

12 July 2018

Submission in response to the Productivity Commission's inquiry into Superannuation: Assessing Efficiency and Competitiveness report dated 29 May 2018

Who we are

Combined Fund Services (CFS) is the parent company for the IFAA group of companies, which includes:

- *Independent Fund Administrators & Advisers* (IFAA) – provides industry leading administration, executive management and secretariat services, marketing, financial management, client servicing and call centres to small and medium sized industry superannuation funds;
- *Superannuation Compliance Services* (SCS) – provides expert advice to Trustee Boards and Committees in relation to risk management, compliance, legislative and regulatory changes, internal audit, and training services;
- *MySuperFuture* (MSF) – provides specialist financial planning services to superannuation fund members. MSF also facilitates the offering of limited personal advice to members through online advice tools.
- *Independent Professional Services* (IPS) – provides professional executive management, administration and secretariat services to one of the top performing infrastructure funds in Australia;
- *Corvus Technologies* (Corvus) - provides tailored IT business solutions for superannuation funds, including integrations between client data, existing core registry and ancillary IT systems to drive business improvements and intelligence.

IFAA is Australia's third largest provider of external fund administration services with over \$10bn in funds under administration. This submission is made by the IFAA group and also supports the submission made by two of our clients: QIEC Super and Club Super.

The IFAA group operates as more than just a baseline administrator by providing a broad range of high quality services to Trustees, members, and investors. The IFAA group is actively involved in the superannuation industry and seeks to ensure the industry and its governing framework is best serving the objective of providing members with enhanced financial security in retirement.

The IFAA group also seeks to ensure that reform of the industry is undertaken with this objective in mind, and for political considerations to be minimised. Consequently, the IFAA Group welcomes the opportunity to provide feedback on the Productivity Commission Draft Report into the Efficiency and Competitiveness of the Superannuation System (the Report).

Overview

The IFAA group supports the underlying focus of the Report being the identification of ways in which the superannuation system can be changed to enhance the efficiency and competitiveness of the sector, and thus delivering higher net returns to members. For example, we support the intent of **Recommendation 1**, which proposes that default superannuation accounts should only be created for members who are new to the workforce or do not already have a superannuation account (and do not nominate a fund of their own). For existing members, their account would follow them through career changes, unless they made an active alternative choice. If implemented, this will reduce the proliferation of multiple accounts across the industry, resulting in members being subject to fewer fee deductions, which will result in higher account balances at retirement.

We also concur with some of the findings in the Report around there being too much concentration in some service provider markets, including administration, where the market is dominated by two major players. This hinders competition and choices for Trustees. However, we don't agree with the observation that there is a growing ability for large funds to insource administration. With the ever increasing expansion in the regulation of the industry, the cost and complexity of configuring systems to comply with the raft of regulatory requirements is prohibitive to insourcing. There has been very little new evidence of administration insourcing occurring in the industry. Instead, insourcing has been more prevalent in ancillary functions such as marketing and call centres.

Another finding of the Report is that while there has been considerable increase in economies of scale across the industry over the past decade, individual funds have generally not been able to realise cost efficiencies. As outlined above, the level of regulation is ever changing and expanding, and with that comes significant and growing cost associated with regulatory compliance, which detracts from the ability to obtain cost efficiencies. The report also observed that superannuation fees in Australia are higher than those observed in many other OECD countries. The retirement income systems in various countries are inevitably very different, with varying structures, and vastly differing regulatory environments, and hence different cost structures. For the Report to make this observation without paying sufficient regard to the contributing factors, was surprising.

The IFAA group also notes that a central focus of the report is to identify opportunities for sectoral efficiency, thus lowering costs and increasing net returns to members. A number of draft recommendations contain complex and onerous additional cost impacts on funds. We note that there has been no assessment of the impact of the additional regulatory costs on the competitiveness and efficiency of the superannuation industry in the Report. We believe it would be insightful for the Productivity Commission to investigate the cost/benefit impact of a number of these recommendations. Recommendations that accentuate a consolidation of superannuation funds (top ten, removal of MySuper license for underperformance) risk a substantial reduction in choice for members and interpose Government into the operation of the free, albeit regulated, market to an extent that is inconsistent with the structure of other Australian financial services markets. As the banking industry has shown, a concentration of large, "too big to fail" providers presents the risk of a range of behaviours that are not in the interests of consumers.

