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Superannuation Efficiency And Competitiveness – Response To Productivity Commission Issues Paper

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About ASFA
ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system so people can live in retirement with increasing prosperity. We focus on the issues that affect the entire superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90 per cent of the 14 million Australians with superannuation.

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1.Executive summary

ASFA welcomes the opportunity to make a submission to the Productivity Commission's Study into Superannuation Efficiency and Competitiveness.

It is vital that the superannuation system is a competitive, efficient, and dynamic. As the keystone of the retirement income system it is crucial to ensuring Australians have adequate income in retirement. Accordingly, it is imperative that retirement income policy and the regulatory framework are developed in consideration of, and support, the objective of the system. In ASFA's view, the primary objective of the superannuation system is to ensure that all working Australians save for their retirement throughout their working life to achieve an adequate level of income throughout retirement. Superannuation also plays an important role as a source of funding for the economy.

When assessing competition and efficiency it will be important to make the distinction between the retirement income system (which includes social security), the superannuation system (which includes policy and regulatory setting) and the superannuation industry (the providers of superannuation products).

Measuring competition and efficiency in superannuation is a challenging task.From a practical perspective, the complexity and heterogeneity of both the system and the industry means it is difficult to determine the degree of competition and system-wide efficiency. The diverse mix of participants, while demonstrating a healthy level of competition, means that efficiency should be assessed in discrete groups - the choice and default (MySuper) segments of the APRA regulated superannuation system as well as Self-Managed Superannuation Funds (SMSFs).

Furthermore, if comparisons are to be made with overseas jurisdictions, there will be a need to recognise the distinguishing features of the Australian superannuation system that make it materially different to other jurisdictions.

The superannuation system bears the hallmarks of a competitive system as there are relatively low levels of market concentration. Initiatives such as choice of fund, member investment choice and MySuper have served to further enhance competition.

In assessing efficiency, it is important to focus on the value and benefits delivered to members, not just the fees and costs. Accordingly we advocate that a balanced scorecard approach be adopted, which examines the outputs/benefits delivered as well as the inputs/costs. This may necessitate a mix of quantitative and qualitative assessment.

While we believe the optimum approach is a balanced scorecard (which we are intending will be covered in a subsequent submission) as a first, and possibly primary, measure we suggest an approach that combines inputs and outputs. The prime outcome which superannuation providers need to deliver is net investment returns (after all investment and administration fees, operational costs, indirect costs and taxes), which assists fund members to accumulate sufficient superannuation savings to generate an adequate income in retirement. We refer to this in this submission as the '*net benefit*' to members. For an individual on average earnings, with contributions made during a full working life, the *net benefit* will account for around 70 per cent of the value of their total amount at retirement.

Accordingly, we propose that one method for assessing the value to fund members provided by the superannuation industry could be to examine the average *net benefit* to members, measured over a rolling twenty year period, across all MySuper products. Given forecasts with respect to investment market performance over the foreseeable future, we believe that a benchmark for MySuper products of *net benefit* of CPI growth plus a margin of 2.5 percent may be appropriate.

In relation to a balanced scorecard approach, the provision of insurance in particular will need to be incorporated into any assessment of system efficiency. Importantly, for the majority of members, this is provided on a default, opt out, basis, and provides fund members and their beneficiaries with valuable, cost effective, protection against the financial hardship which can be caused by disability or premature death. It also serves to reduce significantly the level of underinsurance in the economy.

Other key outputs which should be considered in efficiency analysis include the provision of advice to fund members and improvements in the ease of doing business, especially web-interactivity, for both for members and employers.

ASFA considers that continual improvements in efficiency are crucial to the future success of the industry.

2. Key Points

Introduction

1. When measuring competition and operational efficiency it will be important to make the distinction between;
   - the retirement income system;
   - the superannuation system; and
   - the superannuation industry.

2. There are distinguishing features of the Australian superannuation system, including
   - the heterogeneity of superannuation providers;
   - its relatively high exposure to growth and alternative assets;
   - its relative immaturity;
   - the high proportion of members in defined contribution products;
   - the range of ancillary services, including default life insurance cover, provided by APRA funds;
   - the volume and complexity of regulatory requirements.

Approach to assessment of competition and efficiency

1. The distinguishing features of the Australian superannuation system make international comparison difficult.
2. There are a number of domestic comparators of fund performance which may prove useful.

Competition in the superannuation system

1. Competition within the superannuation system differs between retail (superannuation providers to consumers) and wholesale (service providers to superannuation providers) and so should be assessed separately.
2. The superannuation industry demonstrates the characteristics of a competitive market.
3. Fee-based competition can lead to lower fees, but this will not necessarily lead to higher efficiency/net returns.
4. There are some barriers to entry for APRA-funds, though these are necessary to maintain the integrity of the system.
5. There are a number of barriers to exit for funds, which include the absence of on going capital gains tax relief, potential to inherit liabilities and legacy products.
6. Most members have the option to choose their fund and there are minimal barriers to consolidating superannuation accounts.
7. Improved disclosure is likely to improve members' engagement and increase demand-side competitive pressure.
8. Use of outsourced service providers enables economies of scale.

Assessment of operational efficiency

1. SMSFS should be excluded from any assessment of operational efficiency, and MySuper and choice products should be assessed separately.
2. Assessment should use a ‘balanced scorecard’ approach.
3. A primary measure of efficiency is *net benefit* to members (net returns after deduction of investment and administration fees, costs and taxes).
4. Average *net benefit* to members, on a rolling-twenty-year basis, across MySuper would be an appropriate indicator.
5. Given the volatility of investment markets, the benchmark should be a relative one, not an absolute.
6. In addition, consideration should be given to the value to members of ancillary benefits, in particular insurance.

Barriers to efficiency – regulation

1. The regulatory regime is highly prescriptive, and has been subject to significant change. The regulatory framework and constant change has resulted in significant ongoing compliance and implementation costs.
2. There are a number of examples of regulation where the net benefit is questionable.

Allocative and dynamic efficiency

1. The superannuation system has a positive effect on economy-wide allocative and dynamic efficiency, including on national savings.
2. Assessment of allocative efficiency is more suited to qualitative, rather than quantitative, analysis.
3. Dynamic efficiency could be assessed through an innovation lens.

3. Introduction

Key points

1. When measuring competition and operational efficiency it will be important to make the distinction between;
   - the retirement income system
   - the superannuation system; and
   - the superannuation industry.
2. There are distinguishing features of the Australian superannuation system, including:
   - the heterogeneity of superannuation providers;
   - its relatively high exposure to growth and alternative assets;
   - its relative immaturity;
   - the high proportion of members in defined contribution products;
   - the range of ancillary services, including default life insurance cover, provided by APRA funds;
   - the volume and complexity of regulatory requirements.

3.1 Retirement income system versus superannuation system versus superannuation industry

When measuring competition and operational efficiency it will be important to make the distinction between: -

- the *retirement income system* – which comprises both superannuation and social security measures, such as the age pension;
- the *superannuation system* – which is broader than the providers of superannuation and incorporates policy and tax settings and the regulatory framework;
- the *superannuation industry* – which refers to superannuation providers.

The *retirement incomes system* is the 'big picture' – it is this which ultimately delivers retirement income to Australian retirees. It comprises: -

- superannuation funds, which provides retirement income streams and lump sums;
- social security measures, such as the age pension and concessions for retirees;
- any income from employment post retirement.

Both the inputs and outputs are largely a function of government policy settings and, as such, any benchmarking would reflect this.

The *superannuation system* is broader than just the providers of superannuation. It extends to policy settings and the regulatory framework. This includes such matters as: -

- the scope and rate of the superannuation guarantee regime;
- tax settings which affect the rate of voluntary contributions and the net end benefits to members;
- regulatory requirements, which impose various obligations on superannuation providers.

