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3 August 2017

Chair Peter Harris, AO
Deputy Chair Karen Chester
Productivity Commission

Lodged electronically

Re: Inquiry into alternative default models for superannuation

Dear Chair and Deputy Chair,

Thank you again for the opportunity to appear at the Melbourne public hearing held last May in connection with the above Inquiry. We note the Commission has now received Terms of Reference for the third stage of the Inquiry and has deferred a final report on alternative default models.

This is a positive development as it will allow the design of the alternative models to be informed by, and benefit from, empirical insights gained in the third stage.

This letter provides certain supplemental information regarding matters raised in the May hearing and subsequent public commentary on related issues, and responds to some specific information requests made of ISA, including information regarding:

- Determinants of performance and the role of scale
- Relative risk of being defaulted into a poorly performing product or sold into a choice product
- Sectoral distribution of MySuper returns
- Product provider incentives to upsell, cross sell, and bait and switch
- The role of commercial structure, culture and values
- The clearing house model used in New Zealand

We are preparing a separate detailed submission in response to the third stage issues paper.

1. Determinants of performance, and the role of scale

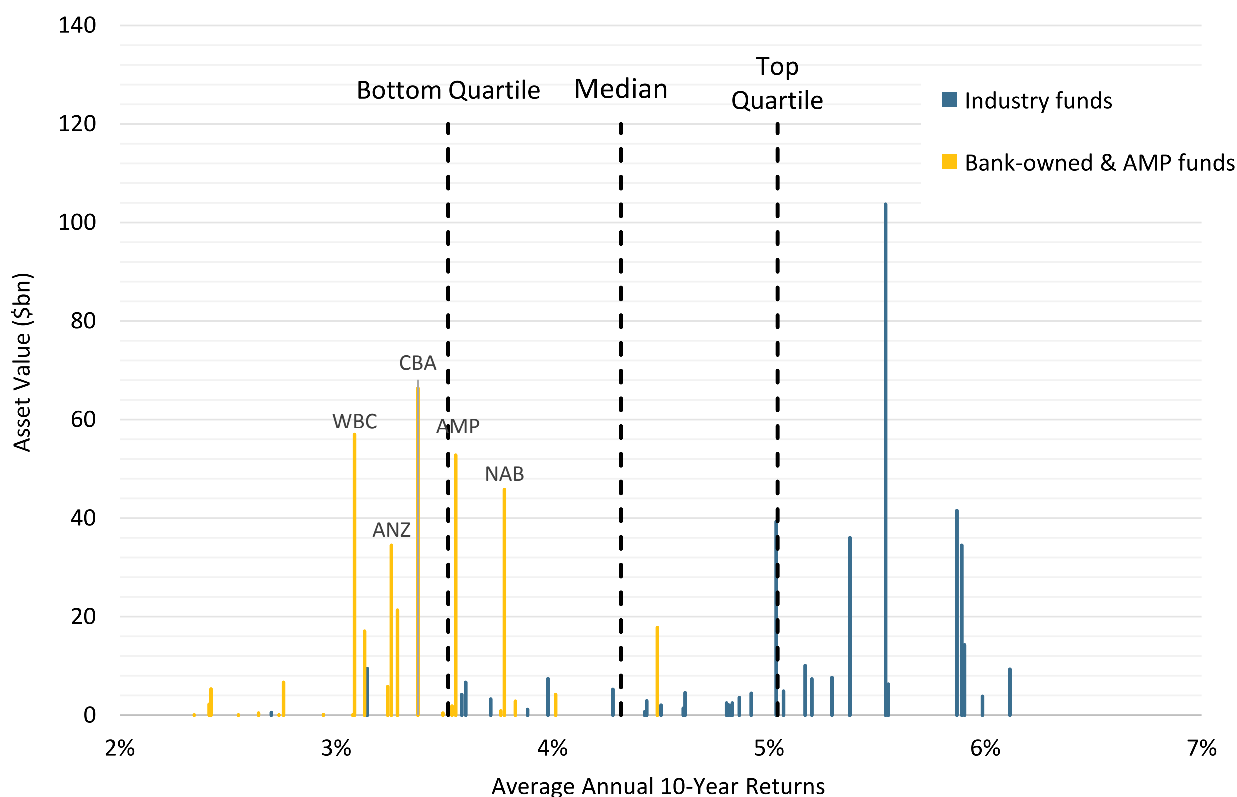
The Inquiry has expressed some interest in the relationship between scale and performance in Australia's superannuation system.[1]

As shown in Figure 1, the commercial model and profit orientation adopted by funds appears to have a greater bearing on returns than scale does. Increased scale is only correlated with increased performance in the not-for-profit sector, while large for-profit funds do not appear to deliver scale benefits to members.

