

# First State Super submission

Superannuation: Assessing Competitiveness and  
Efficiency Productivity Commission Issues Paper,  
*issued July 2017*

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# Executive summary

First State Super thanks the Productivity Commission for the opportunity to respond to the Stage 3 **Issues Paper Superannuation: Assessing Competitiveness and Efficiency**.

The commencement of the Stage 3 assessment comes at a time of increasing political and public disquiet regarding the value of superannuation. We think this is largely caused by concerns regarding the effectiveness of superannuation in providing Australians with financial security and wellbeing in retirement.

We hope the current assessment, although not directly assessing adequacy, does not unintentionally add to this poor sentiment towards a system that, even in its adolescence, helps members in retirement and draws the acclaim of policy makers internationally. Maintaining a firm focus on the ultimate benefit to members from all aspects of the superannuation system is essential.

The greatest challenge in applying the assessment criteria will be prioritising and weighting the many criteria in relation to the ultimate outcome for members. Conceptually, efficiency is a more direct driver of delivering optimal member outcomes than competition. Competition is an input to efficiency, rather than an end in itself. International expertise also supports the prioritisation of efficiency over competition. Given the large number of shared indicators, it would make sense to first interpret indicators through a lens of efficiency, before considering competition as a possible factor contributing to the observed outcome.

The key indicators influencing efficiency in our view are:

- Leakage in contributions to the system due to poor SG compliance and cannibalisation of salary sacrifice (the latter is now addressed in draft legislation).
- Long-term net returns to members, risk adjusted where appropriate. We support the supremacy given to this criterion in both the Stage 1 **Final Report** and the Stage 3 **Terms of Reference**.
- The realisation of scale benefits for members: in our view, the benefits of scale for members are apparent through the services, solutions and lower costs (and generally higher returns) delivered by larger funds. The erosion of scale is, however, more visible at the system level (number of funds, particularly SMSFs, number of investment options, multiple accounts) than at individual fund level. While some members have strategic reasons to maintain multiple accounts, in general multiple accounts result in higher costs to members, ultimately undermining their net benefit.
- Insurance coverage to members: we believe greater emphasis should be placed on the value of insurance than is suggested in the current criteria, and that the incidence of multiple insurance policies should be dealt with primarily as a multiple account issue not an issue limited to insurance. In terms of harder-to-insure workers, there is more to be lost than gained by removing workplace super defaults and the insurance that accompanies those defaults.
- Agency risks: we submit that principal-agent problems should be considered more broadly than trustee duty and behaviour, and should also cover the role of employers, and participants in the investment value chain.

With respect to member satisfaction and trust, we support the sentiment of hearing directly from members; however, there are several known issues that must be addressed in interpreting data for these indicators.

We have identified the specific criteria in the assessment framework relevant to each of the above.

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We also respond on the general questions on alternative default arrangements and transition issues.

Superannuation fundamentally represents deferred wages and we support the continued location of the default system within the industrial relations system. Profit-for-member funds reflect the industrial basis of superannuation in their trustee boards; this arrangement has ensured an alignment of interests between members and the trustee, which in turn, underpins a successful default system.

In relation to transition and timing, we are concerned that the Stage 3 assessment is being conducted far sooner than was originally envisaged by the Financial System Inquiry. The consequence of this is that the data used by the Commission will not reflect the full benefits of the Stronger Super reforms, Single Touch Payroll and the recently announced Improving Accountability and Member Outcomes reforms. This risks creating the perception that any recommendations coming from the Stage 3 assessment will not be justified by an appropriate evidentiary base.

# 1. Introduction

First State Super is one of Australia's largest superannuation and retirement incomes funds. We operate as a profit-for-members fund, and are responsible for the accumulation and pension savings, advice and education needs of over 800,000 members and clients, managing over \$83 billion in funds (including StatePlus). We have a strong interest in the future of our members, those whose lives are often dedicated to helping others - nurses, teachers, emergency services workers and public servants. First State Super is committed to its member community and to the national interest as we believe both are intrinsically linked.