As the outputs of the superannuation system – superannuation funded income stream and lump sums – are more a function of government policy and tax settings than anything else, any benchmarking of the superannuation system as a whole would reflect this.

The *superannuation industry* comprises the superannuation providers – the superannuation funds themselves. While their inputs and outputs are affected by government policy settings, regulatory requirements and the performance of investment markets (and to a lesser extent the insurance market), providers nevertheless have a degree of control and influence over their outputs. Within regulatory constraints, trustees are able to design their product offerings, including the provision of ancillary services, and to determine their expenditure and the fees charged. Accordingly, while some of the influences on outputs are beyond the control of the providers, benchmarking could be performed with respect to the output of superannuation providers.

Though it would be appropriate to assess allocative and dynamic efficiency at the system level, operational efficiency should only be assessed at the industry level.

3.2 Distinguishing features of the Australian system

There are a number of features which distinguish the Australian superannuation system from overseas pension systems.

3.2.1 Heterogeneity of superannuation providers

Superannuation in Australia is provided both publically and privately. Most public sector schemes originally were pure or hybrid defined benefits schemes – most defined benefit schemes have been closed to new members and over 90 per cent of members are in accumulation schemes (see 3.2.4 for more details).

Privately provided superannuation is heterogeneous, with providers falling into one of three main types of superannuation product offering: -

- *SMSFs* – where all of the members are also trustees and control all decision-making;
- *choice products* – which members have chosen to acquire to meet their needs for investment choice, tailored insurance and/or other services;
- *MySuper* – which are chosen by employers as 'default' funds for their employees, in the absence of employees making an individual choice as to their superannuation fund.

Not only do these three different types of superannuation product reflect markedly different business models, more importantly they reflect significantly different degrees of member choice and control.

In an SMSF, all of the members are also trustees of the fund. Consumers tend to be attracted to setting-up an SMSF because it provides the trustee(s)/member(s) with unfettered control (apart from regulatory constraints) over their investment and divestment decisions. This not only includes specific asset selection but also the timing of both acquisition and disposal, which can have significant implications with respect to capital gains tax. As trustees of SMSFs make all of the decisions with respect to the operations and investments of the SMSF they control the inputs/expenditure and have maximum influence over the investment outcomes.

Consumers generally select a 'choice product' offered by APRA-regulated funds in order to direct their investment allocation. This can range from selecting to invest different proportions of their account balance and contribution in-flow across a range of 'pre-mixed', diversified investment options offered by the trustee, through to wrap and platform type products where members are able to choose to invest and divest in specific assets. On occasions, consumers may also have tailored insurance or some other ancillary service offering. Members of choice products generally pay a higher fee than MySuper members (but generally significantly less than the cost of an SMSF). For those members in wrap/platform type products, who choose to invest/divest in specific assets, the incurrence of transaction-based costs, such as buy/sell spreads, brokerage and stamp duty, is within their control. In the same way as SMSFs, the investment returns received by members of a choice product are a function of their individual investment decisions.

MySuper products are designed for 'default' members who do not make an active decision as to which superannuation fund to join to have their compulsory employer contributions paid into. A Registrable Superannuation Entity (RSE) licensee must apply to APRA for authority to offer a MySuper product, which involves an assessment of the design of their MySuper product. There are a number of specific legislative requirements, which must be met when designing a MySuper product, including that a RSE licensee generally may only offer one MySuper product.

In summary: -

- with respect to SMSFs – consumers actively choose to run an SMSF and make all of the investment and operational decisions;
- with respect to choice products – the consumer makes the investment decisions with respect to their benefit, while the provider makes the (non-investment) operational decisions with respect to the product;
- with respect to MySuper products – the provider makes all of the investment and operational decisions.

These are three distinctly different business and operational models.

Given this, any benchmarking of operational efficiency should also make the distinction between SMSFs, choice products and MySuper.

Accordingly: -

- SMSFS should be excluded from any assessment of operational efficiency;
- MySuper and choice products should be assessed separately, especially as the investment outcomes of MySuper products are a function solely of provider decisions, while the investment returns of choice products are a function of individual member decisions.

3.2.2 Relatively high exposure to growth and alternative assets

In aggregate, Australian superannuation fund assets have a relatively high allocation to growth and alternative assets, including overseas assets, compared with defensive assets.

By way of example, in Australia fund exposure to: -

- equities is around 46 per cent. This compares to 10 per cent in South Korea, 12.5 per cent in Chile and 38.2 per cent in the US;
- bonds is around 10 per cent. This compares to 45 per cent in Chile and 65 per cent in Denmark.

Australian superannuation funds tend to invest relatively greater proportions in asset classes such as direct and indirect property and infrastructure.

This has two main consequences – it tends to produce higher returns over the long term but it is also more expensive.

3.2.3 Relative immaturity of the system

Australia's (near) universal superannuation system only began with award superannuation in the mid-eighties and culminated with the introduction of the Superannuation Guarantee (SG) in 1992. The SG was phased in gradually from three percent and did not impose nine per cent (the previous maximum) on all employers until 2002, where it remained until 2013. It still does not apply to the self-employed or those earning under $450 per month.

This means that most people retiring still have not been contributing to superannuation for the whole of their working lives. It will not be until around 2040 that the system will reach maturity.

3.2.4 High proportion of members in defined contribution products

The Australian system is marked by the high proportion of members whose benefits are in accumulation accounts, as opposed to being a defined benefit.

There are significant consequences for a member in a defined contribution product: -

- in the accumulation phase
- they bear the investment risk (as opposed to the employer in a defined benefit scheme);
- if they die/are disabled prior to retirement they receive only their accumulation to date (unless there is insurance);
- in the retirement/draw-down phase
- they bear the investment risk (as opposed to the employer);
- they bear the longevity risk (as opposed to the employer);
- they bear the cost of the fund directly (unless the employer subsidises).

Around 90 per cent of current members of superannuation funds are in defined contribution schemes and that percentage will gradually increase in the future, as practically all new employees will only be able to become a member of a defined contribution scheme.

3.2.5 Range of ancillary services - in particular insurance

APRA regulated superannuation funds offer a range of ancillary services, the most important of which is insurance.

As a result of the advent of defined contribution superannuation (as referred to in Part 3.2.4 above) there was a need to provide separately for death or disability prior to retirement.

In the event of death or disablement in a defined benefit fund, the member generally received a benefit, which reflected their 'future service component', not just their past service. In a defined contribution fund, without insurance cover, all that a member/dependants would receive would be the amount accumulated to date. This could leave the member/dependants at a material financial disadvantage, especially if the death/disability occurred relatively early in the member's working life. To ameliorate this outcome insurance cover, generally on a default, 'opt-out', basis, was introduced.

The provision of insurance provides significant benefit to fund members – it is relatively cost effective when compared to life insurance sold by insurance brokers. Importantly, the fact that in MySuper and some choice products insurance cover is provided as a default, without relying on members making a conscious decision and taking action to acquire it, ensures a far higher degree of coverage than would otherwise be the case.

Currently, superannuation group life insurance arrangements amount to:

- 71 per cent of total death sums insured in the community;
- 88 per cent of total and permanent disability sums insured;
- 59 per cent of total income protection/salary continuance/total but temporary disability benefits insured.

Despite the wide member coverage provided through superannuation funds, the level of underinsurance remains high. Rice Warner estimates that the median level of life cover meets about 60 per cent of the basic needs for average households – and for families with children it is a much-lower proportion of needs.

3.2.6 Extent of outsourcing

The Australian superannuation system is characterised by a high degree of outsourcing to third party service providers, especially with respect to administration and investment management.

3.2.7 Volume and complexity of regulatory requirements

The regulatory regime with respect to superannuation is voluminous, highly prescriptive and has been subject to significant, on-going change, over the past twenty years. This has necessitated the implementation of multiple changes in superannuation and tax settings, as well as in other portfolios/legislation.

