ASX 200 A-REIT Total Return Index
	S&P/ASX 300 A-REIT Index (listed)
	Mercer/IPD Australian Pooled Property Fund Index (unlisted)
Unlisted/listed infrastructure	S&P Global Infrastructure Index (listed)
	MSCI IPD Australian Unlisted Infrastructure Index
	Thomson Reuters Global Infrastructure Total Return Index
Private equity	Australia Private Equity and Venture Capital Index

Source: Productivity Commission

It should be noted that global indices tend to understate the performance of global indices calculated for Australian investors. This is due to how taxes (which vary across jurisdictions) are accounted for in indices.⁶

The reference portfolios should incorporate an appropriate level of fees. A reasonable starting point is fees for systems in other countries that have large savings pools. However care needs to be exercised when interpreting cross-country fee data.

Determining an appropriate tax rate is difficult. This is because of the different tax rates that apply to investment income in superannuation, and tax deductions and credits. The statutory rate on investment earnings is 15 per cent, but only with respect to earnings on accumulation-phase assets. Capital gains tax applies to asset sales, but the discount for assets held longer than 12 months reduces the statutory rate from 15 to 10 per cent. Imputation credits reduce effective tax rates.

To determine an appropriate tax rate, a starting point could be data that funds already provide to the Australian Tax Office (ATO) – as part of income tax determinations – which the ATO publishes in aggregate form. The ATO could provide advice about how to interpret and use the data.

With respect to risk-adjustment, the Commission’s framework – where risk is accounted for *implicitly* using long-term historical returns – requires a suitability long horizon. ASFA has previously noted that a ‘suitable’

⁶ For example, see <https://cuffelinks.com.au/global-index-flaw-flow-on-consequences/>.

time is asset-specific, and that a five-year horizon (as proposed in the Commission's assessment framework) is too short. ASFA considers a 20-year horizon would be appropriate, where possible.

ASFA acknowledges that the Commission intends to apply its assessment framework in the near future. A major challenge for the Commission in calculating and benchmarking long-term returns will be data availability.

4. THE BENEFITS OF INSURANCE IN SUPERANNUATION

ASFA notes the Terms of Reference (ToR) for the Commission's issues paper emphasise insurance, and in particular that the Commission should consider the appropriateness of insurance arrangements in superannuation.

This section outlines the broad benefits of insurance in superannuation to members, and highlights a number of reforms that would help improve insurance offerings. The absence of default insurance cover on an opt-out basis would likely result in a stark disparity in insurance coverage among Australian workers – where a large portion of fund members, who otherwise would have had insurance cover, no longer have cover. ASFA considers the current opt-out arrangements should remain.

4.1 Insurance in superannuation: Overview

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

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

The strength of these benefits has led to the automatic allocation of group insurance cover on an opt-out basis being prescribed as a mandatory feature of default (MySuper) products. As a result, approximately 70 per cent of life insurance cover in Australia is held within superannuation.⁷ More broadly, superannuation insurance arrangements amount to:

- 71 per cent of total death sums insured
- 88 per cent of total and permanent disability (TPD) sums insured
- 59 per cent of total income protection/salary continuance/total but temporary disability benefits insured.⁸

For the financial year ending 30 June 2016, approximately 75,000 death and disablement benefit payments – which amounted to approximately \$5.2 billion – were made to fund members.⁹

⁷ Rice Warner 2016, *Insurance through Superannuation*.

⁸ Rice Warner 2016, *Insurance through Superannuation*.

⁹ Based on APRA Annual Statistics.

4.2 The market for insurance in superannuation

Fund trustees are not passive price takers in the insurance market. Indeed, fund trustees are under a statutory obligation to source insurance arrangements that are in the best interests of members. Typically, a fund's trustee board will run a tender to select the fund's insurance provider, and re-tender for the insurance provider on a regular basis. This enables fund trustees to source insurance arrangements that provide appropriate protection for a reasonable cost, and have features that best suit their members' needs.

Recently, many funds have improved their insurance offerings and adjusted a range of benefits and features (most commonly) to suit a like group of members.

- In the last quarter of 2016 alone, approximately 20 per cent of superannuation funds changed insurance rates or cover.¹⁰ On average, cover per dollar of weekly premiums increased for members across all insurance types – death, TPD and income protection.¹¹
- Trustees are making changes to the design of their automatic insurance offerings – where designs differ markedly across the industry. Changes include differentiation of insurance premiums and insured amounts according to occupation and age (which reduces cross-subsidisation among fund members), variable death and TPD components, and removing income protection as a default offering.
- An example of innovation in insurance offerings is staggered TPD benefits that promote rehabilitation and a return to work.

4.3 Benefits of insurance in superannuation

The purpose of insurance in superannuation is, in effect, to cover the 'future service' period between the event (disablement or death) and retirement age, to put the member (or beneficiaries) back in the approximate position they would have been but for the occurrence of the event. From this perspective, the benefits of insurance in superannuation are broader than members receiving appropriate protection for a reasonable cost.

Provides cover for individuals who otherwise would not have cover

For most Australians, the life insurance cover they have through superannuation is the only life insurance they hold. This cover enables members (and their families) to manage the financial risks associated with disability and death during working life, while also supporting substantially improved retirement outcomes for claimants.

The evolution of group insurance over the past 20 years has seen much of the working population afforded some type of insurance cover that otherwise would not be in place.¹² Recent research indicates that almost half of those with life insurance in superannuation believed they would not be covered if it were not provided automatically¹³ – that is, they would not purchase insurance for themselves. This suggests that

¹⁰ Rainmaker 2017, *Superannuation Benchmarking Report 2017*.

¹¹ As above, using a 40-year old white-collar worker as a proxy.

¹² Rice Warner 2015, *Underinsurance in Australia*.