[1] See, e.g., Hearing Transcript at 39, line 13 ("MS CHESTER: Because the APRA data would lead us to believe that size does matter in the long-standing under-performing funds.").

Analysis of the latest APRA ten-year returns data shows that the five largest public offer bank-owned and AMP funds, each with more than $30 billion in assets, performed well below the median while 13 public offer industry funds with less than $5 billion in assets achieved above median returns.[2]

Figure 1 – Distribution of 10 year net returns compared to assets



Source: ISA analysis of APRA Annual Fund-level Superannuation Statistics, June 2016
Note: Includes only public offer fund and excludes ERF's.

The strongest determinant of performance for members is not simply scale, but the commercial model and profit orientation. Funds that demonstrate scale economies operate within the industrial relations system and have commonalities of governance, profit orientation, business model, and asset allocation. These features are mutually reinforcing. Not-for-profit funds and retail funds differ along these key aspects.

[2] For a discussion of the relationship between scale and performance in superannuation, including a critique of the research relied upon by the Super System Review, which led to the APRA scale test, please see Wilson Sy, Scale and Competition in Australian Superannuation, 2012.

Table 1 - Assets, member accounts and returns award listed and unlisted public offer funds

	Assets	Accounts	10 Yr Asset weighted RoR
Award Listed (of which)	727,030,477	15,328,671	5.1%
Not-For-Profit	614,392,720	12,745,362	5.3%
Industry	466,236,918	11,112,149	5.4%
Public Sector	128,595,628	1,511,170	4.9%
Corporate	19,560,174	122,043	5.1%
Retail	112,637,757	2,583,309	3.8%
Unlisted (Public Offer)	362,683,315	6,379,571	3.4%
Not- For-Profit	-	-	-
Retail	362,683,315	6,379,571	3.4%

Source: ISA Analysis using APRA Annual Fund-level Superannuation Statistics - June 2016

Note: Analysis includes all funds listed in modern awards and unlisted public offer funds with a ten year RoR.

As can be seen from Table 1 award listed funds achieved significantly higher average returns over the ten years to June 2016 than unlisted public offer funds. On average award listed funds delivered returns of 5.1 per cent over the period compared to 3.4 per cent for unlisted public offer funds.

On closer security it is apparent that average award listed fund returns are dragged down by award listed retail funds which hold $112 billion in assets and 2.5 million member accounts but only obtained returns of 3.8 per cent over the period – only slightly more than unlisted public offer retail funds. It would appear retail funds with award listing are unable to deliver anywhere near the returns of not-for-profit funds also listed.

The highest average returns were obtained by Industry Funds listed in awards which outperformed retail funds listed in awards by 1.6 per cent per annum on average, and unlisted public offer retail funds by 2.0 per cent per annum on average. The average return of listed Industry Funds of 5.4 per cent is comparable to the top quartile average return of 5.5 per cent over the 10 years for the sample of funds analysed.

Previous ISA analysis[3] confirmed returns obtained by retail funds (particularly vertically integrated funds) are highly concentrated in the bottom half of returns, and persistently so:

- 94 per cent of all public offer bank-owned fund assets and 97 per cent of their member accounts are held in funds that earned below median returns
- 96 per cent ($42.9 billion) of cumulative fund-level investment returns above the median over the last decade were generated by the not-for-profit sector, while the retail sector accounted for 96 per cent ($25.4 billion) of value lost relative to the median

[3] Industry Super Australia, Performance Matters, May 2017 http://www.industrysuperaustralia.com/publications/reports/performance-matter/

2. What is the "greatest risk" to a member in superannuation? Is it being defaulted into a poor-performing product, or it is being sold from a default product into a retail choice product or an SMSF?

The Inquiry asked many of those who appeared at its public hearings in May whether the greatest risk a member faced in superannuation was being defaulted into a poor-performing product. In a recent appearance before the Senate Economics Committee, the Commission put forward a view that being defaulted into poor products is the biggest risk:[4]

> I think the other thing—drawing on evidence that we have received from many in the industry, including the CEO of one of Australia's largest superannuation funds—is that the biggest risk today for a default member, particularly a new job entrant, is that they are defaulted into an underperforming fund.[5]

The statistical evidence does not support this view. Instead, the evidence shows that the greatest risk to a member is being sold into a choice product.

The degree of risk is a function of the probability of a harm (in this case, low net returns), and the magnitude of that harm (in this case, the degree to which the returns are low).

In terms of probabilities, only a small proportion of accounts in award-listed default funds[6] received long term net returns in the bottom quartile.