We appreciate the opportunity to respond to the Stage 3 *Superannuation: Assessing Competitiveness and Efficiency Issues Paper* released July 2017. We provide summary comments on the Commission's approach and issues we have identified. We understand this process will be followed by fund and CEO surveys, and direct requests for information. This submission is supplementary to our submissions to Stage 2 on alternative default models, and to submissions by ASFA and AIST in response to Stage 1 on how to assess efficiency and competition. We also support the submissions of AIST and ASFA to both Stage 2 and Stage 3.

Our response does not attempt to answer every question raised by the Commission; we address those questions which are of most interest to us and our members.

## Importance of superannuation adequacy

The primary concern for members is the capacity of their retirement savings to provide financial security and well-being in retirement. Over the past 25 years since the beginning of universal superannuation, the annualised investment return for the system has averaged CPI +5.8% per annum<sup>1</sup>. This measure demonstrates that broadly, the superannuation system has been delivering excellent investment performance for members.

However, during the past three years a number of social and economic factors appear to be contributing to a broad disquiet about savings adequacy, ranging from scepticism about the long-term system benefits for all members, to outright calls to end compulsory superannuation. The causes include stalled increases to the SG rate, constant change to superannuation and retirement regulation, low wages growth, national residential housing prices growing faster than returns on super - particularly in Sydney and Melbourne - relatively subdued economic growth and demographic transition as the Baby Boomer generation retires.

The Commission's review focuses on efficiency and competition in line with its terms of reference; however, we suggest that the underlying issue generating public and policy interest in the superannuation system is about adequacy and cost to the nation. In other words, the real debate is about the trade-off between:

- 1) reduced taxation revenue as a consequence of supporting superannuation (cost of tax revenue foregone as members increase their contributions), and
- 2) lower Age Pension expenditure as super savings increase.

Our view is that superannuation will prove its retirement adequacy over the coming decade as members' balances grow, with increased SG contributions over entire working lives and as the superannuation system matures. While we acknowledge the limits set by the terms of reference, we encourage the

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<sup>1</sup> Chant West, quoted from in a public speech at an ASFA lunch in July 2017.

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Commission to focus as much as possible on the degree to which adequacy is increased and the timeframe in which this can be achieved.

## Efficiency and competition

The review of efficiency and competition will hopefully result in improved long-term outcomes for members directly, and indirectly, through sustainable public finances. Our overall view is that the industry is competitive but oversupplied.

We also acknowledge that the majority of members have shown limited interest in their savings. This is due to several reasons including having higher priorities (such as finding and maintaining a good job, supporting a family, and funding housing, education, transport and health), behavioural habits of discounting future incomes, compulsory savings, the complexity of the system, and levels of financial literacy. We trust that this review will not further distance both the public and policy makers from understanding the benefits of superannuation, and from recognising that even relatively modest savings can make a useful addition to retirement income.

In terms of over-supply, we note the importance of scale for the future best interests of all members and national savings. The right balance must be struck between the efficiency of large scale operators, market concentration, and open competition. The concurrent inquiry into Competition in the financial system will provide important comparative data relating to competition and concentration in personal banking, business banking, insurance, investment banking and funds management and financial planning.

We remain concerned that the number of measures identified by the Commission, absent any weightings of criticality, may deliver a broad assessment of efficiency and competition, which nonetheless does not provide direction or clarity, or point to those measures which could improve adequacy for individuals and sustainability for the economy.

## 2. Overall approach to Stage 3

The Commission has identified the task of assigning relative weights to the criteria, developed in Stage 1, as a key task for Stage 3. The Commission has previously stated that this task will be informed by the Stage 3 terms of reference and the interpretive value of the evidence gathered.

We support the priority assigned to system-wide, long-term net returns, given in the terms of reference.

The task of assigning relative weights can be informed by accepted understandings of retirement income systems which we outline below. These are consistent with the Commission's starting assumption that those criteria that are 'most directly related to the ultimate objectives of meeting members' best interests and retirement incomes – such as net returns – would attract the highest weight'. We also suggest that the biggest component of system effectiveness, or adequacy, is the level of contributions made on behalf of and by members.

Assessing the effectiveness of the system in delivering retirement incomes would be the most straightforward and meaningful assessment of the superannuation system. As noted, we consider the focus on efficiency and competition in the terms of reference, rather than adequacy, represents a missed opportunity.