¹³ AIA Insurance 2016, *Life Today Study*.

without default cover on an opt-out basis a substantial claims gap would be created (for 2016-17, total claims paid with respect to life, TPD and income protection insurance was \$4.9 billion).¹⁴

In the absence of default cover (offered on an opt-out basis), some employers might purchase cover on behalf of their employees – although this is likely to be limited and confined to large employers. Not only would small business owners be less likely to purchase insurance on behalf of their employees, but they would be less able to negotiate on price.

In addition to the effects of limited bargaining power, insurance purchased by employers would be more expensive than insurance in superannuation (for a given amount of cover) due to distribution and marketing costs. The relative cost – in quantitative terms – of insurance inside and outside superannuation (including with respect to distribution and marketing costs) is explored below.

Provides access to cover on better terms than otherwise would be the case

Life and disability insurance cover held in superannuation typically has lower premiums than comparable policies held outside superannuation.

For insurance in superannuation, premiums for a given level of cover are lower across age categories between 30 to 60 years, for both genders. For women, the difference in premiums ranges from approximately 25 per cent to 55 per cent – increasing with age. Similarly for males, the difference ranges from approximately 35 per cent to over 60 per cent – also increasing with age (Chart 1).

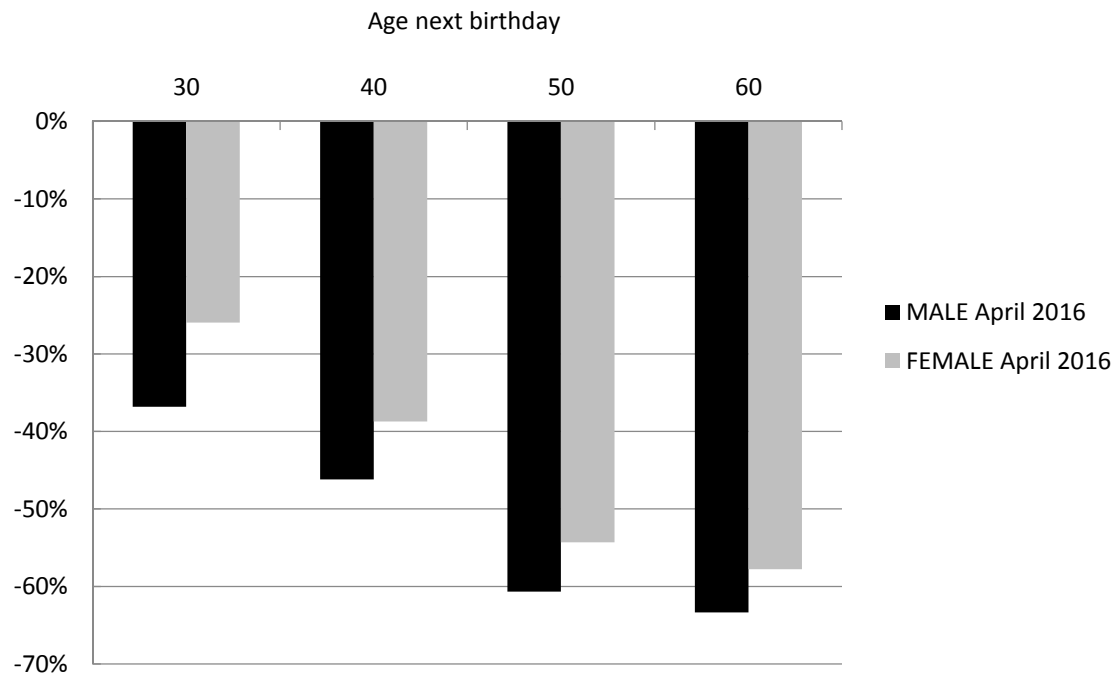
The differences in premiums – as outlined above – reflect differences in expenses and commissions. For example, data from APRA show that for group insurance, 80 per cent of premiums are paid back to members in claims, while the insurers' expenses and commissions amount to around 12 per cent of premiums. For retail insurance offerings, 50 per cent of premiums are paid back to members in claims, while the insurers' expenses and commissions amount to around 40 per cent of premiums.

It is important to note in this context the distortive effect of the regulatory settings with respect to the taxation of insured benefits inside and outside superannuation. While, as evidenced by Chart 1, it is more cost efficient to provide death and TPD lump sum insurance through superannuation, the differing tax treatment of benefits paid out can lead to significant differences in the amount of the net benefit received by the member/beneficiaries.

Part of lump sum TPD benefits (before age 60) and all of death benefits (to non-dependants) paid from superannuation funds are subject to tax at a rate up to 32 per cent, whereas death and TPD insurance payouts made outside superannuation are tax free in the hands of the recipient.

As a consequence of this disparity, while provision of insurance in superannuation is generally more cost effective, depending on their circumstances some members may receive advice to obtain insurance outside superannuation because of the reduction of the amount of a benefit received from a superannuation fund due to the effect of tax.

¹⁴ APRA, *Annual Superannuation Bulletin*, June 2016.

Chart 1: Price of superannuation life insurance relative to retail life insurance (% discount)*

* For the same level of cover/sum insured. This does not take into account the effect of tax on the end benefit received by the member.

Note: The data is sourced from a sample of ten, mostly very large, superannuation providers and thirteen insurers. The scenario is for an accountant (professional occupation) with \$1,000,000 sum insured for death and TPD 'any' occupation.

Source: Rice Warner.

Provides access to cover that may not be otherwise available

Group insurance is based on a pooling of lives that, in the absence of individual medical underwriting, includes a selection of both good and bad risks. This means that members who may have pre-existing medical conditions, work casually or part-time, or work in high risk occupations, are generally able to access insurance cover. Access is through group arrangements at an affordable price without the imposition of restrictions, exclusions or premium loadings (or even denial of cover), compared with insurance that is individually underwritten.

Provides individuals with support through their claim beyond financial benefits

The benefits delivered under group life insurance are more than just the amount of the financial benefit paid to the member or their dependants.