There are about 15,328,671 accounts in funds that are named as default funds in one or more modern awards. More than two thirds of these accounts (10,354,464) are in funds with long term net returns *in the top quartile*. This means that, probabilistically, there is greater than a two in three chance that an account that was established through the default system will have received top quartile long-term net returns. By contrast, there are only 375,659 accounts in award-listed funds that have had long-term net returns *in the bottom quartile*.[7] Put another way, there is about a 2.5 per cent chance that an account established through the modern award default system will be in the bottom quartile. In terms of magnitude, the difference in aggregate default fund long-term net returns attributable to those funds in the bottom quartile is very small, because they have relatively few accounts.

The difference in performance between these default funds (i.e., award listed) in the bottom quartile and, say, median returns is, however, not insignificant: median long-term (i.e., 10 year) net returns across the system are 4.3 per cent per year. The weighted average[8] long-term net returns of default funds in the bottom quartile is 3.0 per cent, or a difference of about 1.3 per cent. Again, this difference is in respect of a relatively small number of accounts.

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[4] Hearing Transcript at 39, line 13

[5] Hansard, Senate Economics Legislation Committee, Estimates, Wednesday 31 May 2017, page 41.

[6] Including all funds named in awards, both not-for-profit and retail.

[7] This methodology is not perfect, because some of these accounts were opened during the 10 year period over which the returns were generated, so there will be some differences due to sequencing. However, the performance characteristics of award-listed funds in the top quartile is not random (as shown in our last submission): not-for-profit funds in the top quartile of performance in the five years to 2011 were also often in the top quartile of funds in the five years to 2016.

[8] The weighted average is a smaller difference.

With just 2.5 per cent of accounts being in award-nominated funds in the bottom quartile, it is very difficult to credibly suggest that the biggest risk to a member is being defaulted into a poor-performing fund.

Table 2 – Performance distribution of funds named in one or more modern awards by account numbers

	Quantile of 10 year net returns to June 2016				Total number of accounts
	Top Quartile	2nd Quartile	3rd Quartile	Bottom Quartile	
Number of accounts	10,354,464	1,782,787	2,815,761	375,659	15,328,671
Percentage of accounts	67.5%	11.6%	18.4%	2.5%	100%

Source: ISA analysis of APRA Annual Fund-level Superannuation Statistics, June 2016, funds with ten year RoR, Award listed and public offer funds.

Note: AMP a retail award listed fund has 2,023,686 (72%) of the accounts in the 3rd quartile.

What about the risk of a person being sold from a default into a choice product?

The risk of being sold into a poor performing choice product is high, both in propensity and magnitude. The Inquiry has already acknowledged that not-for-profit funds tend to be distributed through the default system to a much greater degree than retail funds, and the data presented in Figure 1, above, clearly shows that retail funds, particularly those owned by the major banks, dominate the bottom quartile of long term net returns.

However, looking at information regarding the distribution of accounts confirms the point. There are only 9,842 accounts – that is not a typo – in public offer funds (ie. they can be sold) that are not named in an award and are in the top quartile of long-term net returns.[9] In the bottom quartile there are a whopping 3,521,549.

Table 3 – Performance distribution of funds sold to the public, not named in an award

	Quantile of 10 year net returns to June 2016				Total number of accounts
	Top Quartile	2nd Quartile	3rd Quartile	Bottom Quartile	
Number of accounts	9,842	424,468	2,423,802	3,521,549	6,379,571
Percentage of accounts	0.15%	6.65%	40.0%	55.2%	100%

Source: ISA analysis of APRA Annual Fund-level Superannuation Statistics, June 2016

The remaining choice sector accounts are in SMSFs. According to the ATO, as of June 2016 there were 1,087,841 SMSF members. The Inquiry would be well aware that the average performance of SMSFs is substantially lower than the average of APRA-regulated funds: average annual returns of SMSFs over the 7

[9] Namely, accounts in public offer funds that are not named in an award.

years ended June 2015, which is the entire period available from the ATO, is 4.9 per cent, compared to the average annual returns of all APRA funds over that period of 5.4 per cent.[10]

This indicative analysis suggests that[11]:

- More than 67 per cent of people defaulted by an award were likely to be defaulted into a fund which realised top quartile long term net returns, and almost 80 per cent of people defaulted by an award were likely to be defaulted into a fund which realised above median returns
- Only 3.7 per cent of people defaulted by an award were likely to be defaulted into a fund which realised bottom quartile returns
- By contrast, a staggering 95.2 per cent of accounts in public offer funds that are sold rather than distributed via an award have below median long-term net returns, with 55.2 per cent realising bottom quartile returns

In addition to contradicting the assertions of those who told the Inquiry that the greatest risk in superannuation is being defaulted into a poor-performing product, this evidence suggests the Inquiry should substantially increase the protection of members from being sold out of a default, and to prevent efforts by for-profit providers to game the Inquiry's proposals with a view to up-selling and cross-selling.

