ISA SUBMISSION

ISA Submission to the Productivity Commission

PRODUCTIVITY COMMISSION:
SUPERANNUATION COMPETITIVENESS AND EFFICIENCY

May 2016

Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members. Please direct questions and comments to:

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SUBMISSION

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EXECUTIVE SUMMARY

Industry Super Australia (ISA) undertakes policy research and advocacy on behalf of the five million members of Industry SuperFunds to ensure system settings improve their retirement outcomes. We welcome this opportunity to provide a submission to the Productivity Commission ("the Commission") on the important issue of measuring the efficiency of Australia's superannuation system, which will contribute to enhancing the performance of the system and further improving member outcomes.

At the outset, ISA would like to offer comment on the staged process of the Commission's Inquiry. The Terms of Reference establish a process whereby the Commission measures the efficiency of the super system as a final third stage, after its consideration of default fund processes in Stage 2. However, the insights and findings in relation to the efficiency of the super system which emerge from Stage 3 would be likely to be useful to the Commission's work in assessing processes to allocate members to default funds. We would respectfully submit that, as recommended by the FSI, the application of efficiency criteria and benchmarks should ideally precede the consideration of default fund processes. ISA intends to write to the Government to suggest that Stages 2 and 3 be reordered.

Superannuation – a heterogeneous and complex system

Since the introduction of award and then superannuation guarantee legislation, the super system has evolved to significantly improve the income, living standards and dignity of Australians in retirement. The superannuation system is one of the foundations of Australia's future economic security, both at an individual and aggregate level. The maturing of the super system and planned increases in the level of superannuation guarantee will enhance retirement income adequacy and wellbeing, alleviate fiscal pressures associated with the ageing of the population, continue to provide an important pool of funding for long term productive investment, and continue to help to stabilise the Australian economy when international conditions are volatile.

The structure of Australia's superannuation system is unique globally in its near universality, mandated savings levels and role for the private sector in product provision and management of savings. This structure has involved a significant risk transfer from the state to individuals. The involvement of the private sector has led to large and growing industry segments which derive economic rents from the system. This gives rise to "agency risk" that leads to conduct and outcomes that may be contrary to system objectives.

Section 1 sets out a summary of the key dynamics of the super system, including sectoral differences in structure, asset allocation and performance, and the distribution of member outcomes.

Members should be considered the key beneficiaries of the super system

With the risk transfer and agency issues that are part of the system noted above, we are strongly supportive of the Commission's positioning of members as the key intended beneficiaries of the superannuation system. Section 2 summarises our view on how the Commission's process can be guided by a policy objective for the super system.

Like disclosure, member engagement on its own will not ensure system efficiency or competition on merit

We applaud the Commission for incorporating behavioural economics into its consideration. The decision to create a compulsory system of retirement savings occurred before behavioural economics emerged as a

mainstream school of thought. However, the architects of compulsory super put in place a system which was broadly consistent with what behavioural economic research revealed about the way consumers engage with their finances in the real world. While behavioural economics has since been used to analyse the disengagement of members in the default sector in Australia, its lessons have been overlooked in terms of understanding the outcomes of choice sector members.

In fact, the evidence points to a challenging conundrum for policy makers and economists – those consumers perceived to be "more engaged" typically fare worse in terms of their retirement savings, compared to the outcomes achieved by the members of (largely not-for-profit) default funds.

This is in no small part due to the willingness of many for-profit choice providers to exploit consumers. Research attributes the underperformance of retail funds to "agency issues" – uncommercial payments to related parties, a failure to realise economies of scale, lower allocations to higher returning illiquid assets and retaining members in poor value legacy products. The system architecture and the lower regulatory settings that exist around the choice sector have placed considerable responsibility on individual savers to manage these conflicts of interest and other risks; the evidence would suggest that too often they are not equipped to do so.