We submit that efficiency indicators should be given higher weighting than competition indicators. As recognised by the Commission, competition is an 'intermediate objective insofar as it drives more efficient outcomes for members'. In areas of the system where key efficiency indicators (for example the indicators for net returns or unused economies) suggest poor member outcomes across the system or in particular segments, competition indicators could be considered to determine if the level of competition is a contributing factor to the observed level of efficiency. As approximately half of the competition indicators are also efficiency indicators, assessing these shared indicators first through the efficiency lens could provide an appropriate approach for the Stage 3 assessment.

International expertise supports the prioritisation of efficiency over competition. The Mercer Global Pension Index draws on indicators comparable to some of the Commission's efficiency indicators<sup>2</sup> and does not consider competition. To paraphrase Keith Ambachtsheer at the 2016 ASFA Global Pension Summit, 'superannuation is a social insurance system, the point of which is not to facilitate choice, but to protect workers from making bad choices'. Drawing on his extensive experience, Ambachtsheer concluded that effective pension systems should prioritise efficiency over competition in having a strong and responsive Pillar 1, high coverage in Pillar 2 and very little Pillar 3.<sup>3</sup> Nicholas Barr, professor of public economics at the London School of Economics, has recently made a similar observation. According to Professor Barr 'Choice should be optimised, not maximised'.<sup>4</sup>

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<sup>2</sup> The Mercer Global Pension Funds index has a sub-index which incorporates voluntary contribution behaviour, tax treatment, growth asset allocation, and replacement rate. The Integrity sub-index incorporates regulatory regime, information provision, complaints, and costs. See <https://www.globalpensionindex.com/how-is-it-calculated-2/background-to-the-approach-used/>

<sup>3</sup> Global Pension Summit 2016, ASFA Conference 2016, Gold Coast Australia, 9-11 November 2016.

<sup>4</sup> Professor Barr quoted in Sally Patten, 'Federal government urged to restrict competition in superannuation', *Australian Financial Review*, 10 July 2017.

<http://www.afr.com/business/banking-and-finance/financial-services/federal-government-urged-to-restrict-competition-in-superannuation-20170707-gx6rxv>

## 3. Critical efficiency indicators

### Effectiveness

As stated above, the effectiveness or adequacy of the system is the most meaningful and member-oriented metric for assessing the superannuation system. Sentiment and concern regarding ‘being prepared’ and ‘having enough’ for retirement are the highest-ranking issues identified by superannuation members.<sup>5</sup> The importance of adequacy is also reflected in the top information needs of members. In 2016, these member priorities were:

- how much is needed to retire comfortably,
- what balance is likely to be accumulated at retirement,
- the amount likely to be received from super (per month) in retirement,
- what can be done to improve retirement outcomes, and
- whether additional contributions into super are needed.

We note that Treasury’s work with the industry on Comprehensive Income Products for Retirement (CIPRs) is squarely focused on trying to address some of these member concerns. We are contributing to this work through product development and through the policy discussion. We anticipate a combination of member account consolidation, increasing account balances and the introduction of new retirement products will be evident over the coming five years.

While the effectiveness of the superannuation system cannot be considered directly as it is out of scope, its importance will influence the assessment and interpretation of indicators. Member sentiment towards the system, including satisfaction and trust, will be strongly influenced by members’ feelings towards adequacy (E8). It will also be a strong factor driving contribution rates and savings behaviour as well as information needs (E6).

Efficiency is directly impacted by leakage from the system (E5), especially at the starting point of unpaid SG contributions. The Senate Economics References Committee has recently found significant weaknesses in both the reporting and compliance in the SG arrangement. The Committee made 32 recommendations. We submit that the Commission consult the Committee’s report in identifying regulatory impediments to efficiency as relevant to Objective 1, Criterion E5.

Once a member has the correct SG contribution paid into their account, additional voluntary contributions and long-term net returns are the most material factors in improving member outcomes. We support the Commission’s continued focus on long-term net returns; Objective 1, Criterion E1.

### Realisation of scale benefits for members

Economies of scale and more critically the passing on of benefits of scale to members are important factors in helping members optimise their savings. This was recognised by the Commission in the Stage 1 Final Report. Economies of scale can be exploited at both a system level and within funds.

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<sup>5</sup> Investment Trends **2016 Retirement Income Report**, based on a survey of 6,987 Australians aged 40 and over



We are concerned that Stage 3 has taken a narrow approach to economies of scale focussing on fund level costs, even though Stage 1 found that ‘trade-offs between costs and quality should not be ignored’.