3. Regarding statements by the Commission to the Senate Economics Committee

When it appeared before the Senate Economics Committee on 31 May 2017, the Commission stated (emphasis added):

> At this stage, because we have not assessed that evidence ourselves, we do not have a view. That said, I look at the APRA data, which one would consider to be objective and unbiased. If we are looking at what the major risk is, and that is someone defaulting into an underperforming fund, my focus is kind of on the tail: which funds, over an extended period of time, have continued to underperform? That is the greatest risk that has been identified by the CEOs of some of our leading and largest superannuation funds. When you look at that tail in the APRA data across the MySuper products over a medium- to longer-term period of time, all of a sudden you realise it is jersey agnostic. There are industry funds, there are retail funds—indeed, in the very far reaches of the tail, there are six industry funds and six retail funds—there are corporate funds, and there are two public sector funds. That would suggest to me that, if we are identifying what we think is the largest risk, particularly for default members—those that are being compelled to save but are not making their own choice—and we are looking at performance metrics, one of our key focuses would be on that tail and why that tail has continued to remain in place.

The Inquiry should note:

- The reference to "APRA data across the MySuper products over a medium-to-longer-term period of time" is to data that does not exist. Audited MySuper data is available for only the three years to

[10] ATO Annual SMSF Statistics, 2014-2015 and APRA Quarterly Superannuation Statistics Q3, 2016. Please note that returns data for SMSFs prior to 2012-13 does not include non-deductible expenses, and therefore may be overstated (in other words, if these expenses had been included, the net returns would have been lower).

[11] Assuming the proportion of member accounts for award-listed funds in the APRA fund level data reflects the proportion of members allocated via award defaults

June 2016,[12] although only two years is useful for comparison due to the late commencement of retail MySuper products. Three years of performance data is not medium term, much less long term.

ASIC has in place long-standing regulatory guidance in relation to the use of past performance information, and specifically in respect of superannuation performance information. Past performance information can be misleading if it is for an inappropriately short period of time relative to the nature of the investment. At least five years of performance information is sought as a general rule, and ASIC has specifically expressed the view that superannuation is a lifetime investment, and short-term figures are not very useful.

- Caution is warranted when using MySuper data because it is so short term. A number of funds that would be in the bottom quartile for two year returns are not for three year returns. It is only after several more years that funds whose asset allocation, fees, and other performance factors are resilient through different economic and financial conditions will be able to demonstrate in a reliable way superior performance (and vice versa).[13]
- Caution is warranted when comparing retail funds to other kinds of funds using MySuper data because retail funds have significant accrued default amounts that have only been rolled into MySuper as of 1 July 2017. It will not be until the MySuper data for June 2018 is available (around February 2019) that the impact of the inclusion of these amounts will begin to be seen.
- We reviewed the most recent unaudited MySuper data published by APRA (May 2017 for the quarter ended March 2017). This data contradicts the Commission's statement to the Senate Economics Committee.
  - The Commission stated that there were six retail funds and six industry funds in the "very far reaches of the tail". The data do not support this characterisation. First, there are fewer than six industry funds in the bottom quartile of MySuper funds. Second, there are more than six retail funds in the bottom quartile: the majority of funds in the bottom quartile are retail funds, with 14 in total. It is unfortunate that the Commission both overstated the number of industry funds in the bottom quartile, and substantially understated the number of retail funds.
  - The information provided to the Senate Committee was arguably selective way in a way that created a false impression. The Commission focused only on the number of industry and retail MySuper funds in the bottom quartile in an effort to support the Commission's position that these data are "jersey agnostic" (which, as indicated above, is not true). But MySuper data also includes information about how many industry fund and retail fund *accounts* are in the bottom quartile, as well as how many industry fund and retail fund *assets* are in the bottom quartile.

[12] Unaudited MySuper data is available quarterly, resulting in data for three years and six months as of this writing (i.e., the period June 2014 to March 2017).

[13] For many MySuper products, longer term return data is available and might be useful for higher quality analysis. MySuper products offered by not-for-profit funds have a long term history because they are continuations of these funds' balanced options. The trustees of these funds judged that their longstanding approach remained appropriate in the new regulatory environment. As a result, long term comparisons are possible.

These data are arguably more important to policy makers because people and assets are more relevant to system outcomes. These data are also arguably more important to questions of "jersey agnosticism".[14]

This data shows a marked difference between industry funds and retail funds. Specifically, more than 80 per cent of the accounts in the bottom quartile of performance are in retail funds, and nearly 70 per cent of the assets are in retail funds. Only about 10 per cent of the accounts and 15 per cent of the assets are in industry funds. There is no "jersey agnosticism" in the MySuper data.