Superannuation funds, together with insurers, have increasingly extended the support services offered to members through occupational rehabilitation and return to work support. In part, this has been delivered by life insurer claims assessors themselves, many of whom have allied health experience. This is a reflection of the focus on the member's ability, rather than their disability, and the desire of all parties involved – the

member, the employer, the superannuation fund and the insurer – to see the member return to work in some capacity where possible.

Assisting a member to return to work, while also giving the member a sense of purpose, ensures they can continue to earn an income and save for their retirement – further reducing the drain on the public purse. This supports not only the objective of insurance in the superannuation system, but also a number of the other system objectives pertaining to retirement outcomes.

There are regulatory impediments that prevent insurers from providing targeted rehabilitation benefits to members that would assist them to return to the workplace faster. These should be addressed to improve outcomes for members (see subsection 4.4).

Reduces degree of underinsurance and the burden on the social security system

Insurance in superannuation reduces the Australia's significant underinsurance problem.

Notwithstanding the wide coverage of insurance provided through superannuation, the level of underinsurance within the Australian community remains high. For instance, the median level of life cover meets about 61 per cent of the basic needs for average households – and for families with children it is a much-lower 37 per cent of needs.¹⁵

Overall, KPMG has estimated the level of underinsurance in Australia to be \$304 billion per annum in disability cover, while the level of underinsurance on the lives of employed people against premature death in Australian families is estimated to be \$800 billion.¹⁶ As noted above, these figures would be much higher without insurance in superannuation, given that the majority of cover across all insurance types is held through superannuation.¹⁷

More broadly, insurance in superannuation reduces the burden of underinsurance on society and government resources. In particular, insurance in superannuation reduces the level of social security benefits payable due to a lack of coverage.

Currently, underinsurance in relation to death, TPD, and income protection costs the government over \$1 billion per annum in additional social security payments.¹⁸ This comprises:

- \$60 million per annum for death
- \$840 million per annum for TPD
- \$140 million per annum for income protection.

Indeed, these figures are likely to be an underestimate – for instance, the figures would not fully capture potential claims on the basis of mental health.

Given that the degree of underinsurance would increase markedly in the absence of default cover on an opt-out basis, so would the burden on the social security system.

¹⁵ Rice Warner 2014, *Insurance Administration Expenses*.

¹⁶ KPMG 2013, *Underinsurance: Death Protection Gap in Australia*.

¹⁷ Rice Warner 2014, *Insurance Administration Expenses*.

¹⁸ Rice Warner 2015, *Under Insurance in Australia*.

4.4 Reforms that would help improve insurance offerings

Facilitate better outcomes for people undergoing rehabilitation

The limited ('all or nothing') nature of the regulatory definition of TPD has led to difficult, and sometimes protracted, decision-making for funds. In particular, the regulatory definition does not provide for the possibility of subsequent rehabilitation or recovery, or for future changes in technology, that may permit a member to return to work.

There is evidence that framing a person's medical condition in terms of their 'disability', as opposed to their 'ability', can have a deleterious effect on their psychological condition. Furthermore, the 'one time' assessment as to disability can, in some circumstances, act as a disincentive for a member to recover some ability, as this may cause them to miss out on being paid a lump sum TPD benefit.

ASFA considers that members' best interests could be served by modifying or removing the regulatory impediments that prevent insurers from providing targeted rehabilitation benefits and/or staged payments to members that would assist them to return to the workplace.

Facilitate more consistent payment outcomes between insurance inside and outside superannuation

As noted above, it is important to consider the distortive effect of the regulatory settings with respect to the taxation of insured benefits inside and outside superannuation. While it is more cost efficient to provide death and TPD lump sum insurance through superannuation, the differing tax treatment of benefits paid out can lead to significant differences in the amount of the net benefit received by the member/beneficiaries.

Part of lump sum TPD benefits (before age 60) and all of death benefits (to non-dependants) paid from superannuation funds are subject to tax at a rate up to 32 per cent, whereas death and TPD insurance payouts made outside superannuation are generally tax free in the hands of the recipient.

The benefits of insurance in superannuation could be improved by making the tax treatment equivalent to non-superannuation insurance arrangements.

Initiatives to reduce duplicate insurance cover

Although it is true that unintentional duplicate insurance policies unnecessarily reduce member balances, the issues around duplicate insurance are complex.

The number of people with multiple accounts has declined over last decade – on average people have approximately 1.9 accounts, down from 2.5 accounts a decade ago.¹⁹ Approximately 43 per cent of the 14.8 million Australians that have a superannuation fund account have more than one superannuation account.²⁰

However, some members have made a conscious choice to pay multiple premiums for higher levels of aggregate cover where multiple policies would respond in the case of an insurable event (typically the case

¹⁹ ASFA derived, based on APRA and ATO data.

²⁰ ATO 2016, *Super Accounts Data Overview* (<https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Super-accounts-data-overview/>).

for death and TPD). This includes maintaining default levels of insurance cover offered by one or more providers.

Furthermore, many trustees have arrangements in place to either cancel, or engage with members to confirm cover is still required, in certain circumstances, for example when accounts become inactive or reach a low balance threshold. Trustees are subject to duties under trust law, statutory obligations and the requirements of *Superannuation Prudential Standard SPS 250* to achieve a reasonable balance between providing insured benefits that are suited to the circumstances of a like group of members and not (unduly) eroding balances.

Overall, the risk of extinguishment of insurance rights without member consent, leaving affected members and their families without insurance cover to protect them from misfortune as a result of injury, illness or premature death, should be contrasted with the risk presented by duplicate insurance policies of paying more in premiums.

Funds' use of new communication technologies, combined with the advent of intra-fund advice, are gradually leading to increased levels of member engagement with their insurance, mitigating the potential for unintentional duplicate policies.