Furthermore, the regulatory environment is complex. For example, trustees (other than SMSFs) must deal with three main regulators: -

- the Australian Prudential Regulation Authority (APRA) regarding the governance of the fund/product;
- the Australian Securities and Investment Commission (ASIC) regarding conduct of the provider and disclosure to consumer;
- the Australian Taxation Office (ATO) regarding the range of complex taxation requirements – both at fund and member level.

There are three major sets of primary and subordinate legislation with which superannuation funds must comply: -

- the *Superannuation Industry (Supervision) Act 1993*;
- the *Corporations Act 2001*;
- the *Income Tax Assessment Acts (1936 and 1997)*.

In addition, there are a host of other regulatory obligations contained in legislation as diverse as the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*, the *Privacy Act 1988* and the *Family Law Act 1975*.

The range of regulatory obligations and requirements imposes material ongoing compliance costs on the various entities in the superannuation system. Changes to the regulatory regime impose further significant implementation costs – frequently necessitating material changes to information technology systems, to processes and procedures and to consumer disclosure material, and also requiring funds to develop and deliver training to staff.

4. Approach to assessment of competition and efficiency

Key points

1. The distinguishing features of the Australian superannuation system make international comparison difficult.
2. There are a number of domestic comparators of fund performance, which may prove useful.

4.1 Distinguishing features of the Australian superannuation system

The distinguishing features of the Australian superannuation system make international comparisons difficult. The main challenges in comparing the performance of the Australian superannuation system with retirement systems in other jurisdictions are that the Australian system does not operate to a standard model and is relatively complex, as outlined in Part 3.2.

Though there are number of international comparators of system performance, these have significant limitations:

- the measures typically are contextual. Countries' systems vary markedly across many dimensions – for example, the relative size of the public and private components, the degree to which private systems are compulsory and the degree of system maturation;
- in general, the measures do not abstract from factors that are outside the control of the system;
- further, by their nature, the measures are not granular enough to assess competition or efficiency adequately.

The OECD's *Pensions at a Glance* publication contains a comprehensive set of performance indicators that encompass pension system coverage and adequacy. However, for the reasons stated above, direct comparisons based on such indicators can draw misleading conclusions.

The OECD's roadmap for the good design of defined contribution pension plans is a useful high-level benchmark against which to assess Australia's defined contribution system.[1] This is, however, a qualitative framework for benchmarking performance rather than a quantitative framework.

The Issues Paper suggests the Melbourne Mercer Global Pension Index (Mercer Index) as a possible source of international comparison. It is important to note that many of the measures contained in the index are affected by government decisions and policy settings, which are outside of the control of individual pension and superannuation funds. Accordingly, it is important to note that the Mercer Index measures the Australian superannuation system, not the superannuation industry.

That said, the Mercer Index is the best international proxy for system performance available at the moment. In the most recent index, Australia ranked highly in terms of the overall index, being third after Denmark and the Netherlands (in a sample of 25 countries). With regard to the index sub-components, Mercer ranked Australia's system first for adequacy, fourth for long term sustainability and third for integrity. Areas for improvement highlighted by Mercer include higher labour force participation at older ages and some aspects of superannuation system design. It is important to note that the areas for improvement are outside the control of the superannuation industry – they instead form part of the retirement income system.

[1] As approved and endorsed by the OECD Working Party on Private Pensions in June 2012.

4.2 Existing domestic comparators of performance

Existing domestic comparators of entity (fund) performance may be useful.

There are a number of organisations operating in Australia that undertake activities that, broadly speaking, involve the rating of superannuation funds.

The major agencies in Australia are Canstar; Chant West; Lonsec; Mercer; Morningstar; Rainmaker; Rice Warner; SuperRatings and Zenith.

Typically, ratings are based on quantitative and qualitative assessments of a range of fund characteristics. Ratings usually rank funds from 'top' to 'bottom' based on a set of criteria that have been chosen and weighted by the particular ratings agency. Each agency has a different ratings structure. Examples of rating agency methodology are in Appendix 1.

The approached adopted in designing the various composite measures utilised by ratings agencies are relevant to this study. For example, the SuperRatings composite measure incorporates fund inputs and outputs and, as such, could be interpreted as a proxy for fund efficiency. On occasions the rating agency makes available data, relating to the various components of the ratings, which can makes the measure even more useful.

5. COMPETITION IN THE SUPERANNUATION SYSTEM

Key points

1. Competition within the superannuation system differs between retail (superannuation providers to consumers) and wholesale (service providers to superannuation providers) and so should be assessed separately.
2. The superannuation industry demonstrates the characteristics of a competitive market.
3. Fee-based competition can lead to lower fees, but this will not necessarily lead to higher efficiency/net returns.
4. There are some barriers to entry for APRA-funds, though these are necessary to maintain the integrity of the system.
5. There are a number of barriers to exit for funds, which include the absence of on going capital gains tax relief, potential to inherit liabilities and legacy products.
6. Most members have the option to choose their fund and there are minimal barriers to consolidating superannuation accounts.
7. Improved disclosure is likely to improve members' engagement and increase demand-side competitive pressure.
8. Use of outsourced service providers enables economies of scale.

5.1 Competition between superannuation funds and between service providers

Competition within the superannuation system is complex. The system comprises a diverse mix of entities that are connected through vertical and horizontal relationships. At the industry level, the superannuation value chain comprises a variety of market interactions, which encompass fund members, superannuation funds, superannuation providers and service providers. The nature of competition within these markets differs markedly. With respect to funds, there is a diverse mix of fund types (Box A).

The nature of competition throughout the superannuation value chain varies markedly. In some parts of the value chain, market conditions approach those of a perfect competition model – for example, in the market for wholesale investment management. In other parts, non-price competition is more dominant. This is particularly the case in the market for choice members where there are competitive responses such as product differentiation.

The differences between the retail and wholesale markets mean that separate competition assessment should occur with respect to each market.

Box A: Fund type

In broad terms, there are two main types of funds: -

- APRA-regulated funds, which can be categorised into corporate funds, industry funds, public sector funds and retail funds; and
- SMSFs, which are a unique feature of the Australian system, allowing superannuants to manage their superannuation monies.

Table 1 shows the structure of the superannuation industry as at 30 June 2015. The table shows that there are significant differences between the major segments of the superannuation industry.

Table 1: Industry structure, 30 June 2015

	No. entities ('000)	No. accounts ('000)	Assets ($billion)	Ave. account ($000's)
Corporate	34	346	54	146
Industry	43	11,303	434	36
Public Sector	38	3,524	351	97
Retail	146	13,751	537	39
Small funds*	559,286	1,054	592	562

Source: APRA Annual Superannuation Bulletin.

**Comprising SMSFs (largely) and small APRA funds (non-RSEs).*

The industry has evolved markedly over recent decades (Table 2). With respect to APRA-regulated funds, the number of players in the superannuation industry has declined, nevertheless market concentration remains relatively low. At the same time there has been a shift in the composition of fund types, away from corporate funds towards industry and retail funds.

Table 2: Changing industry structure

Fund type	Number of entities	
	1995	2015
Corporate	4,211	34
Industry	152	43
Public Sector	97	38
Retail	541	146
Small funds*	100,447	559,286

Source: APRA Annual Superannuation Bulletin

**Comprising SMSFs (largely) and small APRA funds (non-RSEs).*

These changes in numbers reflect the fact that:

- a large number of corporate funds have closed or consolidated into master trust arrangements (retail) or industry funds;
- the number of industry funds has reduced by more than two-thirds since 1995, as has the number of retail funds. This is largely the result of mergers, as players have looked to increase scale to help drive operating efficiencies;
- the number of small funds, more specifically SMSFs, has risen markedly.

5.2 The superannuation industry demonstrates competitive characteristics

5.2.1 Competition for members

When you look at the competition by superannuation providers for members a high degree of competition can be seen.