Table 4 – The bottom quartile of MySuper performance ranked by net returns for the three years to March 2017

Category of fund	Number of funds	Assets (billions)	Accounts
Retail	14	$27.9	1,102,926
Corporate	5	$5.2	65,147
Public Sector	1	$1.2	11,558
Industry	5	$6.4	134,320
Not-for-profit combined	11	$12.8	211,025
Total	**25**	**40.7**	**1,313,951**

Source: APRA Quarterly MySuper Superannuation Statistics, March 2017

The Commission told the Senate that, "When you look at that tail in the APRA data across the MySuper products over a medium- to longer-term period of time, all of a sudden you realise it is jersey agnostic."

This is simply not true:

1. The MySuper data covers only three years. It is not medium-to longer-term, as the Commission stated.
2. The data is not jersey agnostic. Fourteen of the MySuper products in the bottom quartile are retail funds. Five of the MySuper products in the bottom quartile are industry funds. More than 80 per cent of the accounts in the bottom quartile are in retail funds, and nearly 70 per cent of the assets.

The Commission may wish to consider updating its representations to the Senate Committee.

4. Upsell, Cross-sell, and "Bait & Switch"

In the public hearings, the Inquiry suggested that the submission of PricewaterhouseCoopers was "really helpful" and requested that interested parties review PWC's proposals in respect to member protection against upselling and cross-selling.[15]

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[14] To illustrate, imagine that 24 of the 25 MySuper funds in the bottom quartile were retail funds, but that 99% of the members and 99% of the assets in the bottom quartile were in industry funds.

[15] Hearing Transcript - All, page 29, lines 23-42 (Stating that the "PWC submission – and, again, I'm hoping a lot of people might read the submission because it was a really helpful one – came up with a few suggestions in response to

The PWC submission suggested three options for addressing the “bait and switch” problem:

- Specific controls on inducements to upsell
- FOFA best interests test
- Regular reporting of movement of members from default into related provider products

As explained below, these options are not adequate (and it is not clear that PWC themselves believed they would be).

Cross-selling

It should be noted that none of the PWC suggestions would address (nor do they seek to address) “cross-sell” efforts of other financial products. The ban on conflicted remuneration that is part of the FOFA regime does not extend to most retail banking products as these are specifically exempt. The exemptions apply to basic banking products, general insurance products and consumer credit insurance. In addition, FOFA does not apply to credit products (loans, mortgages, credit cards, etc.) as these are not classified as financial products.

Cross-selling is a significant risk under the Inquiry’s proposals, because the information about members and their circumstances obtained through each allocation model is valuable from a cross-sell perspective. In addition, cross-selling has a substantial effect on culture.

Cross-selling is a major driver of poor consumer outcomes in financial services, as observed by the Sedgewick Review:

> A number of submissions to this Review have provided examples and case studies of products sold to customers that were not in their interest and that resulted in poor customer outcomes. Examples typically include inappropriate sale of add-on insurance products and cross selling of insurance products that were not wanted or suitable for the customer; for example, the sale of consumer credit insurance (CCI) to customers who cannot claim on the policy. Other examples include customers being sold loans and credit products that the customer was not seeking, and did not require, by bank staff remunerated by product-related payments or whose overall performance pay was heavily influenced by their sales record.[16]

Sales incentives (including but not limited to cross-selling incentives) drive and reinforce problematic culture through two key channels, identified by the Sedgewick review (emphasis in original):

- They *signal* to employees what more senior management value in that work place, or the goals that are to be achieved; and

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that information request. Greater controls on inducements around non-super and member non-benefit products. They pointed to the FOFA best interest test being a new obligation that would apply here. They also suggested reporting to APRA in movement of members from default to related-provider products and then, of course, the current member best interest obligation.”

[16] Stephen Sedgwick AO, Retail Remuneration Review: Issues Paper, 17 January 2017

- They act as a *sorting device*, since different approaches to their design may attract different types of employees. This can affect who applies to be recruited to particular roles, who is promoted and who leaves the organisation.[17]

Switching and Up-Sell

The FOFA reforms were introduced to curtail commission-driven selling of superannuation by financial planners, typically employed by or tied to major banks and insurers. While the reforms significantly increased consumer protections, a number of loopholes exist. ISA strongly supports FOFA, but as we have suggested in respect of all regulatory policy settings, it should be seen in an evolutionary context. From inception, FOFA has been subject to substantial lobbying efforts that seek to weaken it, and for-profit entities have immediately sought to "work around" and adapt to FOFA in a way that maintains as much of their lucrative businesses as possible. For so long as the superannuation system allows participation by entities that have a strong culture of prioritising themselves rather than serving others, this will happen. The Inquiry's proposed default models will certainly be subject to the same dynamic.