Further, recently implemented regulatory mechanisms are driving measurably higher levels of account consolidation – thus reducing unintentional duplicate insurance policies. For members, account consolidation is easier to undertake as a result of a range of recently implemented regulatory mechanisms, such as through myGov, and the provision of information on how to consolidate superannuation accounts readily available on ASIC's MoneySmart website.²¹

With respect to industry-based initiatives, ASFA is one of the superannuation associations represented on the Insurance in Superannuation Working Group (ISWG) that is engaging with government regarding development of an Insurance in Superannuation Code of Practice.

One of the key priorities of the ISWG is “reducing inappropriate, multiple insurances” and the forthcoming draft Code will require trustees to cease automatically acquired insurances held by members when contributions from an employer cease being made – but only after a prescribed time period and following a number of communications to the member.

The ISWG is also working closely with the ATO to ensure that future iterations of Superstream and the introduction of Single Touch Payroll capitalise on the opportunity of improving the level of visibility and access to information that individuals could have from enhanced data management and data sharing across the industry.

4.5 Effect of insurance premiums on retirement incomes

It cannot be disputed that insurance premium deductions from a member's account will have an effect on member balances. Therefore it is reasonable to determine quantitatively what this effect might be on the balances that members may otherwise have had at retirement. However, equal attention needs to be given

²¹ For details see, <https://www.moneysmart.gov.au/superannuation-and-retirement/keeping-track-and-lost-super/consolidating-super-funds#how>.

to the potential benefits (insurance payouts) that might have been provided due to a premature death or disability occurring.

Many superannuation fund members (or their beneficiaries) will unfortunately have to claim a death or disability benefit from their superannuation fund, so a measure of how many do this, and the amounts involved, is important. Successful claims are in effect early retirement payments, with the account balance increased by an insurance amount to compensate for the individual not being able to complete a full working life and missing out on future income, as well as contributions and earnings in superannuation.

For those who do not ever make a claim and enjoy a full working life, and the corresponding lifetime contribution and earnings outcomes, recognition needs to be given to the value of the ‘peace of mind’ and ‘risk mitigation’ that these members enjoy. Like most insurance premiums paid by individuals for any purpose, a sacrifice is made to cover potentially disastrous outcomes should a risk event occur.

Life insurance as a product can be inherently difficult for consumers to both value and understand. It insures an asset which is intangible (that is, someone’s future income rather than their car or house) and deals with a topic that many find difficult to confront. What we do know is that those fund members value their cover. Recent research conducted by insurer AIA reported that 74 per cent of those with life insurance in their superannuation consider its inclusion as a positive.²²

In terms of the quantitative impact of premium deductions on superannuation balances, outcomes would vary across different cohorts of members – for example, impacts would be larger for members on low incomes. For a white-collar worker (on average), premium deductions over a whole working life could be expected to reduce balances at retirement by around 5 per cent (for death and TPD cover only), and around 10 per cent (with the inclusion of income protection cover).²³ Of course, as outlined earlier, the cost of insurance in superannuation compares favourably with insurance outside superannuation.

5. INNOVATION IN THE SUPERANNUATION SYSTEM

Innovation is central to the competitive dynamic in the superannuation system, as it is in many industries, where funds and service providers innovate as a means to distinguish themselves in their market. Ultimately, innovation is a source of ongoing improvements in member outcomes.

It is therefore crucial that conditions in the superannuation system enable innovation to flourish. While some recent government initiatives have targeted innovation, certain aspects of the regulatory environment tend to stifle innovation. In particular, changing and expanding regulatory requirements can represent a considerable opportunity cost for funds and related service providers. This creates the risk that funds and service providers will under-invest in innovative solutions. Specific legislation also constrains innovation in certain areas.

²² AIA Insurance 2016, *Life Today Study*.

²³ Rice Warner 2017, *Affordability Study Group: Insurance in Superannuation*.

Innovation with respect to superannuation, and the financial services industry, is broader than just product design. With regard to superannuation, innovation applies to services, products and functions at all stages of the superannuation supply chain.

- For the products and services that funds provide to members, innovation relates to products and services that better meet members' preferences, and means of delivering products and services that best suit certain members. The latter, in particular, is enabled by advancements in digital technology, which can enhance the member experience and serve to improve member engagement – and ultimately facilitate better member decision-making. Member-focused products and services include those that are developed in-house, and those that fund trustees source from third parties in the supply chain (a typical example is insurance).
- Innovation also relates to specific wholesale service provider markets – such as administration, custody, investment management, asset consulting and insurance. Again, these functions can be in-house or sourced from third parties.

With respect to the Commission's assessment framework, ASFA considers the framework underplays the benefits of, and the constraints on innovation – particularly from regulation.²⁴

5.1 Areas of innovation in the superannuation system

There are many examples of ongoing innovation within the superannuation industry that are delivering efficiency improvements and improving member outcomes. This includes innovations with respect to delivery, disclosure and the shift to models of self-service.

Digital delivery of disclosure material

Funds can now more easily disseminate information to their members. ASIC released guidance (*RG 221 - Facilitating digital financial services disclosures*) on 29 March 2016 in relation to default digital delivery of financial services disclosure. This had the effect of removing some regulatory barriers to the use of innovative Product Disclosure Statements, Financial Services Guides and Statements of Advice.

Previously, digital delivery had required specific prior agreement from the member – this requirement has been largely removed. When releasing RG 221, ASIC advised that it was “aiming to strike an appropriate balance between administering the law effectively and with minimal procedural requirements (reducing red tape) and promoting investor trust and confidence in the financial system”.

Overall, these new regulatory settings are allowing for cheaper and more efficient digital disclosure and messaging, and are reducing the costs associated with the preparation, printing and posting of paper documents.

Digital disclosure

It is important to note, however, that the cost savings from more efficient delivery may not always translate into lower costs to members. Instead, savings may be used to enhance the quality of communications to members.

²⁴ See ASFA 2016, *Productivity Commission Draft Report: How to Assess Superannuation Competitiveness and Efficiency* (14 September 2016). <https://www.superannuation.asn.au/policy/submissions/2016>.