While improving financial literacy and engagement is important, particularly for the superannuation industry, the lessons of behavioural economics and the evidence of outcomes of many choice members point to the fact that, like disclosure, member engagement on its own will not ensure system efficiency and competition. More effective consumer protection is needed, with strong settings that connect members to high quality providers and products, even for members who are seen as being more engaged. Section 3 provides a summary of the importance of contextualising any study of the superannuation system within the lessons of behavioural economics. Meanwhile, efforts to further enhance the outperformance of the default system, to incorporate specific net performance measurement into the selection of default products through the Fair Work Commission, remains stalled after legal action by the bank-owned super funds.

In addition to the agency issues listed above, there is evidence of other drags on system efficiency – including non-compliance with SG obligations, poor targeting of tax concessions, the potential for agency issues with employers, a lack of adequate oversight and transparency in corporate tenders, gaps and inconsistencies in super system data (particularly in the retail choice and SMSF sectors) and the fact that the system is early in the process of transitioning from a focus on accumulation to retirement income provision.

Section 4 summarises these issues and a more detailed account of existing research and evidence of these factors is contained in Appendix 1.

A "top down" approach to measure overall system efficiency is warranted

An efficient superannuation system is one that maximises all inputs including contributions from members and concessions and transfers from government, supercharged by strong net returns, to maximise members' retirement income. However as observed in the Issues Paper, it is a complex system and measuring it will present many challenges.

We urge the Commission to focus on developing an overarching method to measure the overall efficiency of the superannuation system in delivering retirement income to members, rather than start from the theoretical framework of 'operational, allocative and dynamic efficiency'. The actual system – all its inputs and outputs – should be compared against a set of constructed benchmarks for inputs and outputs. Existing research on system inefficiencies should assist in identifying the gaps in efficiency between "actual" and "benchmark". We are concerned about a method that starts the analysis with the more granular decomposed aspects of efficiency (such as "technical efficiency"), rather than a high-level input-output

analysis, because it could be difficult to apply to the very complex structures, numerous participants and processes which make up our super system.

We also recommend that system efficiency be tested against a benchmark for retirement income adequacy, including distributional analysis of outcomes by income, gender and age (the latter will reveal whether the system is improving over time). The benchmark must also incorporate the interactions with the age pension system and tax expenditures to assess individual member as well as aggregate fiscal effects. Analysis of the performance of different sectors will also be needed to identify inefficiencies in funds/sectors. Section 5 sets out ISA's formulation of a "top-down" methodology to measure the overall efficiency of the superannuation system.

In measuring the efficiency of conversion of savings into retirement income, a benchmark will need to weigh up competing considerations: maximising the level of income, the longevity of income and the stability of income. Appropriate weightings should be applied to each consideration. Products such as lifecycle products place heavy emphasis on ensuring stability of income, but this comes at a considerable cost in terms of not only reducing the average level of income provided but also create greater reliance on the age pension system, and so these products should not be presumed to be an efficient option.

Finally, while the efficiency of investment by super funds will be captured by criteria related to long-term net returns, the opportunity for the super system to supercharge national savings and direct investment in productive capital assets are of such importance that they should be discretely measured.

1. Overview of the superannuation system

Key observations:

- The Australian superannuation system is made up of many participants. The industry itself has diverse segments with varying outcomes.
- Superannuation saving is compulsory, but the system architecture from that point forward is incomplete. Outside the default segment, there is no policy mechanism that connects savers to high quality providers. There is broad support for the benefits provided by superannuation to be retirement incomes but the policy architecture for this has not been developed.
- The default segment is relatively efficient, achieving significantly lower cost and better net performance than the OECD average and other industry segments.
- The choice segment is relatively inefficient. For-profit superannuation funds have consistently underperformed not-for-profit funds on average over the long term. Many SMSFs also underperform APRA-regulated funds on average over the long term.
- There are significant disparities in the outcomes of the retirement income system, including for many women and low income earners.