Account balances have been relatively low for typical Australian employees, who have been served by low cost profit-for-member funds (SG has been a feature for approximately 25 years in comparison with a working life of 40-45 years - and it was only in 2002 that SG reached 9%). The pursuit by profit-for-member funds of economies of scale through pooling systems and investments, and passing benefits on to members has been a crucial factor in optimising member benefits. Improving member outcomes by passing on economies of scale has resulted not from member-driven competitive pressures, which appear to be largely absent in a compulsory system, but by the strategies and institutional arrangements pursued by profit-for-member funds. For example, scale can afford investment in illiquid assets that achieve an illiquidity premium. This premium can be passed on to members as comparatively higher long-term net returns, even though the cost of these investments may be higher than other more liquid asset classes.<sup>6</sup>

The trade-offs between quality and costs are evident in the following member benefits. In our experience these benefits can only be achieved without unreasonably impacting long-term net returns by the larger funds within the Australian superannuation system:

- Institutional buying power - for both investment assets and as a corporate buyer of services and goods,
- Extensive use of data analytics for member segment management and business support, driving both member engagement and strategic direction,
- Relationship improvements enhancing member engagement including:
  - digital platforms delivering targeted communications, information and tools for members,
  - ability to internalise member services including call centres and financial planning to better meet diverse member needs and control the quality of interaction,
  - provide distributed contact centres to reach members in regional centres, providing walk-in help with forms and processes, as well as access to information and advice appointments,
- Transactional improvements in both quality and efficiency including:
  - electronic transactional tools such as account joining for new members, investment switching, insurance dialling up or down (or cancelling) electronic delivery and storage of periodic statements, updating of personal details, nominating beneficiaries (see Regulatory Impediments section for discussion on improving binding nominations process).

The experience of First State Super has included the merger with Health Super in 2011 and the acquisition of StatePlus in 2016. The following selected examples of internal economies of scale, and consequently scope, arise from the growth achieved through the merger and acquisition:

- Increased geographic reach and servicing - ability to reach members across Victoria, New South Wales and other states, through the First State Super and Health Super merger,
- Ability to deliver scalable advice - both the Health Super merger and the StatePlus acquisition led to larger combined advice teams to support members more effectively,
- Following the merger with Health Super, internalisation of our call centre (noted above) from the administrator to the trustee office to enhance members’ experience, responding to their needs as quickly and completely as possible, while monitoring for efficiency,
- Partial internalisation and amalgamation of investment functions to optimise performance and control costs following both merger and acquisition,

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<sup>6</sup> James Richard Cummings and Katrina Ellis, *Risk and return of illiquid investments: A trade-off for superannuation funds offering transferable accounts*, November 2011:  
[http://www.apra.gov.au/AboutAPRA/Documents/SA\\_WP\\_RRII\\_102011\\_ex.pdf](http://www.apra.gov.au/AboutAPRA/Documents/SA_WP_RRII_102011_ex.pdf)

- Sharing internal legal services for consistency, legal adviser management and cost management.

Across the industry, the existence of multiple trustee offices may point to erosion of economies of scale, although we note that scale can also be observed in smaller funds which have high account balances (ie, the economic value is driven by a variable mix of high volume and/or high value). The pursuit of scale to improve member outcomes through both net returns and member services can be contrasted to the substantial diseconomies of scale evident in the vast number of choice investment options, provided by some super funds.

APRA data at June 2016, shows there are 41,011 investment options in 126 public offer APRA regulated funds, excluding eligible rollover funds, and that 98% of these investment options are in the retail sector. This fragmentation is exacerbated by the exemption from much of the disclosure regime which is rigorously enforced on the MySuper regime but not the Choice sector (although this is changing with the final 'accrued default amounts' transferred into MySuper products in the lead up to 30 June 2017).

As well as influencing the erosion of economies of scale, the absence of disclosure in the Choice sector is relevant for indicators for competition (C1).