The removal of the aforementioned barriers by ASIC has provided incentives for superannuation product providers to develop more innovative disclosure that is better able to meet members' preferences and needs. This includes interactive web-based disclosure, videos, games and audio presentations, which can lead to an improved communication experience for members.

Ultimately, these types of developments will improve member engagement and also allow funds to better understand their members. These developments are particularly relevant for those superannuation funds that have a relatively young membership. Engagement of younger members is challenging, given that their retirement is decades away.

Member self-servicing

Technological advancement is facilitating a greater prevalence of on-line self-servicing.

Superannuation fund 'applications' provide a 'one-stop shop' for superannuation products and services, and particularly appeal to younger members. Applications can provide members with the capacity to make contributions electronically and perform other transactions. Applications can also incorporate electronic retirement calculators and tools, and display insurance details.

These types of innovations create back office efficiencies, where self-administration by members reduces the need for manual processes by the fund.

Robo-advice

Robo-advice is another innovation offered by many superannuation funds whereby fund members are able to access digital advice through fund websites. Many funds have found that offering advice through a variety of channels – for example face to face, telephone and online – improves member engagement.

The *Investment Trends 2015 Direct Client Report* survey suggests there is substantial member demand for robo-advice. The survey found that there are 1.5 million Australians who would use robo-advice services for investment recommendations and 2.6 million who would use those services to receive a detailed recommendation on how to achieve their financial goals. It also found that 36 per cent of people prefer their superannuation fund to provide these tools. Accordingly, it is likely that robo-advice tools will become increasingly popular.

Education and engagement

In broad terms, innovation with respect to education and engagement relates to products, services and information to help members optimally consume their retirement incomes (within the constraints imposed by the regulatory regime).

This includes a number of aforementioned innovations – for example web-based tools (such as calculators), web-based education, intra-fund and scaled advice, and easier electronic access to accounts (including the use of mobile applications linked to superannuation accounts). More advanced engagement tools could include website personalisation and intelligent service assistants (that is, Siri-like assistants).

More targeted, bespoke products

Ongoing developments in data analytics and associated technologies is enabling product issuers to build and distribute financial products in a more segmented, targeted way to better meet consumers' needs. Examples of this include lifecycle MySuper products, where the investment strategy is tailored to particular cohorts – generally a function of age, but sometimes other factors such as account balance.

Cloud computing

Cloud computing is allowing funds, their administrators and other service providers (such as custodians and insurers) to access, process and store data more efficiently. Subject to being able to ensure that the cloud provider complies with regulatory requirements, some superannuation funds are able to utilise cheaper overseas servers.

Service providers

Service providers, from which trustees source various services, also innovate to reduce operating expenses and increase operational efficiency. Examples of improved processes in recent years include:

- streamlined administrative processes (such as enabling member self-servicing through web-based platforms)
- centralised trade execution to manage investments and redemptions, to minimise transaction costs and to manage tax effectively, especially among funds with internal investment functions and external providers of investment management services.

Distribution

Current modes of product and service distribution are increasingly likely to be challenged by innovations in distribution. For example, in the insurance industry, online aggregators (that allow customers to compare prices and purchase products) are disrupting the traditional channels for distributing insurance products and services.

Electronic binding nominations

Technological advancements might facilitate electronic signing of binding death benefit nominations. Under the current SIS regulations, a binding death benefit nomination:

- must be in writing
- must be signed, and dated, by the member in the presence of two witnesses
- must contain a declaration signed, and dated, by the witnesses stating that the notice was signed by the member in their presence.

There is no legislation that clarifies whether or not binding nominations can be signed and witnessed electronically. In the absence of this, it is possible that trustees could accept binding nominations made via

the fund's portal (or in some other electronic manner), provided the trustee can satisfy itself that the document has been signed by the member and witnessed by two separate witnesses.²⁵

5.2 Constraints on innovation

There are both general and specific constraints on innovation in the superannuation system.

Regulatory constraints

The need to comply with changing and expanding regulatory requirements can represent a considerable opportunity cost that can stifle innovation. Regulation potentially inhibits innovation in the system, as participants' investment dollars are concentrated on implementing changes to comply with the regulatory requirements rather than on innovation. Indeed, unduly onerous regulatory requirements can act as a deterrent to developing appropriate products and solutions to meet consumer needs, as future regulatory change may affect these disproportionately.

These issues are discussed in more detail in Section 6 (Regulation of the Superannuation System: Costs and barriers).

Barriers to developing new retirement income products and more tailored default products

There are particular regulatory barriers to the development of new retirement income products and more tailored MySuper (default) products. ASFA has highlighted some of these issues in its recent submission to government on Comprehensive Income Products in Retirement (CIPRs).²⁶

One barrier to product innovation relates to the risk of creating legacy products – which are products that have been closed to new members but must be maintained for a gradually decreasing number of existing members. In particular, the need for product providers to achieve scale with respect to product offerings, and the possibility that scale may not be achieved, exacerbates the risk of creating legacy products. Removing impediments to product consolidation, such as the absence of permanent capital gains tax (CGT) relief in superannuation (as opposed to corporate restructures, where it has existed since the beginning of the CGT regime) would help mitigate the risk of creating more legacy products.

ASFA acknowledges that recent amendments to the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) reduced barriers to development of new retirement income products. Trustees can now meet the SIS Regulations by ensuring the pension product complies with the capital access schedule. Given that the amendments have been in place for only a short period, it would be prudent to monitor their effect on product innovation, and then determine whether further changes are necessary.

Favourable social security treatment for amounts in superannuation income stream products, other than account based income streams, will be necessary to provide individuals with an incentive to purchase these products (that is, to compensate the individual for committing an amount of their capital to a product that would restrict access to it). The government is reviewing the social security means testing of retirement income streams and ASFA has provided feedback on this consultation.

²⁵ Mills Oakley 2015, *Death Benefit Nominations – hard or soft copy nominations in the digital age?*.