Australia's superannuation system has grown substantially since the introduction of award superannuation and the superannuation guarantee. At June 1992, system assets were $142 billion; 23 years later, system assets have grown to just over $2 trillion. The system is still decades from reaching maturity. Total system assets are estimated by Deloitte to reach $9.5 trillion by 2035.[1]

Australia's retirement system is described as a three-pillar approach to retirement income. The first pillar is a relatively modest and means tested government funded age pension. The second pillar is the superannuation system and the third is private savings. A large number of retirees rely on the first pillar, which is below some measures of poverty. As a result, securing reasonable living standards for retired Australians relies, to a greater degree than in many OECD countries, on the second pillar.

Advanced economies generally have either an occupational pension system – mandatory savings paid into a specified employer or industry-based provider with benefits in the form of a lifetime pension – or an alternative system of mandatory private savings. Australia's superannuation system is closer to the latter, being a system of mandatory savings largely delivered by private entities.

The structure of Australia's second pillar arguably gives rise to one of the system's principal weaknesses. The occupational pension systems of many countries provide the basis for a "lifetime wage" and manage longevity, inflation, and investment risk for beneficiaries.

Service providers in Australia's superannuation system are generally private entities, but are highly varied, having distinct characteristics and operating models.

[1] Deloitte, Dynamics of the Australian Superannuation System, 2015, p 2

Figure 1 – Sector heterogeneity

Sector Characteristic	Not-for-profit funds	For-profit funds	SMSFs	System overall
Trustee structure	Operated on a 'run only to benefit members' basis	Run by a profit making parent, to generate a profit	Managed by members	N/A
% market share of super system	41%	27%	29%	100%
Average long term investment performance (%), 10 years to June 2015	6.33%	4.61%	N/A	N/A
Average long term investment performance (%), 7 years to June 2014[2]	3.6%	1.9%	3.09%[3]	N/A
No. of funds	115	146	556,998	261 APRA regulated + 556,998 SMSFs
Asset size of sector ($ billion)	$839	$537	$590	$1,375
No of member accounts ('000)	15,173	13,751	1,050	N/A
No of inactive member accounts('000)	3,760	4,189[4]	N/A	7,949
Ratio of members in retirement phase	7%	20%	36%	N/A
% of total assets in default[5]	81%	19%	0%	N/A
% of choice market[6]	20%	30%	50%	N/A
Average investment options	11	349	N/A[7]	N/A

Source: APRA Annual Superannuation Bulletin 2015, APRA Fund-level Data 2015, ATO Self managed superannuation funds- A statistical overview 2013-2014 Note: Unless otherwise noted, all figures are as of June 2015

[2] This is the longest period that reliable data is available for SMSFs

[3] SMSF average returns across SMSFs by fund size, as reported in ATO Self managed super funds 2013- 2014

[4] Including Retail ERFs

[5] Default assets are calculated from APRA fund-level data as at June 2015, and aggregated by fund type

[6] Choice market size is estimated using the total system assets minus the estimated assets held in APRA regulated default funds. All SMSF assets are classified as choice assets

[7] Note that 12% of SMSFs, representing 5.3% of SMSFs assets, invested in only one asset class (ATO SMSF Annual Data 2014)

1.1 Segment differences in efficiency

There are three broad industry segments in superannuation: Not-for-profit APRA-regulated funds, for-profit APRA-regulated funds, and SMSFs. There are clear differences in efficiency between the various segments of the superannuation industry, and assessing the reasons behind these differences is of central importance. It would be useful for the Commission to consider prior analysis of the operation and efficiency of the segments of superannuation industry by APRA and others. When assessing the outcome of a top-down efficiency analysis as outlined in Section 5, analysis of segment differences helps interpret gaps between a system-level efficiency benchmark and observed system efficiency.

1.2 Sectoral differences in net performance

There are significant and persistent differences in net performance between the various sectors. Over the long term, not-for-profit funds have consistently achieved superior net performance compared to for-profit funds and SMSFs.