5.2.1.1 Default

In the market for default fund members funds compete for employers' business. This can include competition through tender processes, generally undertaken by larger employers for their default (MySuper) fund or corporate sub-plan. Industry funds account for the largest share of the default market, though the retail segment is increasing its share.

The tender process generally is performed on a 'balanced scorecard' basis, looking at the value and benefits delivered to members. Fees are but one of the factors that employers take into account – they also consider returns, the provision of insurance and advice, the range of services available to members and service standards.

Competition has resulted in both retail and industry superannuation funds tailoring their offerings. In particular, retail superannuation funds have responded by developing directly distributed superannuation products.

5.2.1.2 Choice

Funds in the market for choice members compete by differentiating their products and services to attract customers. Features include the ability to exercise investment choice across a range of investment options, the ability to tailor insurance and the availability of other services such as advice and web-interactivity.

This reflects the broad range of consumer preferences when it comes to making investment decisions, such as differences in risk appetite, financial resources and needs, which often reflect the member's stage of life. The degree to which funds meet consumers' preferences is a crucial indicator of industry performance.

In particular, industry and retail funds compete for choice members with marketing focused on fees and returns. The increase in superannuation products directly marketed to consumers over the internet, rather than through a financial intermediary, has increased the role of price competition even at the level of the individual consumer.

5.2.1.3 SMSFs

SMSFs are an alternative to APRA-regulated funds, and represent a significant source of competition for retail and industry funds with respect to choice members. The number of SMSF funds has grown strongly over the last few decades, up five-fold since 1995.[2]

APRA-regulated funds have responded to competition from the SMSFs by offering 'SMSF like' products that enable members to direct investment into specific assets, such as equities and term deposits.

5.2.2 Low degree of concentration in the superannuation market

Despite substantial consolidation over the past few decades, Australia's superannuation industry is marked by the range and diversity of suppliers and the role of niche/boutique players. This is in contrast to some domestic markets (Box B).

There are a large number of APRA regulated superannuation funds in the Australian system – around 260 funds with at least five members.[3]

[2]APRA Annual Superannuation Bulletin
[3]APRA Annual Superannuation Bulletin.

Market concentration is relatively low. The top four funds account for only around 20 per cent of the market. The Herfindahl Hirshman Index for superannuation funds (2.8 per cent in 2012) is well below the benchmark for industry concentration (15 per cent).[4]

Box B: How does market concentration in the superannuation system compare with other domestic markets?

Compared with most other domestic industries, the superannuation market in Australia is marked by the range and diversity of suppliers, and relatively low levels of market concentration.

There is significant market concentration in a number of key retail markets. In the Australian grocery market the top four entities account for around 75-80 per cent of the market. In petrol, six entities control over 90 per cent of the market. Retail electricity markets differ from state to state, with the number of retailers ranging from five to one.

5.2.3 Margin compression among APRA-regulated funds over the last decade.

For superannuation funds, margins are the excess of fees over expenses. A general decline in margins over time, all else being equal, would indicate ongoing competitive pressure in the superannuation industry.

Arguably, margins are a better indicator of competition than fees or expenses alone. Fees reflect expenses and higher expenses can reflect additions to/improvements in products and services.

Research undertaken by Rice Warner shows that, in broad terms, APRA-funds have experienced margin compression over the past decade. In particular, Rice Warner estimates that the margin in superannuation fees over expenses has declined by 11 basis points over this period. Rice Warner attributes this reduction to competition amongst funds to reduce fees, relative to competitors, and the increasing market share of all-profit-to-member funds.[5]

In terms of fund segments, the margins of retail funds have reduced at a rate around double the industry average. Rice Warner suggests that this reflects greater competition for members with the introduction of choice of fund in 2005.[6]

This margin compression among APRA-regulated funds over the last decade is evidence of a healthy level of competition.

5.2.4 Product and service innovation

Product and service innovation, as well as innovations to suppliers' internal processes, are indicators of a dynamic competitive environment.

New products and services provide a point of difference between funds. Innovations in products and services are an indicator of a healthy and dynamic competitive environment.

[4] Qu, J.Z. 2014, 'An efficiency study of the Australian superannuation industry', http://www.apra.gov.au/AboutAPRA/WorkingAtAPRA/Documents/Zhiwei-Qu-2013.pdf).
[5] This is detailed in ASFA's initial submission to the Financial System Inquiry (*ASFA 2014, Financial System Inquiry: submission, March*).
[6] For details, see ASFA 2014, *Response to the Financial System Inquiry Interim Report*, August 2014

In recent years there has been innovation in superannuation products, both at the fund level and with respect to product features. Examples include: -

- more targeted, bespoke products and services – ongoing developments in data analytics and associated technologies are enabling funds to build and distribute financial products and services in a more targeted and efficient way to better meet consumers' needs;
- better member engagement, for example, through web-based tools, such as calculators; web-based education and intra-fund and scaled advice; and through easier electronic access to accounts – including the use of mobile applications linked to superannuation accounts;
- use of member data to identify and engage with members with respect to tailored advice – graduated advice provides members with the advice that they need when they need it, while minimising funds' expenses;
- as the retirement products market matures, funds will compete by offering services and products at a segmented, more individualised, basis.

Competition in future will be driven by those funds which better understand the retiree member segments. This can include identifying those who prefer professional help and/or products to manage their cash flow predictably (e.g. a lifetime income stream, with or without advice), compared with those who prefer to direct their own finances – whether through an account-based income stream or a wrap/platform product.

Competition also spurs innovation in the processes of superannuation providers and/or their out-sourced service providers to lower operating expenses and increase operational efficiency. Examples of improved processes in recent years have included:

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

In addition, there have been considerable enhancements to superannuation system efficiency brought about by the introduction of SuperStream, which has markedly improved the efficiency of both rollovers and contributions. The ATO found that employers who implemented SuperStream and completed more than one payment cycle experienced between a 65% (small employers) and 47% (large employers) reduction in time spent in processing their superannuation contributions.[7]

5.2.5 Scale efficiencies are being realised but are masked in aggregate expenses

Competition drives the search for scale efficiencies. Aside from mergers, this can involve funds out-sourcing certain functions to external service providers to achieve scale economies. In general, fund expenses per member decline with scale but scale benefits do tend to taper off with size.

Though scale economies may be realised – and reflected in downward pressure in some expense categories – the effect of this may be masked by higher expenses in categories that are not subject to scale economies. Indeed, Rice Warner research suggests that recent scale benefit savings have been absorbed by higher regulatory and technology costs, and any remaining is being used to improve product design and service features for members.

[7] *ATO Super Reform Final Report* - Colmar Brunton, 2 Dec 2015

5.3 Fee-based competition and efficiency/returns

Competitive pricing (fees) paid by members can put downward pressure on fund expenses and margins.

Fund returns (past and potential) are also a source of competition. However, from the point of view of members, comparison of returns is more difficult than for fees – not least because of the inherent uncertainty and volatility of returns.

It should be noted, however, that fee-based competition will not necessarily result in higher efficiency/ returns. Higher investment fees may reflect superior investment strategies, which deliver higher gross and net returns.

Data from SuperRatings shows that, at the fund level, there is little correlation between the SuperRatings' net benefit measure (a proxy for returns, less fees and taxes) and the level of fees charged.

From a system perspective, competition that is focused on fees risks a broad transition among funds to more defensive investment strategies, which are less expensive to operate but generally this comes at the expense of lower returns. It also risks reduced quality and range of services and fewer resources devoted to product development and innovation. This could have long term implications for system outcomes.

In particular, a broad-based shift towards lower-cost, defensive investment strategies (for instance, products with a heavy investment weighting toward bonds and fixed interest) would increase the risk that members' portfolios might diverge from their optimal asset allocations.

Overall, such developments would have implications for system efficiency – both allocative (sub-optimal portfolios) and dynamic.

Competition based on returns that are net of all fees and costs to members would be a superior basis for delivering industry-wide efficiencies.