Diseconomies of scale in the SMSF sector are a major concern at the system level. This sector holds approximately 30% of all superannuation assets, and coupled with SMSFs' ability to leverage funds and their focus on property and cash, this sector probably represents the greatest risk to the superannuation system. If their investments perform very poorly or fail, these members will rely on social security (and hence taxpayer) support. Scrutiny of this sector is challenging as it is not required to report in the same fashion as APRA regulated funds, nor is the ATO providing the same statistical resource to the industry that APRA supplies for comparison and benchmarking purposes.

There is a risk that because one can only 'manage what one measures', the comparatively large amount of data on MySuper funds may cause undue focus on this segment. The more serious issues impacting member outcomes, and as a consequence public finances, are in the Choice and SMSF segments where there is less consistent measurement.

With respect to mergers, we make the following observation: we have found that seeking strong alignment of members and fund culture is an important ingredient for an effective merger. We appreciate that this may be hard to quantify in an assessment such as the one the Commission is undertaking. In our case, the blend of members who place high priority on other people's safety, education and health is reflected in the culture of our organisation, and in the communications and services we offer to our members. We think there is an observable, but difficult to measure, virtuous feedback loop with members within workplaces and specific industries. We also observe this with certain other funds.

We expect that unused economies of scale are likely to be more evident at system level than at individual fund level, and will be informed by an examination of costs and profits (or surpluses) across funds, administrators and other suppliers. It may be possible to observe, for example:

- Indications of unused economies of scale could be obtained by understanding administration costs per member on a comparative basis. Large funds have the option of self-administering, while smaller funds do not, or of negotiating better administration costs. Where large and small funds outsource to an administrator, there may be a risk of cross-subsidisation between the funds managed making it difficult to measure the benefits realised by size,
- Comparisons of marketing costs across funds should reveal either inefficiencies or unused economies of scale,
  - we note that disclosure of such costs varies from fund to fund, and that where holding companies exist, these are sometimes used to 'remove' marketing, advertising and brand costs from the fund's accounts,

- It may also be possible to observe undue retention of profits at the expense of sharing reduced expenses with members,
- Another source of unused economies of scale could be excessive expense behaviour in head offices or operations arising from lax cost controls at the expense of member servicing or best financial outcomes.

## Insurance

We have previously detailed the value of insurance within superannuation and the importance of occupational pooling created by the current default system in our submission to the Stage 2 Draft Report. While we will not repeat the evidence and case studies we have provided previously, the following excerpt provides our position relevant to Stage 3:

The purpose of insurance is to provide income where a worker leaves the workforce early, due to permanent incapacity or death. This is consistent with the proposed objective of superannuation. Group insurance in superannuation has significant benefits for members, funds, insurers, Government and the community as a whole.

Group insurance is a cost-effective wholesale offering; the pooling of lives under a group policy allows insurers to more effectively price risk, which means members typically pay less for cover under a group policy than they would in the retail insurance market. Retail insurance is necessarily more expensive as each individual policy is marketed, sold and administered on an individual rather than a group basis.<sup>7</sup>

Our submission also noted the significant variations in risks for different occupations. The ability to source occupation-specific group insurance afforded by the current default arrangements delivers significant benefits to many members, including the emergency services workers who are members of First State Super.

We are concerned that the indicator data gathered for Objective 5, criteria E11 and E12, unduly focus on cost and coverage. Moreover, the Commission should undertake some analysis of the detrimental effect of any recommendations that will promote adverse selection and ultimately undermine the insurance industry's ability to offer products of value, especially to the emergency services occupations which benefit from the association between our fund and these industries.

With respect to duplicate insurance policies and the erosion of superannuation balances of inactive accounts, these issues should be addressed at the root cause - accounts proliferation - rather than being considered as an insurance only issue. In fact, our experience of identifying low balance accounts being eroded by insurance premiums is that, where it is not a symptom of multiple accounts or very low balances, it is often members of SMSFs using the APRA regulated environment to access group insurance (these members can also appear to have very low balances, as they only contribute enough to fund insurance premiums).

With respect to addressing the issue of multiple accounts please refer to our submission to the Stage 2 Draft Report.

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<sup>7</sup> First State Super, *Submission to Productivity Commission Draft Report Superannuation: Alternative Default Models*, 28 April 2017: p 9. Retail insurance may also be called "non-super stand-alone insurance" in recognition that group insurance is still a retail product.

## Satisfaction and trust

The Commission has identified member satisfaction and trust in the system as ‘outcome’ indicators for both efficiency (E8) and competition (C10) objectives. In the simplest terms, this approach can be expressed as ‘if the system is doing well, then members will be happy’.