Over the 10 years to June 2015, for-profit funds underperformed not-for-profit funds by an extraordinary 1.73 per cent per year.[8]

The performance difference between not-for-profit and for-profit funds is not the result of for-profit funds having an older membership, and therefore a more conservative asset allocation. Analysis of the volatility of the 10 largest funds from each sector, as well as certain benchmark strategies, shows that for-profit and not-for-profit funds exhibit similar levels of volatility.[9] This finding accords with research by the Grattan Institute which found similar levels of volatility between higher fee/lower return and lower fee/higher return funds.[10]

Option level sectoral comparisons by SuperRatings also reveals a similar patterns of significant outperformance by not for profit options when compared to those offered by for-profit providers.[11] For example, SuperRatings found that over the ten years to 2015, the median not-for-profit high growth option outperformed the median retail master trust high growth option by 1.46 per cent (See Figure 2).

Figure 2 – High Growth option returns

	1-year	3-years (pa)	5-years (pa)	7-years (pa)	10-years (pa)
NFP Median	6.14%	12.74%	9.12%	6.79%	5.60%
RMT Median	5.86%	11.80%	8.04%	5.82%	4.14%
All Fund Median	5.92%	12.48%	8.68%	6.40%	5.16%

Source: AIST and Superratings Fee and Performance Analysis, December 2015

New data released last year by the ATO has facilitated closer analysis of SMSF sector performance, although the ATO still flags issues in relation to the true comparability of the SMSF data set. Analysis shows that, on average, the SMSF sector underperforms not-for-profit funds and often underperforms the APRA-regulated sector.

Over the seven years to June 2014 average returns for SMSFs were 3.09 per cent, compared to 1.93 per cent for retail funds and 3.57 per cent for not-for-profit funds.

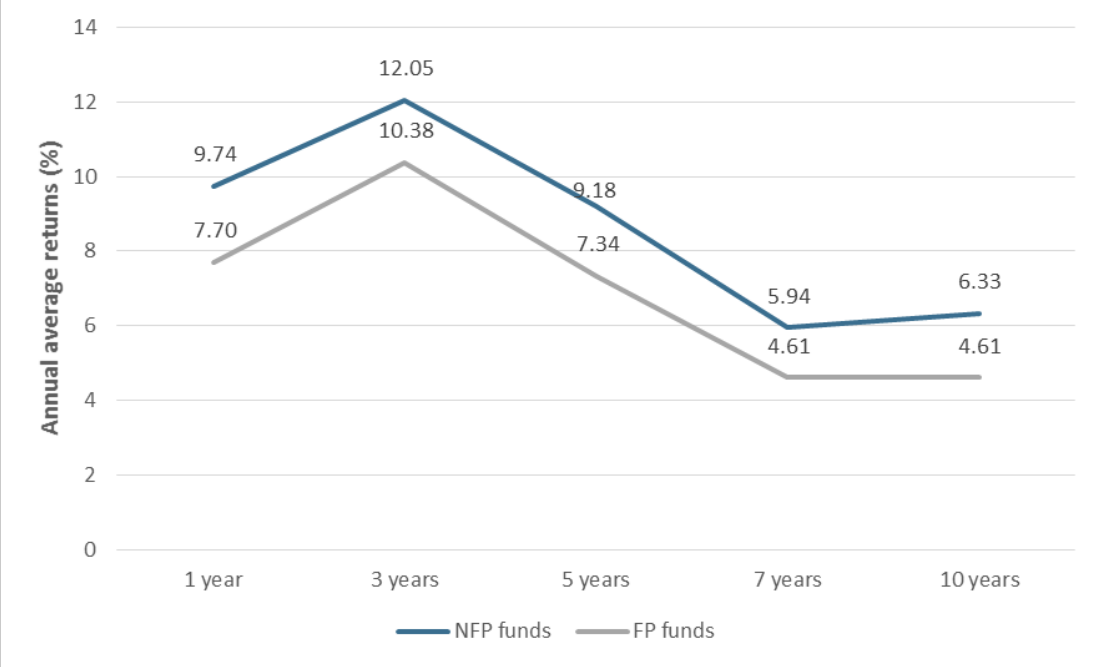
[8] Source: APRA (2015) Superannuation fund level rates of return (see Appendix 1, Figure 1)