5.4 Barriers to entry

Barriers to entry do exist but are not a major constraint.

With respect to funds, the main barrier to entry for an APRA-regulated superannuation fund is the need for the trustee to obtain a Registrable Superannuation Entity (RSE) licence from APRA and, depending on the functions performed and services provided, an Australian Financial Services Licence (AFSL) from ASIC. Furthermore, if the fund will be offering a MySuper product, it will need to be authorised by APRA. Given the nature of superannuation, and the fact that it is compulsory, these barriers are appropriate to ensure the quality and appropriateness of providers.

When it comes to scale, in broad terms potential providers in the superannuation system face similar barriers to entry as in many other markets in Australia. In general, a large incumbent fund inherently has advantages over smaller potential entrants.

That said, the extent of outsourcing in the superannuation sector materially reduces a number of the operational barriers to entry via facilitating realisation of scale economies. There are many instances of relatively small superannuation funds outsourcing investment and administration functions to third party service providers. This enables smaller funds to better compete with larger players based on fees and returns, and, given the greater flexibility that outsourcing affords, they can better target the needs of their members.

5.5 Barriers to exit

Arguably, barriers to exit are more pervasive and represent a more significant constraint. This includes a number of regulatory barriers that can act to discourage fund mergers.

5.5.1 Fund consolidation

Fund consolidation can be an indicator of a healthy competitive environment. Consolidation is a means by which funds can realise scale efficiencies and gain cost and other advantages over their competitors.

In the past 10 years there has been a large (around 80 per cent) drop in the number of APRA-regulated superannuation funds, mostly via mergers.[8] Recently, however, consolidation activity has slowed. Reasons for the drop-off in consolidation activity include:
- difficulties in meeting the regulatory requirement to ensure that members receive 'equivalent rights' (on a 'bundled' basis) in their new fund as they did in their old fund;
- the absence of enduring Capital Gains Tax (CGT) relief and other tax issues;
- the risk of inheriting liabilities from the 'transferring-out' fund;
- funds have had to focus on implementing the various regulatory reforms, such that consolidation activity either was bought forward in anticipation of these or, more likely, has been deferred;
- in certain circumstances consolidations may trigger the re-pricing of group risk policies, which could substantially affect members;
- the 'low hanging fruit' has already been taken.

Some of the barriers are explored in more detail below.

5.5.2 Fund level – need for orderly exit

One of the functions of trust law and the regulatory / prudential framework for the superannuation system is to enable an orderly exit of funds. This helps maintain the integrity of members' savings and participants' confidence in the broader superannuation system.

[8] APRA Annual Superannuation Bulletin

The need for an orderly exit, however, represents a major barrier to exit.

Funds that exhibit persistent high net outflows may be operating for longer than otherwise might be the case, where transference of members' monies to another fund would be in the best long-term interests of fund members.

5.5.3 Fund level – absence of on-going Capital Gains Tax (CGT) relief

The absence of CGT rollover relief creates a significant barrier to fund mergers.

The triggering of CGT events, such as the realisation of otherwise unrealised gains and the inability to carry forward losses, can prevent a trustee from entering into a successor fund transfer arrangement.

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

Depending on the volatility of the market, after a downturn, a fund can carry deferred tax assets of an amount equivalent to 1.5 per cent or more of member account balances, the benefit of which would be lost if a merger were to go ahead without CGT relief. For a member with an average account balance of approximately $70,000, this could represent a reduction in the value of their superannuation account of over $1,000.

In such circumstances, the absence of CGT rollover relief may cause the costs to members, through the extinguishment of deferred tax assets, to outweigh the benefits of any proposed merger.

5.5.4 Fund level – other tax issues

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

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

5.5.5 Fund level – risk of inheriting liabilities

Another barrier to exit is the potential risks and liabilities that the trustee of the 'transferee fund' may be assuming when they transfer members from the 'transferring fund' into their fund.

While in some circumstances this can be remediated through the trustee of the transferring fund providing a warranty to the trustee of the transferee fund, in the majority of cases, as the trustee of the transferee fund is being wound-up, this is of limited value.

5.5.6 Product level – legacy products

Notwithstanding the benefits of product innovation, various legal and regulatory barriers have often seen products forced to continue where it would be more efficient to rationalise those products. For an individual fund, the existence of legacy products can be a barrier to a potential merger.

Frequently these products are closed to new members (legacy products), while new products are launched for new members.

In some cases – a lifetime pension product by way of example – an inability to commute (under the regulatory provisions), combined with reversionary provisions, may see providers compelled to support such products for decades, even if they are not commercially viable.

5.6 Choice of fund and consolidating accounts

5.6.1 Choice of fund

The majority of employees are eligible to exercise choice of fund for their compulsory employer contributions.

Around 25 per cent of employees do not have choice of fund either because they are a member of a defined benefit fund or because they are covered by a collective enterprise agreement that does not allow an employee to exercise choice of fund for contributions.[9]

The *Superannuation Legislation Amendment (Choice of Fund) Bill 2016*, introduced into Parliament in March 2016, provided that employees employed under a workplace determination or enterprise agreement made after 1 July 2016 would be able to choose the superannuation fund for their compulsory employer contributions. This bill lapsed when Parliament was prorogued on 15 April 2016.

5.6.2 Consolidating accounts

With the advent of MyGov there are minimal barriers to members consolidating their superannuation accounts. The ATO has utilised MyGov's high security protocols for identifying taxpayers to create an enhanced process for rolling over balances from one fund to another (previously delayed by the necessity for member to provide proof of identification on exit, as employer-enrolled members are not identified on entry), and for finding ATO-held amounts of superannuation.

Once a member has identified themselves through the MyGov process, the ATO provides the member with information on all of their superannuation accounts. The member is able to apply to transfer one superannuation account into another on-line, via a few button clicks. The ATO relays the instruction to the rolling-out fund and, provided the receiving fund is an APRA regulated fund and not an SMSF, generally the roll over will be actioned within three working days.

5.7 Improved disclosure, education and advice

The disclosure regime historically produced complex and lengthy documents that often did not enhance consumer understanding of financial products and services.

Improvements over the last few years have seen the regulatory framework allow shorter (eight page) Product Disclosure Statements (PDS) and incorporation of more detailed materials by reference or link. These shorter PDSs are semi-prescribed to ensure consistency and comparability and have served to materially improve comprehensibility. A recent enhancement to disclosure has been the development of product dashboards for MySuper products.

Another initiative arising from the Stronger Super reforms has required funds to more openly disclose investment management fees to members. In theory this allows greater transparency, particularly around fees that are incurred when a superannuation fund invests through a number of feeder funds and/or multi-manager funds or where there are performance-based fees that are incorporated into unit prices or crediting rates.

[9] ASFA research.

In addition, superannuation providers expend considerable resources in the provision of member education, through such mechanisms as seminars, and in providing web-based information and assistance, including via such tools as interactive calculators, webinars and fact sheets. The provision of intra fund and other advice is another method by which members engage with their superannuation provider.

Improved disclosure, education and advice is likely to improve members' engagement and increase demand-side competitive pressure.

5.8 Outsourced fund functions

Funds can outsource a range of functions, such as administration and funds management. Outsourcing often allows funds to reduce costs, access expertise and reduce operational risk.

5.8.1 Wholesale investment management services

A significant part of the activity in the superannuation industry involves funds outsourcing investment management. A number of features of this market indicate robust competition.

In the case of corporate, public sector and industry funds competition largely occurs through the wholesale purchasing decisions of fund trustees. Typically, such decisions are made on the basis of formal evaluations — taking into account returns, fees and the nature of services provided.

There are numerous suppliers. Most major financial institutions in Australia offer investment management services either directly or through a subsidiary. There are also boutique-style investment managers, and multinational and overseas fund managers that offer services in Australia.