The Issues Paper states that member sentiment<sup>8</sup> is ‘more directly linked to the objectives of competition in superannuation’ than evidence of increased demand in services. This is due to the difficulty of determining an appropriate counterfactual as demand is strongly influenced by other factors including economic growth, market performance and changes in broader retirement income policies.

We submit that member sentiment is no more likely to be directly linked to the objectives of competition than demand, and should not be given preferential consideration or weighting. We note that most members have competing priorities for their short-term savings and consumption needs compared with their long-term superannuation savings, and that the weekly or monthly income tends to be inelastic.

The superannuation system is complex, in part due to its interconnectedness with the other two pillars of the retirement incomes system and the tax system, and has many participants. The Final Report of Stage 1 dedicated 13 pages to defining the superannuation system. This complexity and heterogeneity means that a better performing system may not be clearly reflected in higher member sentiment.

It will be important that members are asked which parts of the system most drive their feelings of satisfaction and trust. These may include:

- Market performance and investment returns,
- System structure (profit-for-member funds, SMSFs, public sector and defined benefit funds),
- Personal savings activities, including increased regular savings (contribution) rates, or history of contributing windfalls (eg tax refunds or bonuses),
- Persistent changes in Government policy and settings (SG rate, tax settings, contribution caps),
- Regulatory settings and enforcement (MySuper regime, SG compliance, bans on commissions, disclosure),
- Product and service (interactions with their own superannuation savings and retirement benefit, including monitoring balance, statements, their fund’s offerings and its services, benefit structure, and fund specific investment returns).

Such a distinction will assist in using member satisfaction and trust in the system as an indicator of competition and efficiency. If satisfaction is largely driven by government policy, regulatory settings or market performance (or a combination of these), sentiment would not be expected to drive competition.

For example, if members are dissatisfied or distrustful with the ‘system’, largely understood as government policy and market returns, they will not look to change funds. On the other hand, if sentiment is driven largely by sentiment towards fund offerings, or their own savings behaviour, then this may be expected to drive competition as members seek funds they judge to provide more satisfactory outcomes.

However, if satisfaction and trust are used as indicators in the competition objective, it will again be important to understand which (non-price) aspects of superannuation products and services members do value or understand in relation to their satisfaction. These could include:

- Control

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<sup>8</sup> ‘Sentiment’ is used broadly to refer to both satisfaction and trust. When we specifically refer to satisfaction to trust, these terms will be used.

- Trust
- Ease of doing business
- Financial performance
- Service offering and accessibility
- Recognised brand
- Confidence in savings adequacy / expectation of future income stream.

Understanding this will be important in relating member satisfaction, through competition, to member outcomes. For example, if control is highly valued by some members, high satisfaction may correspond to poor system performance in terms of lower net returns over a working life. Evidence from the analysis of member behaviour data in the Mercer Superannuation Trust found that members making their own investment choice received lower investment returns than members in the default option over the same period.<sup>9</sup> Control has been found to be a strong preference for those who start SMSFs, despite the large role played by accountants and advisers.

Members have also been found to be unreliable in assessing the value of financial services. ASIC has previously found that 86% of the participants in their shadow shopping of retirement advice felt that they had received good quality advice. However, only 3% of the advice was considered good quality under ASIC's analysis.<sup>10</sup>

The distinction between 'system' and participants is also important in relation to trust. For example, members may have a lower level of trust in participants than the system because while they do not trust all funds to act in their interests, they do trust the system to protect their interests.

Trust towards funds can be broken down into three elements:<sup>11</sup>

- 1) Interests - trust that a fund is an ethical business and acts in the interests of members,
- 2) Capability - trust that the fund is competent and that if an error occurred, it would be quickly rectified and members would be compensated,
- 3) Ease - trust that if an issue arose for members, the fund would make it as easy as possible for its members to have it resolved.

These different aspects of trust may be of assistance in assessing whether the member trust indicator informs E8 (Are principal-agent problems being minimised?) and C10 (Are outcomes improving at the system level?). E8 is more concerned with interest whereas C10 is more relevant to capability and ease of interacting with the fund whether for access to information or resolution of issues.