It is noted that a number of the recommendations in the report propose additional disclosures to members, on the assumption they will then make informed choices. We consider that it would be of considerable benefit for the Government to promote education of superannuation members, and broader financial literacy, at the same time as introducing such initiatives. This would improve the knowledge of superannuation amongst members generally, and increase their confidence to understand and engage more with the system. Without this, we consider additional measures will incur additional cost to industry and ultimately members, but are unlikely to prove effective.

There are a number of recommendations contained within the report which, in the IFAA group's opinion, will result in unintended outcomes which risk overall system stability and performance. Our major concerns with the Productivity Commission Draft Report, are set out below.

Draft Recommendation Two – Top 10 ‘Best in Show’ shortlist for new workforce entrants, and those without a current superannuation account

We consider this is perhaps the most concerning recommendation in the Report, and we make the following comments in respect to this recommendation.

Significant adverse impact on ‘unsuccessful’ funds and their members

- Implementation of a ‘Best in Show’, top ten competitive selection process, to award default superannuation status, risks significant disruption to the viability of several otherwise well performing funds delivering a valued, differentiated proposition. Funds which are ‘unsuccessful’ in achieving top 10 status would lose access to default contributions, which is a large component of contribution income for many funds. Consequently, inflows will significantly reduce for these funds, while outflows will continue, and in fact are proposed to significantly increase under the 2018 Budget proposals (i.e. proposed transfer of inactive accounts under \$6,000 to be transferred to the ATO).

This will reduce the ability of these funds to attain required scale, and detract from the ability to achieve optimal member outcomes, which runs counter to the Government's expectations on Trustees. The detrimental impacts on these funds and their members has not been sufficiently examined in the Report. It is conceivable that funds which are ‘unsuccessful’ in achieving top 10 status may have no option but to wind-up or merge, in the medium term. Implementation of this recommendation could irreversibly and in our view, unjustifiably, alter the structure of the industry. The consequence of this could be that in the medium to long term, the superannuation industry could resemble the banking industry, with a small number of large dominant players. In this scenario, there would be reduced competition in the market, and less pressure on funds to reduce costs and innovate. If this was to eventuate, we consider this would not be in the best interests of members.

Potential creation of significant systemic risk in triggering multiple mergers

- This in turn then raises issues associated with potentially numerous fund consolidations and mergers being undertaken in a similar timeframe, and the very real risks associated with transition of millions of account records to other funds, aside from the other risks associated with mergers.

Doubtful validity of making past performance the basis of future default contribution flows

- The proposed competitive selection process would place primary weighting on net returns, but also with consideration of other factors, given less weight. Given the fact that past investment performance is not a reliable indicator of future performance, using past performance as a key criteria in allocating future default contribution flows, appears fundamentally flawed. The end result of this process could be that many well run funds who may fall outside of the top 10 due to investment returns over a given period being (marginally) inferior to the top 10, being wound up. Yet such funds may have performed better than the top 10 funds in the past, and may do so in the future. The top 10 performing funds in one 10 year period are very unlikely to be the same top 10 performing funds over the next 10 year period. This highlights that conclusions around outperformance should be made with extreme caution.
- Further, as has been noted by a range of commentators, a Best in Show, top ten may cause fundamental change in investment strategies across funds. There are then risks of a herd mentality (diminishing ultimate choice for members) and/or outlier or short term risky investment strategies being adopted by funds striving to make the top ten which may expose members to unintended levels of risk. Trustees' focus should be on long term strategies, not short term speculation, yet this process could inappropriately incentivise exactly that outcome.

Consideration should be given to qualitative as well as quantitative factors

- The proposed process would apparently require funds to make a submission addressing a range of (primarily) quantitative factors. We believe consideration should be given not only to quantitative factors, but also to qualitative factors such as service levels, which we consider to also be significant contributors to achieving optimal retirement outcomes.

Unproductive costs

- If this process is implemented, given the importance of making the top 10, funds will deploy considerable resources (at cost) in making a submission to the panel, to give themselves the best chance of success. This exercise will come at cost to the members of each fund. We consider this to be unproductive cost, as these are resources which could otherwise be invested in improving member services, or increasing returns applied to member accounts.

Questionable comparability of results

- Establishing a reliable, consistent basis for examining and comparing the investment performance of funds is an inexact science. This is particularly the case given the current problems with the RG97 fee and cost disclosure regime. Inconsistent interpretation and application of RG97 across the industry has meant net returns for various funds may be overstated or understated depending on the way in which RG97 has been interpreted. For the panel to be making very significant decisions on the inclusion or exclusion of funds from the top

10 based (in part) on net returns which are of doubtful comparability, would be inappropriate. This recommendation is not supported.