As well as having an array of investment managers available in the market, both large and small superannuation funds have the option to invest some or all of the assets of the fund directly. A number of large funds do this to varying degrees. This is a source of additional competitive pressure on fund managers.

The expected growth in the size of funds means that potential scale and expense/tax management benefits will be a focus for more funds over coming years. Should the funds that currently hold $20 $50 billion grow at the same rate as total funds under management, there will be around 15 funds with assets greater than $50 billion by 2030.[10]

5.8.2 Administration services

Superannuation administration typically demonstrates increasing returns to scale given that there are significant fixed costs in developing information technology and other systems and processes.

[10]ASFA research.

6. Assessment of operational efficiency

Key points

1. SMSFS should be excluded from any assessment of operational efficiency, and MySuper and choice products should be assessed separately.
2. Assessment should use a 'balanced scorecard' approach.
3. A primary measure of efficiency is *net benefit* to members (net returns after deduction of investment and administration fees, costs and taxes).
4. Average *net benefit* to members, on a rolling-twenty-year basis, across MySuper would be an appropriate indicator.
5. Given the volatility of investment markets, the benchmark should be a relative one, not an absolute.
6. In addition, consideration should be given to the value to members of ancillary benefits, in particular insurance.

6.1 Distinction between SMSFS, MySuper and choice products

As outlined in Part 3.1 there are three distinctly different business and operational models in superannuation: -

- SMSFs – where consumers actively choose to run an SMSF and make all of the investment and operational decisions;
- choice products – where the consumer makes the investment decisions with respect to their benefit, while the provider makes the (non-investment) operational decisions with respect to the product;
- MySuper products – the provider makes all of the investment and operational decisions.

Given this,

- SMSFS should be excluded from any assessment of operational efficiency;
- MySuper and choice products should be assessed separately, especially as the investment outcomes of MySuper products are a function solely of provider decisions, while the investment returns of choice products are a function of individual member decisions.

6.2 'Balanced scorecard' approach

Ideally any benchmarking exercise should adopt a 'balanced scorecard' approach, which takes into consideration the outputs delivered as well as the input costs. ASFA will be making a supplementary submission with respect to this.

Choice of the specific inputs and outputs for this approach would depend upon the level of operation at which benchmarking is focused. For example, measuring the efficiency of the superannuation industry would require broader inputs and outputs than when measuring the efficiency of a specific function of the industry, such as investment performance.

6.3 Primary measure

We propose that the primary indicator of efficiency should measure inputs and outputs combined.

The prime outcome which superannuation providers need to deliver to members is net investment returns (after deducting all investment and administration fees, operational costs, indirect costs and taxes), which assists fund members to accumulate sufficient superannuation savings to generate an adequate income in retirement. This is what we describe as being the '*net benefit*' to members. For an individual on average earnings, with contributions made during a full working life, the *net benefit* will account for around 70 per cent of the value of their total amount at retirement.

Accordingly, we recommend the approach of measuring the '*net benefit*' to members, which takes account of the combined effect of both: -

- inputs – expenses and margins (covered by fees); costs and taxes (deducted from returns); and
- outputs – investment returns.

While such an indicator would provide a relatively broad measure of the *net benefit* that superannuation funds provide to their members, it would not capture all of the benefits which superannuation funds provide (discussed in Part 6.6). It is important that any balanced scorecard assessment of the operational efficiency of the industry incorporates these additional benefits, either qualitatively or quantitatively.

While it may be attractive to benchmark fees/expenses as a measure of efficiency, lower fees/expenses are not a guarantee of higher net investment returns or *net benefit*. Investment returns are not necessarily correlated to investment fees/expenses – in fact higher investment fees/expenses are often incurred in pursuing investment strategies which, involve a greater degree of exposure to growth and alternative assets which, over time, tend to deliver higher net returns. The quantum of the difference in returns yielded by implementing such strategies tends to significantly exceed the extra investment fees/ expenses, thereby producing higher net returns.

Accordingly, we suggest that the most appropriate single indicator would be *net benefit* to members.
This should be measured: -

- over a suitably long time period;
- across MySuper products. If choice products are to be assessed they should be measured separately.

6.4 Rolling average net benefit to members over twenty years

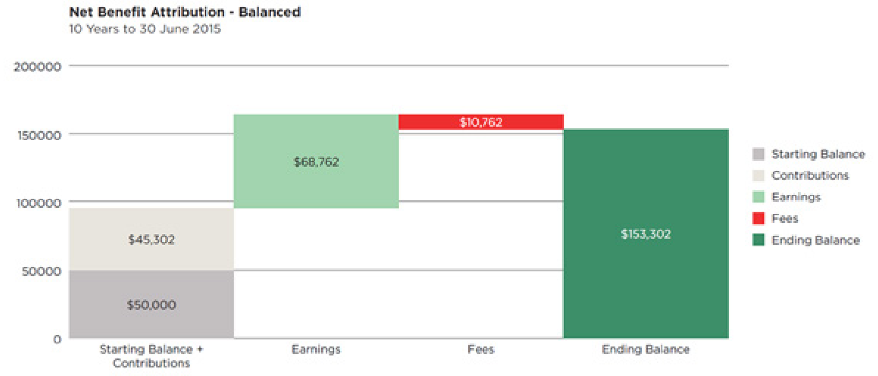
Given the nature of superannuation, where members frequently invest for periods up to 40 years in accumulation and up to another 20 years or more in retirement, coupled with the volatility of investment markets, a suitably long time period is warranted.

Any indicator should take the form of a rolling average across all MySuper products, with a period of at least 20 years.

Given that returns are being measured over a period of at least 20 years, there should be no need to adjust returns to reflect risk. Instead, real returns should be utilised.

The indicator should be applied across the entire population of the products being measured. The average measure of investment and administration fees, operational costs, indirect costs and taxes across all products should be deducted from average gross earnings to determine the average *net benefit* to members of that population of products.

One example of a similar, but slightly different, approach is SuperRatings 'Net Benefit to Member' analysis. By way of example, the chart below shows the median outcome for a member of the 50 largest funds in the industry over the past decade under a scenario with a starting balance and salary of $50,000.



MySuper

In ASFA's view, as the products designed specifically for 'default members', we believe any assessment should focus on MySuper products.

Generally MySuper products are confined to a single investment option, into which all members are placed. The one exception to this is if the MySuper offers a 'lifecycle' product, whereby there are different investment options, employing different strategies, for different cohorts of members. The cohorts can be defined only by reference to prescribed variables. Most often the factor employed by providers to determine the cohorts is the member's age, although sometimes this is used in conjunction with the member's account balance. Generally, as the cohort ages, the investment strategy becomes increasingly weighted towards defensive assets, with (generally) corresponding lower costs and returns. Applying the *net balance* indicator to a MySuper lifecycle product/fund could be done on the basis of a weighted average across all cohorts of members, to produce a figure for that product/fund which could then be aggregated with the figures for the other MySuper products.

Choice

If it is proposed to extend the assessment to choice products then, as an absolute minimum, wrap and platform type products, where the member is able to determine their individual asset allocation and choose to invest and divest in specific assets, should be excluded. In ASFA's view, however, if the *net balance* indicator is to be used to assess choice products, it would only be appropriate to apply it to trustee offered, diversified, investment options which are considered to be a 'balanced' option. 'Balanced' options generally are regarded as being those where the usual allocation to growth assets is between 60 and 80 per cent.

6.5 Benchmark should be a relative one

Given the volatility of investment markets, any benchmark should be a relative, not an absolute, one.

An example of a possible relative benchmark for MySuper (and balanced choice options should they be included) would be CPI growth plus 2.5 percentage points.

Fundamentally, funds need to deliver net investment returns above inflation to ensure that members' balances increase in real terms (notwithstanding the effect of contributions and withdrawals). A benchmark that comprises a margin over inflation provides a means to assess the degree to which funds contribute to members' real balances and, ultimately, to their retirement income.