## Agency risks

The Stage 1 Final Report recognised the 'unique role' of employers in the system as a 'key principal-agent relationship'<sup>12</sup>. However, the Commission determined that, due to the lack of objectivity in a possible metric regarding employer decision-making, the final assessment criteria would not directly consider the

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<sup>9</sup> Paul Gerrans, Jimmy Feng, Carly Moulang, Gordon Clark, *Member Retirement Investment Behaviour and Performance*, Monash Superannuation Research Cluster Working Paper, November 2016.

[http://www.superresearchcluster.com/\\_data/assets/pdf\\_file/0016/720322/CP62016-11.pdf](http://www.superresearchcluster.com/_data/assets/pdf_file/0016/720322/CP62016-11.pdf)

<sup>10</sup> ASIC, *Report 279: Shadow shopping study of retirement advice*, March 2012.

<sup>11</sup> Professor Don O'Sullivan presentation to FEAL/CSBA Forum, Melbourne Business School, October 2016.

<sup>12</sup> Productivity Commission, *Superannuation: Assessing Competitiveness and Efficiency Issues Paper*, July 2017: p 41

role of employers.<sup>13</sup> The consideration of principal-agent problems (criteria E8) is primarily directed at the trustee as the agent.

It is important that the role of employers is given due consideration in Stage 3, despite the lack of formal criteria. The consideration of employers is now critical to the success of Stage 3 since the final advice on alternative default arrangements is now being developed in Stage 3.

Agency risk should also be addressed in upstream investments. We suggest the Commission's assessment of the following criteria should include the interpretation of results through the lens of principal-agent relations and value leakages in the investment chain:

- C5 'Are there material anticompetitive effects of vertical and horizontal integration?'
- E2 'Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?' and
- E3 'Do all types of funds have opportunities to invest efficiently in upstream capital markets?'

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<sup>13</sup> Productivity Commission, *How to Assess the Competitiveness and Efficiency of the Superannuation System - Study report*, 25 November 2016: p 83

## 4. The current default arrangements

The current saving and incomes products through which superannuation is delivered are highly complex products and will often be beyond the financial literacy of many Australians. The resulting information asymmetry means that, in the absence of strong defaults protecting member interests, their interests will rarely prevail over the interests of product providers. Assuming adequate safeguards, the paramount risk of any default arrangement in a mandatory and complex financial system, such as a retirement incomes system, is if the policy settings do not prevent a large flow of members being taken out of the safety net and ending up with poorer retirement outcomes than if they stayed in the default system.

Superannuation contributions are deferred wages. This fact underpins the superannuation system and is generally understood and accepted. In January this year, Minister O'Dwyer stated, 'in its simplest form, compulsory superannuation is deferred wages.' The existing default system is based upon this fact, and is appropriately implemented and embedded within the industrial relations system. The result has been a very successful super system and default arrangements.<sup>14</sup>

The industrial foundation of superannuation is also the basis of the strongest performing funds which have a trustee board with equal representation from employers and employees and are run on a profit-for-member basis. This structure enshrines an alignment of interests between the governance of the fund, the employers and employees. Incentives 'for funds to maximise long-term net returns and allocate members to products that meet their needs' are therefore embedded into the governance and operations of profit-for-member funds. External incentives to prioritise member interests, such as those imposed through a tender, are only required and appropriate to counter competing external incentives which may otherwise create a conflict of interest.<sup>15</sup>

The existing industrially based system is highly efficient in selecting a universe of default funds, which reduces the search costs for employers and members, and reduces the administrative cost to employers. It also enables efficiencies in insurance from occupational pooling, and the provision of member information through workplace seminars. The current system has proved efficient for government in that it has selected, on average, high-performing funds and reduced the cost of the Aged Pension relative to a laissez-faire system, where either non-default funds had a larger share of the default market, or a larger proportion of members were not covered by the default safety net.

Account portability has been in place since 2004, however member behaviour has failed to fully remedy the issue of multiple accounts and account proliferation. The decline in superannuation accounts since 2010 was to a large degree the result of fund and industry account matching initiatives which have been wound back. The ATO has replicated aspects of these initiatives to a degree, with services such as SuperMatch2. It is our view that SuperStream and Single Touch Payroll will continue to help realise the policy intent of account portability by providing the systems necessary to overcome member inertia.