The loopholes in FOFA include:

(i) An exemption in FOFA successfully lobbied for by the major banks that allows bank staff to earn a volume-related bonus for selling superannuation under general advice
(ii) An exemption to allow the payment of commissions on individual life and income protection insurance on policies paid for out of choice superannuation products, providing strong financial incentives for advisers to switch members out of default superannuation products
(iii) Very limited obligations for those selling super products to make sure the products are suitable and in the interests of consumers
(iv) No requirement to disclose the receipt of conflicted remuneration for sales made through general advice[18]

It is impossible to determine at this time all of the strategies being developed by for-profit financial institutions to seek to work around FOFA. So far, we can see clear strategies based on general advice and switching members to choice superannuation products to obtain risk insurance commissions.

This is clear from the substantial increase in the number of people switching into bank-owned super funds via the "direct" distribution channel, as illustrated in Tables 5 and 6 below. These tables show two changes that illustrate the dynamic: (i) a shift away from sales via financial planners, to the financial institution directly, and (ii) a major uptick in the share of switchers moving to a bank-owned super fund.

The major banks have long used their vertically integrated financial advice businesses to sell consumers bank super funds via *personal advice*. There is now clear evidence of an enhanced strategy to leverage their vertically integrated structures – taking advantage of the lower levels of consumer protection outside personal advice to aggressively sell super directly.

According to data extracted from Roy Morgan's Superannuation and Wealth Reports, this type of sales activity – switching advice delivered by the financial institution directly – has almost doubled across the four

[17] Id at 13

[18] There also is an exemption for accountants in respect of establishing, operating, structuring and valuing an SMSF (but not recommending whether a client acquires or disposes of an interest in an SMSF).

major banking groups from 10 per cent in the 2011 Report, compared to 19 percent for the 3 years to December 2015.

Table 5 – Switching advice channel, 2011 compared to 2015, Big 4 banking groups

Advice channel for super switchers who obtained advice (%)	2011 Report (Big 4 Banking Groups)	2015 (Big 4 Banking Groups)	Change in share %
Financial planner/adviser	53%	49%	-8%
Accountant	7%	9%	29%
Employer	25%	16%	-36%
Friend/Family	11%	13%	18%
Financial institution directly	**10%**	**19%**	**90%**

Source: Roy Morgan Superannuation and Wealth Management in Australia, Dec 2011 Report and updated to 3 years to December 2015. St George added to WBC group in 2011 to ensure comparability between periods. Columns may not sum due to rounding.

The growth in direct advice sales activity varied across the institutions with ANZ and the Commonwealth Bank groups recording the strongest gains over the period followed by Westpac.

NAB had the lowest level of direct advice while Westpac had the highest overall level of direct sales activity with nearly 30 percent of super switchers who obtained advice.

Among the big 4 Banks direct sales advice appears to be increasingly favoured and come at the expense of other advice channels, with the exception of accountants.

The significant overall increase in direct advice sales seems to have paid dividends for the big four banking groups with their collective share of super switching gains increasing by 41% between 2011 and 2016.

Table 6 – Super switching by institution (products gained) 2011 and 2016

Institution	% switched products *gained* 2011 Report	% switched products *gained* 2016	Change in share %
CBA Group	7.6	10.2	34%
ANZ Group	2.4	7.9	229%
NAB Group	6.2	5.3	-15%
Westpac Group	7.0	9.2	31%
Total	**23.2**	**32.6**	**41%**

Source: Roy Morgan Superannuation and Wealth Management in Australia, Dec 2011; Report updated to 12 months to March 2016 (Table 7). St George added to Westpac Group for 2011 Report.

Use of member data for sales campaigns

For-profit superannuation funds use existing member data to undertake sales campaigns. The information about members is used to support sales pitches. These pitches are designed taking into account well-honed sales techniques and behavioural research.

The current ASIC proceedings against BT illustrates this. ASIC alleges that between January 2013 and September 2016, Westpac's superannuation division, BT Funds Management Limited and Westpac Securities Administration Limited, undertook a number of campaigns explicitly focused on generating greater funds under management. The general idea behind the pitch was to roll external superannuation accounts into BT because it could help a member save on fees, and provide better manageability, among other things.

Reviewing ASIC's full Statement of Particulars is worthwhile, and shows that:

- The campaign was focused on existing BT member data, building on the information known to the firm and its affiliates, sometimes combined with prior online information or activity by the member[19]
- The engagement with customers was pursuant to a "structured framework", with several of each salesperson's calls reviewed each month by a "sales coach" and "scored" against the framework

Staff in the telephone unit charged with contacting customers to roll their superannuation into a BT fund were remunerated specifically on the basis of FUM generated, among other things.

ASIC have alleged that the BT sales campaign violated restrictions on providing personal advice, without a statement of advice or ensuring the advice was in the best interest of the member. However, it is possible that the campaign could be structured to be general advice only.