[9] Source: APRA (2016) Superannuation fund level rates of return, Frontier Investment Consultants (2016) Proprietary (see Appendix 1, Figure 2)

[10] The Grattan Institute, 2014, Supersting p 45-46

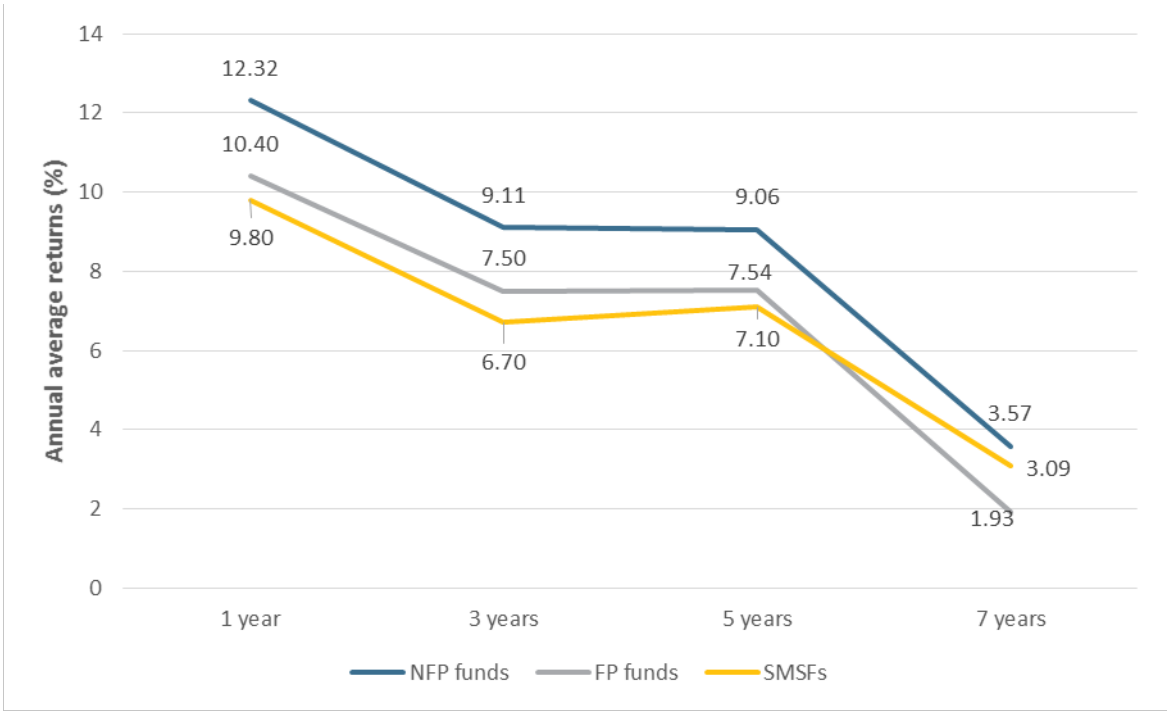
[11] SuperRatings, AIST, Fee and performance analysis, 2015

Figure 3 – Average returns of for-profit and not-for-profit sectors to June 2015



Source: APRA Superannuation fund level rates of return 2015

Figure 4 – Average returns of for-profit, not-for-profit and SMSFs to June 2014



Source: APRA Superannuation fund level rates of return, ATO Self-managed superannuation funds – A statistical overview 2012-2012, 2012-2013, 2013-2014. Note: SMSF figures are only available for 7 years to 30 June 2014

The data also allows a breakdown of SMSFs by size. This paints a concerning picture for most SMSF members, who, over time, are having their savings eroded through sustained poor performance.