Draft Recommendation Three – Government to establish independent panel to run the competitive process for deciding which funds make the top 10.

We consider that establishing a truly independent, non-politicised, expert panel to determine a top ten will be a challenging exercise. It would be very difficult for the Government to identify industry experts, who are not affiliated in some way with a political and / or ideological viewpoint, or a particular sector of the industry. This would leave the process open to suggestions of bias and conflicts of interest, and may fundamentally undermine the perceived integrity of the process.

This recommendation is not supported.

Draft Recommendation Four – Government to authorise APRA to introduce Outcomes test, and require audit standard verification

We consider that introduction of a multi-faceted ‘outcomes’ test will create a range of significant issues. Firstly, the issue of the comparability of results may well be doubtful. Different funds are very likely to decide on different ‘outcomes’ to target, and even where there is commonality, funds may undertake calculations differently. This then raises significant concerns around the validity of comparing results, and coming to conclusions around whether one fund is achieving outcomes and another is not. These are similar issues to those which exist under the current RG97 fee and cost disclosure regime, where comparability is dubious. However, in the context of the proposed member outcomes test, the consequences may be more significant, as APRA is likely to apply pressure to funds which don’t deliver satisfactory relative results on the outcomes test, as to whether they should continue to operate. If such pressure was applied on the basis of results which have doubtful comparability, this would be highly inappropriate.

Additionally, it is unclear whether Trustees will have full access to the outcomes results of other funds, yet the proposal expects this. In a competitive industry, it is also doubtful whether it is appropriate for one fund to obtain access to outcomes results for other funds, as these outcomes results are likely to provide revealing insights into the status and viability of each fund, and could cause funds to target their competitors on various measures.

We also consider that the proposal to require audit standard review of outcomes results to be excessive. This recommendation is not supported.

Draft Recommendation Fourteen – Opt in Insurance for members under 25

Given the relatively low levels of member engagement across the industry, we believe only a small minority of young members would opt-in to insurance. We consider that insurance provides invaluable security to members and that insurance should continue to be provided on a default basis to all members. As an administrator who also processes insurance claims on behalf of its clients, we have seen countless examples of young members suffering disablement and the receipt of an insurance payout has provided them with desperately needed financial security to receive the ongoing treatment they require. The

insurance payout proves to be a critical substitute for lost income. Similar issues apply to dependants in the event of the member's death. Without insurance being in place, these members and their dependants would face great financial insecurity.

It is noted that the Report appears to view insurance within superannuation only through a negative prism, being a source of account erosion. As outlined above, we consider that insurance provides an invaluable source of security to members. In fact for many members, insurance in superannuation will represent their only source of security against disablement or death. Implementation of this recommendation would expose many young people (and their families, if they have one) to devastating financial consequences if they were to become disabled, or die.

Funds already disclose the ability to opt-out of insurance, however additional campaigns could be conducted to further highlight to members that this option is available to them. This would serve as a reminder to those members who don't want insurance that they can easily opt-out by advising their fund of that intention.

A further consideration is that if this recommendation is implemented, there may well be a significant fiscal impact to Government. For example, young people who become disabled without the protection of insurance will inevitably look to Government for financial support. This may result in much greater cost to Government in terms of increased welfare payments, and/or greater claims on the National Disability Insurance Scheme.

Additionally, if members under 25 were to be provided insurance on an opt-in basis, this would represent a significant loss of premiums to insurers. It should also be recognised that in an opt-in regime, there is an increased risk of selection against the insurer, thus increasing the risk of claims. Consequently, and in accordance with the principles of insurance pricing, insurers are likely to increase premiums. This in turn runs the risk of some remaining insured members deciding to cancel their cover, which would reduce and concentrate the pool of insured members, risking further premium increases. This has the potential to become a vicious circle, threatening the viability of some insurance pools. We note APRA has recently highlighted similar issues in relation to this proposal. This recommendation is not supported.

Draft Recommendation Fifteen – Cease Insurance on accounts without contributions

Consistent with our response to draft recommendation fourteen, we consider that insurance provides invaluable security, even for members whose accounts are not actively receiving contributions. Instead of making cancellation of insurance the default position where no contributions have been received to the account for thirteen months, we believe a more appropriate solution would be for funds to contact members in this category and advise them of the option to cancel cover if they wish. The insurance would remain in place unless the member requests cancellation, ensuring no unintended loss of coverage occurs. This option would not leave members exposed to risk.

This recommendation is not supported in its current form.