²⁶ See ASFA 2017, *Consultation on the Discussion Paper on the Development of the framework for Comprehensive Income Products for Retirement* (7 July 2017). <https://www.superannuation.asn.au/policy/submissions/2017>

6. REGULATION OF THE SUPERANNUATION SYSTEM: COSTS AND BARRIERS

ASFA firmly believes in the need for a prudent regulatory framework for superannuation. However, excessive regulation – and unduly frequent changes in the regulatory framework and requirements – adversely affects efficiency, productivity and innovation. ASFA notes the government’s commitment to cutting ‘red tape’ and reducing the regulatory burden on businesses and individuals.

The superannuation system operates under a highly prescriptive regulatory regime, which has been subject to significant change over recent years.

The constant changes to superannuation regulatory and tax settings necessitate the expenditure of significant capital sums to implement. This includes updating information technology systems, amending business processes and procedures; developing new communication materials; and training staff. Furthermore, the complex and prescriptive nature of the regulatory framework imposes material ongoing compliance costs on the various entities in the superannuation system.

Independent research by Tria Partners, commissioned by the Financial Services Council, indicates that the five years of reform (to 2015) cost \$2.75 billion in total across the industry.²⁷

The superannuation industry also contributes directly to the cost of regulation via annual supervisory levies. ASIC’s new industry funding model will recover the cost of almost all ASIC’s regulatory activities from 2017-18 onwards. In addition, the industry will continue to pay levies for the regulatory activities of APRA, the Department of Human Services (DHS) and the ATO. An ongoing concern with the levies is the lack of transparency regarding how they are calculated and spent.

In addition, there are considerable opportunity costs associated with regulation. As noted in Section 5 of this submission, regulation potentially inhibits innovation as participants’ investments are concentrated on implementing changes to comply with regulatory requirements.

The threshold test for any legislative change should be whether the total (social) benefit exceeds the cost. Regulation that is unnecessarily complex or poorly targeted may fail this test. However, even legislative changes that may have a positive net benefit have costs that are borne by *someone*. This should be acknowledged – particularly when measuring and assessing efficiency.

In the case of superannuation, fund members ultimately bear the costs – via a combination of higher fees, lower net returns and a reduction in the quality of products and services provided (particularly where regulation stifles innovation).

As such, ASFA is cautious about any new reforms which add to the regulatory or reporting burden for its members without a clear purpose or benefit first being established.

A recent example is the government’s proposed reforms to improve fund accountability and member outcomes.²⁸ While ASFA considers that superannuation regulators should have appropriate powers and

²⁷ Sally Loane 2016, ‘Achieving the most for financial services and consumers within 100 days of Government’, speech to the FSC Leaders Summit, 20 July.

²⁸ See the exposure draft of the *Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017*.

instruments, there must be a clear justification for the extensions as proposed in the Bill. Regarding the proposals, and in particular the potential for additions to the regulatory and reporting burden for superannuation funds, ASFA questions:

- the operation of the annual outcomes test and the potential to add a fresh layer of compliance and reporting for trustees
- the impact of the logistics of the annual members' meeting on superannuation fund costs and resources
- whether the proposed director penalties have adequate protections
- the breadth of the proposed APRA directions powers and whether they could be more precise
- the rationale for the proposed reporting standard.

6.1 Implementation costs

Regulatory change implementation requires funds and service providers to make significant capital investments. Trustees require detail and certainty from government in order to efficiently implement changes, which is often not forthcoming.

Implementation involves the identification of, and agreement upon the approach to, considerable and extensive alterations, including to IT systems; business processes/procedures; member communication materials such as websites and product disclosure statements. Staff also need to be trained with respect to relevant changes.

Funds often maintain a number of separate IT systems, such as a member registry; accounting system; statements and letters system and client relationship management. These systems need to interact with each other, with various databases and with interfaces such as the web-site and mobile applications. Prior to IT systems work commencing, business requirement documents, and functional and technical specifications, must be agreed upon and signed off. The complexity of IT system design frequently necessitates complex regression testing to mitigate the risk of unintended consequences, which can take longer to perform than the initial coding of the changes to the system.

Change management with this scope, scale and degree of interrelatedness is not only expensive but, more importantly, making significant alterations to IT systems and member databases poses a considerable risk of lost or corrupted data or functionality, which at worst could result in inaccurate or incomplete member records. The most effective means of mitigating such a risk is by utilising robust project management methodologies to determine timelines; identify interdependencies; produce a staged project plan; include sufficient time for regression and user acceptance testing; and then execute in accordance with the plan. All of this takes skilled resources and sufficient time.

When it comes to implementing system changes often there are capacity constraints – especially access to skilled/knowledgeable resources – and interdependencies. Rushing to meet unrealistic regulatory deadlines increases the risks to a project and can increase costs materially, which are ultimately born by the members of the fund.

There is a 'project triangle' which is commonly referred to – the three parameters of a project are scope; timeframe and cost. Any increase in scope or reduction in time frame leads to an increase in costs – in particular in obtaining the services of highly skilled, and scarce, resources such as programme managers and

analysts. Accordingly, any delays in finalising changes to regulatory obligations significantly affect the ability of providers to implement the required changes in an orderly and appropriately risk-managed fashion.