We note that while the new digital employee on-boarding initiative may also contribute to controlling account proliferation, we are concerned that this may be not adopted widely enough to have material effects. Assessing the efficiency of the superannuation system before these reforms are fully operating

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<sup>14</sup> First State Super, *Submission to Productivity Commission Draft Report Superannuation: Alternative Default Models*, 28 April 2017: p 3-4

<sup>15</sup> Note APRA's proposed new powers will deal with small funds that may be protected by industrial system but can no longer sustain themselves as delivering best interest to members.



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and demonstrating their impact undermines the Commission's ability to assess the system and provide a meaningful evidentiary basis from which to carefully plan any reform.

We also note the Commission's recent *Report on Data Availability and Use* and its broad theme of moving from systems based upon risk aversion to ones based upon transparency and confidence. We commend the Commission for its work and suggest it consider applying its findings to the consideration of efficiency in superannuation, in particular the matching and repatriation of lost accounts.

### Alternative default arrangements and transition issues

Neither the Stage 2 or Stage 3 Terms of Reference include a consideration of transition issues. We are concerned that the assessment, and any subsequent transitions required, are being considered sooner than was originally envisaged by the Financial System Inquiry. The justification given to leaving assessment until 2020 was to assess if the 'Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system'. Since then, Single Touch Payroll has commenced and the Government has recently announced reforms aimed at improving member outcomes. As noted above, any assessment before the Stronger Super reforms have become effective, together with Single Touch Payroll and recent announcements, undermines the current assessment's ability to review the impact of these measures which have been implemented at great cost to the industry.

The result of hastening reform to the superannuation system, including the default arrangements, without meaningful assessment of how default accumulation savings underpin a successful retirement savings system could be that the proposed reform is widely perceived as not being justified by an evidentiary base. The ultimate risk of such an approach would be to further weaken public trust in the superannuation system, which in turn could further decrease member engagement and undermine retirement outcomes.



## 5. Regulatory impediments

We would like to take this opportunity to comment on two reforms addressing regulatory barriers (for efficiency and member experience). We note in passing that constant regulatory change to the system creates additional and substantial costs, as well as increasing complexity for members and funds.

### Electronic Binding Nominations

Binding nominations can materially reduce the work for a trustee and ultimately increase the efficiency of processing a claim. The current regulatory requirement is that binding nominations must be made in writing and witnessed by two independent witnesses. Under current legislation (including *Acts Interpretation Act 1901* and *Electronic Transactions Act 1999*) there is no way to witness a signature by electronic means. This means that binding nominations must be provided to a fund in hard copy. An electronic process for members to submit binding nominations would also reduce member effort in completing this process.

There are several electronic methods that may enable this process including the use of GreenIDs, video confirmation, and digital signature verification. These methods would need to be very carefully assessed in relation to fraud risk. We recommend the Commission consider this proposal and recommend a formal consultation on the reform which would necessarily include participation from super funds, probate lawyers and IT security experts.

### Capital top-ups to established income streams

A regulatory impediment exists in the management of retirement incomes, where pension recipients are not permitted to 'top-up' an income stream or account based pension. At present, where a member wishes to add to an existing income stream, the account must be rolled back to accumulation, then a new account issued for the greater amount. Most funds manage this behind the scenes to minimise disruption for members.

There are several reasons to revisit this rule including changing workforce participation in older age cohorts, recent and proposed regulatory changes including the transfer balance cap and home equity contribution relief, and increased visibility of money movements by government agencies.

While it could be possible to accept all types of contributions into income stream accounts, for simplicity, we do not propose acceptance of concessional contributions into income stream accounts. We suggest the acceptance of other superannuation savings or capital amounts, within total thresholds. While minor, this is one area where administration of pension accounts and member experience could be improved.

## 6. Conclusion

We appreciate the opportunity to comment on the Commission's Issues Paper. Our submission has covered areas on which we have previously engaged with the Commission including:

- the methodological approach proposed,
- the strengths of the superannuation system - the foundational role the current default system has played in building Australia's internationally applauded system,
- the importance of scale,
- industry-based insurance, and
- member services and engagement.

In this submission, we have drawn on the experience of our fund and our members to inform the application of the assessment criteria the Commission has developed. We look forward to participating in the other elements of Stage 3.