A CPI growth plus a per cent margin style benchmark is broadly accepted within the superannuation industry as a means of assessing the investment performance of a fund's investment options, after taking into account the effect of investment fees and expenses. Superannuation funds generally publish objectives for their investment returns that are based on CPI growth plus a per cent margin.

Here, of course, we are proposing a *net benefit* indicator, which takes into account administration fees and taxes in addition to investment fees, which will need to be taken into consideration when determining any benchmark.

The proposed benchmark has the benefit of being transparent and easy to interpret.

In applying the proposed benchmark, judgment would need to be exercised in the event of major disruptions to investment markets, such as a protracted series of market downturns; repeated recessions, a financial crisis or a depression.

6.6 Value to members of ancillary benefits, in particular insurance

The Australian superannuation system is unusual in its provision of separately insured benefits as ancillary benefits.

The benefits provided by insurance, as outlined in Part 0, need to be incorporated into any assessment of system outputs.

Default and chosen insurance cover through superannuation has led to much greater insurance coverage of the Australian population than would otherwise have been the case. This reduces the level of underinsurance in the economy and produces a considerable saving on costs that might otherwise be borne by the social security system.

The provision of insurance through superannuation enhances allocative efficiency, by reducing the level of underinsurance and correcting for market failures in the broader insurance market, which leads to a better allocation of resources over time.

The Issues Paper suggests that an appropriate indicator for measuring and benchmarking insurance is the ratio of user costs to claims for bundled insurance. Though the rationale for using this indicator is understandable, there are some issues with this indicator at a fund level, although some of this may be ameliorated with aggregation across the industry:

- there can be considerable mismatches in timing between a premium being paid and the claim being paid (this could be many years);
- assumptions for claims incurred but not reported (which would give an approximation of the expected claims loss ratio) are heavily affected by the specifics of scheme design;
- servicing costs, which are driven by the servicing model adopted by the superannuation funds, will affect the headline claims loss ratio (in some cases transferring costs from the administrator to the insurer);
- if fund memberships are skewed towards certain states then differences in stamp duty between jurisdictions will affect the claims loss ratio.

If this were to be used as a measure, some of the variables within a claims-to-premiums ratio would need to be standardised or removed for fair comparison.

As is the case for insurance, the Australian superannuation system is unusual in its provision of advice to members. Provision of advice represents a material benefit to fund members.

The provision of advice should to be incorporated in any high-level measures of system outputs and outcomes, and thus efficiency. Simple advice related to a member's interest in a superannuation fund can be provided by the fund, where the cost is covered by the administration fees charges (intra-fund advice). The Issues Paper suggests that an appropriate indicator for measuring and benchmarking advice is advice costs, however, data on this may prove difficult to obtain.

Further, member servicing represents a key output of superannuation funds. This includes call centres; assistance to members and employers; interactive web sites, which allow members to view statements and perform some transactions; calculators; member communication materials and member seminars.

In terms of efficiency measurement, robust measures of outputs should reflect the provision of member services and the benefits members derive from those services.

7. BARRIERS TO EFFICIENCY – REGULATION

Key points

1. The regulatory regime is highly prescriptive, and has been subject to significant change. The regulatory framework and constant change has resulted in significant on-going compliance and implementation costs.
2. There are a number of examples of regulation where the net benefit is questionable.

7.1 Regulatory regime is prescriptive and subject to change

The superannuation system operates under a highly prescriptive regulatory regime, which has been subject to significant change over recent years. This was evidenced as recently as the 2016 - 2017 Budget, which announced further wide ranging changes to the superannuation system.

The complex and prescriptive nature of the regulatory framework imposes material on-going compliance costs on the various entities in the superannuation system. Furthermore, the constant changes to the superannuation and tax settings, and to the various obligations and requirements imposed on superannuation providers and members, necessitate the expenditure of significant capital sums in implementing changes to information technology systems, processes and procedures; developing new communication materials and training staff.

APRA-regulated superannuation entities currently contribute to the cost of regulation via an annual supervisory levy. More recently, APRA regulated entities also contributed an additional levy to fund the development of SuperStream. Ultimately, regulatory costs are borne by superannuation members in the form of higher fees.

There are also considerable opportunity costs associated with regulation. Regulation potentially inhibits innovation and product development in the system, as participants' investment dollars are concentrated on implementing changes to comply with the regulatory requirements rather than on product development.

7.2 For some regulations, the net benefits are questionable

The threshold test for any legislative change is whether the total (social) benefits exceed the costs. Regulation that is unnecessarily complex or poorly targeted may fail this test. There are several cases in the current regulatory regime where the net benefit is questionable.

Some examples include:
Work tests for contributions
When accepting salary sacrifice and personal contributions for members aged over 65 the legislation requires the trustee confirm with the member the number of hours they work. A trustee is only able to accept the contribution if the member has worked sufficient hours, otherwise the contribution must be returned. The underlying policy rationale is that this is to mitigate the risk of estate planning, however, there is not necessarily a correlation between employment status and estate planning.

Given that trustees generally are not aware of a member's employment status this obligation necessitates the trustee regularly contacting the member and receiving confirmation in writing. This is both onerous for trustees and intrusive for members. In an era of increasing on-line, real-time, transactions this obligation is especially archaic and can stop automated processing.

This will become an increasing issue as people tend to work longer, or retire but then resume employment. Somewhat ironically, the age test for employers making superannuation guarantee contributions was removed, when age (date of birth) not only generally is known by an employer but is fixed, not a status that changes from time to time and needs to be verified. An age test – as opposed to a work test – would be significantly easier for trustees to implement.

The removal of the work test was announced in the 2016/2017 budget – a welcome, but long overdue, correction.

Trans-Tasman Portability and Australian statutory declarations
The Trans-Tasman portability rules required a person applying to an Australian fund for transfer of their benefits to a KiwiSaver account to provide to a 'statutory declaration'. The application could only be made after the person exited Australia, however, the member had to provide a statutory declaration that complied with the Australian *Statutory Declarations Act 1959*.

This imposed an onerous burden on the applicant, who would have to access staff in the Australian High Commission in Wellington or the offices of the Australian Consulate General in Auckland to witness the statutory declaration. It also placed an unnecessary administrative burden on fund trustees, who were required to deal with member complaints triggered by the rejection of non-compliant applications and created a perception that Australian funds were obstructing the transfer of member monies under the new rules.

It should have been acceptable for a member located in New Zealand to supply a statutory declaration that complied with either Australian or New Zealand law, as is the case under the New Zealand legislation for a member who wishes to transfer their money from a KiwiSaver account to an Australian account. This outcome could easily have been achieved by providing a 'special-purpose' definition of 'statutory declaration' (for the purposes of Trans-Tasman portability only) within the Trans Tasman regulations.

While this subsequently was ameliorated by modifying the legislation, nevertheless it is an example of an unduly onerous and prescriptive legislative provision.

APRA reporting and use of calendar days as opposed to business days
APRA has stipulating the timeframe for quarterly reporting as being 25 calendar days, as opposed to 20 business days. This is problematic in that it fails to recognise public holidays.

By definition, businesses only have 'business days' in which to perform tasks without necessitating people having to work outside their ordinary hours of business, potentially resulting in overtime/penalty payments. This is how the concept of a 'business day' came about.

The month of April frequently has three public holidays that fall on a weekday, which has the effect of reducing the time available from 20 business days to 17 business days. This represents a reduction of 15 per cent in the number of days available to perform the necessary tasks – a material reduction. Similarly, January often has two public holidays falling on a weekday, which represents a reduction of ten per cent in the number of days available. While APRA provided initial relief, through extending the time for lodgement during the transition period, this is coming to an end and the obligation will revert to being 25 calendar days.

8. ALLOCATIVE AND DYNAMIC EFFICIENCY

Key points

1. The superannuation system has a positive effect on economy-wide allocative and dynamic efficiency, including on national savings.
2. Assessment of allocative efficiency is more suited to qualitative, rather than quantitative, analysis.
3. Dynamic efficiency could be assessed through an innovation lens.