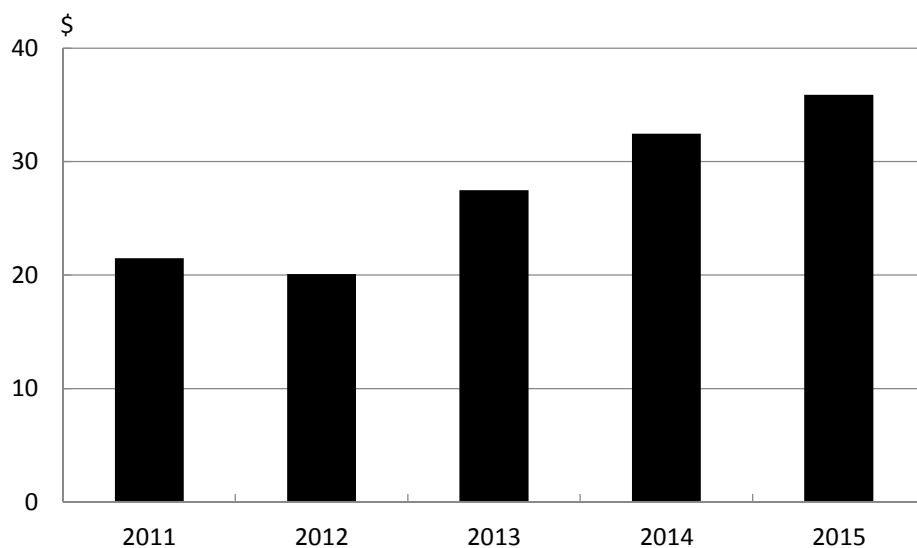
Policy and regulatory amendments over recent years have resulted in providers incurring significant costs in implementing necessary changes to systems; processes and procedures; documentation; and in delivering training. Recent examples have included the costs of implementing the Stronger Super changes, in particular SuperStream (over and above the SuperStream levy) and MySuper, and the changes necessitated to provide reporting of data to APRA.

6.2 Ongoing costs

Complying with the various regulatory obligations and requirements imposes material ongoing compliance costs on the various entities in the superannuation system. Over recent years there have been significant increases in these costs, including in particular the APRA data reporting obligations. There is also some degree of overlap of the reporting requirements of regulators – for example, between the ATO and DHS with respect to data feeds on income stream payments from funds to pensioners.

At the industry level, compliance and trustee support expenses per member increased by almost 70 per cent between 2011 and 2015 (Chart 2).

Chart 2: Compliance and trustee support expenses per account (\$)



Source: Rice Warner.

6.3 Industry levies

APRA-regulated funds pay directly for the public cost of prudential supervision by APRA, consumer regulation by ASIC and services provided by DHS and the ATO through the payment of annual supervisory levies.

From 2017-18, the superannuation industry will pay levies under the ASIC industry funding model. The industry funding model will recover the cost of almost all ASIC's regulatory activities. With respect to the

regulation of superannuation trustees, Treasury's Proposals Paper on the matter suggests that total annual levies will be in the order of \$8.5 million.

The superannuation industry will also continue to pay APRA levies – from which the government will recover the cost of activities of APRA, DHS and the ATO. For 2017-18, APRA levies for the superannuation industry will total \$102.1 million – including \$32.0 million for the continued implementation of SuperStream (the 2017-18 levies also recover some of ASIC's non-ongoing costs with respect to the superannuation industry).

In addition, the superannuation industry will provide funding for dispute resolution arrangements. This includes the set-up and ongoing costs for the Australian Financial Complaints Authority, and for the Superannuation Complaints Tribunal during its wind-down phase (the latter is recovered via the APRA levies).

An ongoing concern with industry levies is the lack of transparency regarding how levies are calculated and spent.

For some time, ASFA has had concerns about the determination of the APRA levies. Lack of information on levy determinations means that it is not possible for industry to assess whether the regulators and agencies are delivering value for money, nor the degree to which the superannuation industry might effectively be cross-subsidising other participants in the financial services industry.

With respect to the new ASIC industry funding model, ASFA has noted in submissions on the industry funding model that ASIC needs to improve its transparency and accountability. ASIC needs to demonstrate that the levies are set and spent appropriately, and that it is improving the efficiency of its regulatory effort – including by minimising the impact of regulation on the regulated population. That said, ASFA acknowledges that there are a number of mechanisms in place (or in train) that should improve ASIC's accountability and transparency.

6.4 Regulatory barriers to improved efficiency and competition

Regulation also affects the ability of the superannuation market to operate efficiently and effectively. In numerous submissions, ASFA has highlighted various regulatory barriers, which if removed, would help to improve efficiency and competition.

Regulatory barriers to exit (funds)

As ASFA has identified in previous submissions, barriers to exit are a constraint on competition and efficiency, and ASFA considers that further action is needed to identify and remove barriers to exit.

CGT rollover relief

With respect to CGT rollover relief, ASFA welcomes the government's decision (in the 2017-18 Budget) to extend CGT relief on fund mergers (until July 1, 2020). However, ASFA considers that relief should be made permanent.

Mergers of funds, generally affected through a 'successor fund transfer', can be a means by which funds can realise efficiencies of scale. The triggering of CGT events on merger, such as the realisation of otherwise

unrealised gains, and the inability to carry forward losses, could prevent a trustee from entering into a successor fund transfer arrangement.

In determining whether to merge with another fund, a trustee of a superannuation fund is under a fiduciary duty to act in the best interests of the members of the fund. As such, the threshold decision as to whether or not to merge is made by taking into consideration the various benefits and costs to members of the potential merger – including the effect of CGT.

ASFA has consistently supported the position that the tax legislation should provide permanent CGT relief for mergers of superannuation funds, equivalent to that in Division 310 of the *Income Tax Assessment Act 1997*.

Equivalent rights in successor fund transfers

APRA recently finalised guidance on successor fund transfers (*SPG 227 – Successor Fund Transfers and Wind-ups*). Constraints on mergers imposed by the bulk transfer rules essentially relate to the difficulties that funds face in meeting the regulatory requirement to ensure that members receive ‘equivalent rights’ (on a ‘bundled’ basis) in the new fund to those they received in their old fund.

Fund level: other tax issues

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

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

Individuals: inactive accounts

While there are valid reasons for some members to hold more than one superannuation account (for example insurance), and there has been a significant reduction in the number of accounts over the last decade (from 2.5 to 1.9 accounts per person), there is still scope for further efficiencies in the reduction of accounts.

While the ATO is active in identifying and contacting account owners and encouraging them to consolidate these lost accounts with their other superannuation accounts, it would appear from discussions with the ATO that only a small percentage of these account holders follow through with the necessary action to enable the ATO Commissioner to consolidate these amounts.