PWC proposals

The PWC submission is to be applauded for recognising the risk of upselling, and being clear that this is a major risk:

> It is possible that a provider could be very successful at designing a low cost default product but then expend significant effort, inducements and/or pressure in moving people into the more expensive choice products. They alone would have the contact details for all members in the default product and could easily target these members.[20]

However, the PWC proposed solutions are unlikely to provide adequate protections, and a careful reading of the PWC submission suggests PWC do not think the proposals are a silver bullet.

[19] For example, a member who accessed the BT website and requested a search be conducted to locate amounts held in external accounts

[20] PWC submission at 6

The issues with each PWC proposal are as follows:

Table 7 – Analysis of PWC submission proposals on upselling

PWC proposals to address upselling	Why it is unlikely to be successful
“Specific controls on inducements” to upsell	▪ Does not cover cross-selling ▪ Incentives for employees are much broader than “specific inducements” ▪ An upsell campaign does not require incentive remuneration: simply staffing a sales campaign at hourly rates could be sufficient to drive behaviour, and result in member harm ▪ Volume-based incentive remuneration is allowed in respect of super sales made through general advice
FOFA best interests test which “has some relevance here”	▪ The FOFA best interests test only applies in certain circumstances, and providers will seek to design campaigns to avoid its strictures ▪ General advice and sales are not subject to a best interests duty, and could be triggered based on balance thresholds, age, address changes, and other member-data-driven prompts ▪ Many cross-sold products, such as consumer credit, loans, and credit insurance, are not subject to FOFA even if in the context of personal advice ▪ The PWC submission impliedly accepts that the “relevance” of the best interests test is unclear
“Require regular reporting by … providers on movements from the default into [choice products]”	▪ This reporting is likely to be next to useless. – If this is reporting to members, the evidence is clear that members are not well-equipped to protect themselves from providers – If this is reporting to the regulator, it would be ineffective without (i) enforceable prohibitions on improper behaviour, (ii) substantial resource allocation to the regulator to monitor and police the prohibitions (which would require access to much more information than mere movements of FUM), and (iii) ongoing political will to support the prohibitions and law enforcement efforts.

5. The Inquiry should not ignore culture and values

All superannuation funds have the potential to seek to exploit the information asymmetry, financial sophistication, and behavioural biases of superannuation fund members. But only some funds have exploited this opportunity. Many funds have not and do not prioritise their own interests ahead of member interests.

A key question the Inquiry should be considering is: why are these providers different?

It is not regulation. The funds that do seek to extract value from members, and those that do not, are subject to the same regulation. While regulation is important, regulation alone has never been enough to ensure good behaviour. And regulation is particularly unreliable in relation to the finance sector because that sector is especially vigorous in its efforts to influence policy makers.

It also is not competition. As the Inquiry and many other commentators have noted, demand-side competition is weak in superannuation. International evidence corroborates the weakness of competition: the top funded retirement income systems based on long term net returns do not rely on competition. Moreover, any real-world instantiation of competition in respect of complex services such as superannuation leave significant space for gaming behaviour by providers. This includes the Inquiry's proposed alternative models.

The reason why some funds tend to consistently perform well, and prioritise members, is an amalgam of culture, values, institutional objectives, and governance.

Australia is fortunate among Anglophone countries to have a strong, not-for-profit sector in superannuation, which is culturally reinforced by oversight from the industrial parties who take a paternalistic view of the system. This gives Australia policy options that other countries might not have.

Each of the Inquiry's proposals seeks to remove superannuation from the industrial system, and envisions private sector, for-profit financial institutions bidding for and winning pools of default superannuation members. Such an outcome will deliver to the for-profit part of the super system a ready-made, government sanctioned, and generally disengaged customer base at a very low acquisition cost. Once this customer base is acquired, these institutions will up-sell and cross-sell other products.

Around the world, there are essentially three kinds of funded retirement income systems:

- The industrial model
- The national model
- The retail model

The core features of the industrial model include that: (i) 2nd pillar default providers are private, industry or multi-industry plans that generally are affiliated with industrial parties and operated on a not-for-profit basis; (ii) products are distributed through the workplace; and (iii) the default product is determined through either industry or company level collective agreements between unions and employers.

There is a substantial amount of evidence about which of these approaches – the industrial model, the national model, and the retail model – is the most efficient and delivers the best outcomes in the real world.

The Inquiry's work could benefit from consideration of why the industrial model has worked well in this country and other countries, and how to maintain these positive factors. This is particularly the case because there are no real world examples of competition-driven systems that outperform the industrial model.

The reason Denmark and the Netherlands are the best performing system in the world, and the Australian industry funds are the best in this country, is because of culture and values. Asset allocation, efficiency in administration, manager selection, and the other operational efficiencies did not happen by accident. They emerged because of culture. Industrial parties are central to efficient and effective 2nd Pillars because they – and the providers they oversee – have a culture of engaging in superannuation to serve others.