8.1 Positive effect on economy-wide allocative efficiency

From a broad perspective, the superannuation system enhances allocative efficiency in the Australian economy.

The superannuation system contributes to a higher national savings rate than otherwise would be the case. The Australian Treasury estimates that the superannuation system currently contributes about 1.5 to 2 percentage points to the national saving rate, expected to rise to 3 percentage points by 2050.[11]

In addition, the superannuation system has facilitated a broadening of the range of assets held by households – reducing households' relative exposure to residential property and bank deposits, and increasing their exposure to equities, bonds, commercial real property, infrastructure and overseas assets. Greater asset diversification contributes to higher risk-adjusted returns and increased life-time incomes for individuals.

8.2 Allocative efficiency difficult to quantify

Allocative efficiency is more applicable to the superannuation system rather than the superannuation industry. Though decisions at the industry level do influence the degree to which resources within the system – i.e. members' superannuation balances – are allocated to their highest value uses, allocative efficiency within the system is more a function of factors that are outside the control of the superannuation industry. This includes the statutory superannuation contribution scope and rates; incentives in the tax system to increase contributions, movements in asset markets and individual member choices.

The allocative efficiency of the system is difficult to quantify, and is more suited to qualitative analysis.

8.2.1 Quantitative analysis

Quantitative assessment and benchmarking of system allocative efficiency would be challenging. For example, whether a system achieves a particular quantitative benchmark of allocative efficiency requires knowledge of the particular preferences of the population. This includes decisions regarding whether to consume or save, and decisions regarding portfolio allocations – including trade-offs of risk and return. Individuals also face personal capital trade-offs arising from decades long changes to health and education systems, as well as the financial system. These changes are contributing to younger people's disengagement from superannuation as they balance the lifecycle' costs of education and housing.

As a result of this, any attempt at a quantitative assessment of allocative efficiency would provide an incomplete, and potentially misleading, assessment.

The Issues Paper suggests some possible aspects of the system for which allocative efficiency could be assessed.

[11] Gruen D. and Soding L. 2011, 'Compulsory Superannuation and National Saving', The Australian Treasury, Economic Roundup, 2011, Issue 3.

Measures of portfolio asset allocation
A key aspect of allocative efficiency with respect to superannuation is the extent to which individuals choose optimal asset portfolios in line with their stage of life.
From a practical perspective, measuring the extent to which the system enables this to occur would be extremely challenging. As noted above, this would require knowledge of the particular preferences of the population.

Measures of adequacy of retirement incomes
The adequacy of retirement incomes is a measure of the extent to which the retirement income system can generate incomes for retirees that support a particular standard of living. As the adequacy of retirement incomes reflects a host of factors that are outside the control of superannuation funds, as outlined in Part 3.1, this is a measure if the efficacy of the retirement incomes system, not the superannuation system or the superannuation industry.

Theoretically, income standards in retirement may be an attractive possible benchmark. For example, the ASFA comfortable retirement standard is the amount of income that is required for a retiree to have a comfortable standard of living, acknowledging that what is considered to be 'comfortable' will be a subjective assessment by each individual.

Any measurement of the adequacy of the current retirement income system should take into account the fact that the superannuation system is immature, as outlined in Part 3.2.3.

8.2.2 Qualitative analysis

Allocative efficiency is more suited to a qualitative analysis. In particular, assessment of allocative efficiency could be undertaken with regard to the barriers or constraints that prevent resources from being allocated to their highest value uses. Such analysis could include the effects of tax settings and the regulatory framework. Previous sections of this submission discuss these issues.

In addition, there are other issues that the Productivity Commission could examine, which are outlined below.

Fee-based competition
As mentioned above in Part 4 an undue emphasis upon fee-based competition risks a broad transition among funds to more defensive investment strategies, which are less expensive to operate. This could have implications for operational efficiency (for example, returns net of fees) but also to allocative efficiency. In particular, a system-wide shift to defensive investment strategies means that members' portfolios are likely to diverge from optimal asset allocations.

Provision of insurance
As discussed in Part 3.2.5 the provision of insurance in superannuation enhances allocative efficiency. The degree to which the superannuation system reduces underinsurance in the Australian economy reflects the degree to which the superannuation system has corrected for market failures in the insurance market. As such, the provision of insurance in the superannuation systems leads to a better allocation of resources.

Retirement decisions
The demonstrated preference of retirees towards term deposits and blue chip shares reflects their familiarity with these products, rather than an active decision around the appropriateness of these products for their retirement needs, and thus may represent a constraint on allocative efficiency.

Excess fund liquidity
The number of funds means excess liquidity is required to fund transaction flows, especially with regard to smaller funds.

The portability and choice features of the system – while of great value to consumers – can add to inefficiency due to higher-than-may-otherwise-be-required allocations to cash (especially for smaller funds or funds with net outflows).This drag on the system can increase the propensity to short-termism, and potentially inadequate capital allocation to support multi-decade investment horizons.

8.3 Dynamic efficiency

For dynamic efficiency, the Issues Paper suggests possible measures could be changes in allocative and operational efficiency over time. Many of the impediments to the measurement of operational and allocative efficiency have already been identified. These are also relevant to the measurement of dynamic efficiency. Dynamic efficiency could be assessed through an innovation lens.

To the extent that robust quantitative metrics for operational efficiency are available, an assessment of dynamic efficiency based on such metrics could be undertaken. This would involve an assessment of the degree to which measures of operational efficiency move towards, or exceed, their given benchmarks over time.

To the extent that measures of dynamic efficiency can be represented by time-based measures of changes in allocative efficiency, qualitative analysis is likely to be the most useful. Such analysis could include time-based assessment of the issues outlined in the previous section. This could include an assessment as to the degree to which tax settings and the regulatory framework have affected the optimal allocation of funds over time.

Dynamic efficiency and innovation
Another possibility may be to assess the degree to which there is movement in the superannuation system's 'technological frontier'. This would include the pace at which innovation is occurring in the products offered by superannuation funds, as well as the quality and levels of services that funds provide.

Part 5.2.4 provides examples of recent innovations to the products and services that superannuation funds provide to their members, and innovations that funds and service providers have made to their internal processes.

Innovation in retirement income products
A key element of dynamic efficiency is the extent to which the superannuation system allows people to manage their superannuation monies optimally through the contribution and drawdown phases.

There are a number of impediments to developing financial products dealing with the consequences of longevity. These include, on the supply side, an overly restrictive regulatory framework and, on the demand side, a lack of awareness among members of such issues as longevity risk and how to mitigate it. This is not an Australia-specific issue. The retirement phase of defined contribution private pension systems generally is underdeveloped globally .

APPENDIX

Methodology for rating superannuation funds

Typically, ratings are based on quantitative and qualitative assessments of a range of fund characteristics.

Ratings usually rank funds from 'top' to 'bottom' based on a set of criteria that have been chosen by the particular ratings agency. Each agency has a different ratings structure.

SuperRatings
For their composite measure, SuperRatings says their "methodology has been designed to reflect each funds' 'Value for money'". In deriving this, Super Ratings places about 45% importance on fees and performance, and 55% importance on other factors like administration, advice and governance

.

Table 3: SuperRatings index methodology

Assessment criteria	Weighting
Investment including: methodology, performance, risk profiles and process	22.5%
Fees & Charges including: cost, structure & transparency over various account balance & employer sizes	22.5%
Administration including: structure, service standards, internet facilities, employer and adviser servicing	10.0%
Advice including: members education and financial planning	10.0%
Governance including: trustee structure, processes & risk management	10.0%
Insurance including: rates, options, terms & conditions	10.0%
Qualitative Overlay including: overall benefits, flexibility & choice, transparency & usability	15.0%

Source: SuperRatings – Methodology Info Sheet