Given changes to superannuation reporting requirements, that enhanced the Commissioner’s information about superannuation accounts, ASFA considers that section 24G of the *Superannuation (Unclaimed Money and Lost Members) Act 1999* should be amended to empower the Commissioner to pay unclaimed money to a complying superannuation plan where the Commissioner is satisfied as to the identity of the lost member account owner and that the person holds an account in the proposed destination fund.

Such a change would be consistent with the policy objective of reducing the number of unnecessary accounts within the superannuation system, and would improve efficiency in the superannuation system and members' retirement balances.

7. OTHER ISSUES: PROPOSED ATO CENTRALISED CLEARING HOUSE

The Commission has, among other things, identified a centralised clearing house administered by the ATO as a 'foundation' reform. Employers would remit all superannuation contributions directly to a single centralised clearing house. In turn, the clearing house would direct the contributions (money and data) to the relevant superannuation funds.

As stated in ASFA's submission to Stage 2, ASFA strongly opposes a centralised clearing house for the Australian market as it would introduce new and substantial risks, and would introduce costs to government, employers and funds (and therefore members). In addition, it would not leverage the benefits of SuperStream.

Box 1: The KiwiSaver model

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

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

A centralised IT and process solution – as per the proposed clearing house – is against the trend of decentralisation of IT systems. The trend towards decentralisation can be seen in innovative IT solutions using, among other things, blockchain and cloud services.

A centralised IT and process solution creates single-point-of-failure risk, where the single point of failure is a part of a system that, if it fails, would stop the entire system from working. An example of such an event was the outage experienced by the Australian Securities Exchange on 19 September 2016 – the market was unable to trade shares and this created losses for market participants.

The ATO has experienced a number of IT outages over the past year that have been disruptive to users of ATO systems, including the superannuation industry. For the proposed clearing house, a system failure would mean that contributions and rollovers would not be allocated to member accounts, so members would miss out on market returns.

The proposed clearing house – as an effective monopoly – would be subject to limited competition, and would lack incentives to innovate and develop customer-focused solutions.

This contrasts with the Superannuation Transaction Network, through which superannuation funds transact member rollover data effectively and efficiently, and where service providers are providing customised services to employers and funds and their agents that minimise the impact on employers (and which comply with the Data and Payment Standard). Indeed, the industry has built thousands of individual solutions to meet the needs of customers. This includes solutions for defined benefit schemes – such as those for government employees – that require very specific data to administer members’ superannuation. Arguably, the industry has made a successful SuperStream implementation possible by reducing modification costs and effort for employers.

As such, introducing a centralised clearing house would require a substantial new investment – the cost of which would ultimately be borne by members. It would expose employers, funds and the ATO to considerable and avoidable implementation risks associated with whole-of-government programs of this magnitude. Further, it would not be able to replace the need for funds to exchange rollover data and for employers to submit optional additional data to funds. Hence, industry would be required to continue to maintain two channels in perpetuity.

With respect to the proposed clearing house, a ‘one size fits all’ service would mean that employers would bear more of the costs, and that solutions would be sub-optimal for employers that would prefer a bespoke option.

An alternative to the proposed clearing house is an ongoing commitment to continuous improvement of SuperStream (led by the ATO and APRA). SuperStream represents a significant investment. Overall, the superannuation industry has invested over \$900 million into SuperStream over the past five years – including \$390 million in levies to fund the ATO program of work. Funds’ costs are ultimately borne by fund members,²⁹ and these costs are not recoverable.

Although it is early days, lasting benefits already have been realised – and these will increase as SuperStream is further bedded-down and matures.

Innovation in the data and payment space will provide opportunities for increasing the efficiency of the SuperStream ecosystem. The commencement of the New Payment Platform (NPP)³⁰ later this year is a good example of such an opportunity where in the near term, SuperStream transactions could also be exchanged through the NPP. As noted above, innovative solutions such as these would be less likely to emerge where there is a monopoly provider.

8. CONCLUSION

ASFA considers that a competitive, efficient and dynamic superannuation system is crucial to ensure Australians achieve an adequate and comfortable retirement. In this regard, ASFA supports reforms to the superannuation system that are in the best long-term interests of fund members – which, as a corollary, would help improve system-level efficiency and competition.

This includes reforms that would improve insurance offerings in superannuation, help promote innovation throughout the superannuation supply chain, and reduce the costs and barriers associated with regulation.

²⁹ Total investment \$1.5 billion: \$900 million by funds and \$600 million by employers.

³⁰ See the website for the New Payments Platform. <https://www.nppa.com.au>.

Insurance is an integral element of Australia's superannuation system. Group insurance cover on an opt-out basis provides cover for employees that otherwise would not have it. This supports individuals, and their families, who suffer health related misfortune, reduces the degree of underinsurance in the Australian community and takes pressure off the social security system. ASFA acknowledges that the insurance arrangements can be improved, and is working with industry (through the Insurance in Superannuation Working Group process) to achieve this.

Innovation is central to the competitive dynamic in the superannuation system and is a source of ongoing improvements in member outcomes. Innovation flourishes under the right conditions. While some recent government initiatives have targeted innovation, certain aspects of the regulatory environment tend to stifle innovation. In particular, changing and expanding regulatory requirements can represent a considerable opportunity cost for funds and related service providers. This creates the risk that funds and service providers will under-invest in innovative solutions.

ASFA firmly believes in the need for a prudent regulatory framework for superannuation. However, excessive regulation – and unduly frequent changes in the regulatory framework and requirements – adversely affects efficiency, productivity and innovation. Changes to superannuation regulatory and tax settings necessitate capital expenditure, and the complex and prescriptive nature of the regulatory framework imposes material ongoing compliance costs. In addition, the superannuation industry pays levies by which government recovers the cost of regulation. With respect to the latter, ASFA has long articulated its concerns with the lack of transparency around how levies are set and spent.