The motivation underlying the retail approach to superannuation, however, is different:

> It is only retail funds that generate profit to distribute to shareholders. Importantly, the operators of the retail funds (i.e. the major financial institutions) earn most of their profit through super fund support services such as funds management, financial advice and asset investment. Essentially, the fund is just a means to attract savings to earn money from.[21]

In Australia, two of these different ecosystems exist in the second pillar. The existence of two distinct ecologies in Australia was identified over ten years ago by APRA research, which observed that there are "two distinct models" of pension funds in this country.[22]

In the real world, motivation based on competition, growing market share and higher individual remuneration, has seldom if ever been associated with good outcomes in funded retirement income systems.

The ontology underlying these systems also differs. The industrial model and national model acknowledge that in retirement incomes policy, a high degree of paternalism is necessary to achieve good public and social outcomes, and that the downside of paternalism in the context of such policy is low: the desire for individual agency in funded retirement income is low (after all, savings need to be mandated or auto enrolled, and few people consistently devote the time and energy to choose and monitor providers – most activity regarding superannuation is driven by people in the business of selling financial products and services, such as accountants, financial planner, and bank staff); in addition, the capacity for high quality sustained individual decision making is low due to low levels of financial literacy, cognitive biases and other factors.

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[21] IBISWorld, *Industry Report K6330: Superannuation Funds in Australia*, September 2014

[22] See, e.g., Wilson Sy, Pension Governance in Australia: An Anatomy and an Interpretation, Rotman International Journal of Pension Management, October 2008 (identifying "two distinct models of pension fund governance with one based on non-profit trustees taking more direct responsibility in portfolio construction for pension beneficiaries in their funds, and the other based on for-profit retail trustees passing the portfolio construction task to related service providers in conglomerate structures.")

Table 8 – Private pension funds net returns, net replacement rates, and adequacy rankings, selected jurisdictions

Country	Model	Melbourne-Mercer Global Pension Index (2016) Ranking	Real 10 year-average net return to 2015, % pa[1]	Net replacement rate, Pillar 2[2],[3]	Adequacy Ranking[4]
Netherlands	Industrial	A; #2 out of 27	3.8	63.4	1
Denmark	Industrial	A; #1 out of 27	4.0	46.3	2
New Zealand	National	Not ranked	3.3	12.4[5]	10
Chile	National	B; #9 out of 27	3.5	32.8	40
Australia	Retail & Industrial	B+; #3 out of 27	3.0	30.9	35
Australia: Industry Funds	Industrial	Not applicable	3.7	*No data*	*No data*

Source: Source: OECD, Allianz, APRA, Melbourne-Mercer Global Pension Index (2016), ISA calculations

Note: (1) OECD (2015), except for Australia: Industry Funds, which is based on APRA data and ISA calculations; data for New Zealand is to 2014, the latest available OECD figures; (2) Replacement rate is for the year 2015, latest available OECD figures; (3) Replacement rate is for a median income earner for the year 2015, latest available OECD figures; (4) Allianz (2015); (5) New Zealand's replacement rate is for its "Voluntary DC" Pillar rather than "Mandatory Private" Pillar because the OECD data places KiwiSaver under the former category.

6. ATO clearinghouse

We have considered the ATO clearinghouse position in the Inquiry's draft report, in light of comments made at the public hearings by the Inquiry regarding the New Zealand Inland Revenue Department.

Our view is that:

1. There is no clear advantage for a single, national, publicly owned central clearinghouse. Existing Superstream facilities provide clearing services adequately: there do not appear to be any barriers to efficient transfer of funds from employers to funds via the various clearinghouses established pursuant to Superstream.

2. The additional features of the IRD system in New Zealand highlighted by the Inquiry, namely that the New Zealand Government or the IRD are responsible for non-payment of contributions, and this creates an incentive to police unpaid contributions,[23] seems factually different from Australia, and therefore not compelling.

The Inquiry expressed the provisional view at the public hearings that the IRD needed to "underwrite" the payment of contributions. We have not found evidence of this. Our research indicates that the New Zealand government guarantees *employee* contributions (ie. salary sacrifice) provided that the employer has lodged an Employer Monthly Schedule with the IRD. *Employer* contributions are not guaranteed and will only be paid if the IRD successfully recovers it from the employer.

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[23] "[T]heir version of the ATO, if there's non-payment, they have to underwrite it. So there's really a set of eyes to make sure the employer is paying up."

There are legal sanctions in New Zealand for unpaid contributions, just as there are in Australia. However, we have not found any publicly available evidence of a more robust enforcement regime by the New Zealand IRD compared to the ATO.

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Thank you again for considering our comments on the Draft Report. We would be very pleased to discuss any matters raised in this letter, the public hearings, or the proceedings more generally.

Kind regards,

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