Figure 5 – Returns of APRA funds & SMSFs by fund size as at June 2014

		3y	5y	7y	10y	% of SMSF sector by size of fund
SMSFs	$1 - $50k	-15.9%	-13.2%	-15.0%	N/A	6%
	>$50k - $100k	-5.8%	-4.1%	-7.2%	N/A	4%
	>$100k - $200k	-1.1%	0.2%	-3.3%	N/A	10%
	>$200k - $500k	3.3%	3.9%	0.0%	N/A	24%
	>$500k - $1m	5.7%	6.0%	1.9%	N/A	24%
	>$1m - $2m	6.9%	7.1%	3.1%	N/A	18%
	>$2m	8.0%	8.6%	4.6%	N/A	13%
APRA-regulated funds	All funds	8.5%	8.4%	2.9%	5.9%	N/A
	Not for profit funds	9.1%	9.1%	3.6%	6.7%	N/A
	For profit funds	7.5%	7.5%	1.9%	4.9%	N/A

Source: APRA Superannuation Bulletin, ATO SMSF data
Note: NFP fund returns are asset weighted returns of industry, corporate and public funds.

Subscale SMSFs which consistently erode capital through negative returns would appear to be the reality for many SMSF members. Over the seven years to 30 June 2014, 44 per cent of SMSFs have balances <$500,000 and experienced, on average, zero or negative returns each year. In addition, it should also be noted that SMSF performance is likely overstated because many costs (especially time spent by the trustee) are poorly captured.[12]

The data does not support the view that the SMSF sector is competitive.

1.3 Aggregate impact of underperformance

The compounded aggregate cost of underperformance across the whole system over the past 19 years is significant. Using APRA and ATO data, ISA has calculated that if for-profit funds had generated the net returns of not-for-profit funds over this time, our pool of retirement savings would be $76 billion more than it is, an increase of more than 4 per cent. Including SMSF sector underperformance in this analysis (using the longest reliable data available), increases the cost of sectoral underperformance to $111 billion.[13]

1.4 Fees

The Issues Paper states that fees are 'a key determinant of final outcomes for members and an objective measure over which the industry has a greater degree of control than net returns, which could be influenced by many external factors'.[14] While fees are an important part of net performance, reliance on fees alone to gauge efficiency can lead to a false economy in which net performance is compromised to

[12] The ATO notes that their SMSF data do not capture the time and efforts of trustees in operating SMSFs. These costs are more likely reflected in APRA funds. Other data issues which impact the comparability of SMSFs is set out in Section 4. 4. - https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2013-14/?page=53#Appendix_2___Data_issues

[13] APRA (2004) Supertrends; APRA (2016) Quarterly Superannuation Performance; ATO Self managed superannuation funds – A statistical overview 2011-2012; 2012-2013; 2013-2014.The actual retail fund assets is a projection. It does not precisely reproduce current APRA data on retail assets since the projection includes pre-2004 data where the APRA reporting of fund returns used a different methodology. NFP returns are the average simple average returns of industry, public and corporate sectors. SMSF projection starts from 2004 due to data availability.

[14] Issues Paper p 16

achieve lower fees. Long-term net investment returns determine outcomes, and are therefore the critical measure for fund members.

Analysis of returns and fees over the period 2004-2013 shows an inverse relationship between fees and performance – funds that charged higher fees delivered lower returns and did not compensate with lower volatility.[15]

There is a wide divergence of fee distribution across the superannuation industry. The Financial System Inquiry noted that the fees offered on MySuper products still vary widely, with a difference of 136 basis points between the highest and lowest fees.[16] However, not-for-profit default funds typically charge lower fees than for-profit funds. Fees in the not-for-profit default sector have been forced up by the introduction of Choice of Fund and MySuper.[17]

ISA agrees that the Commission should measure fees (broken down into administration, investment etc.) as a subsidiary component of net performance.

1.5 Asset Allocation

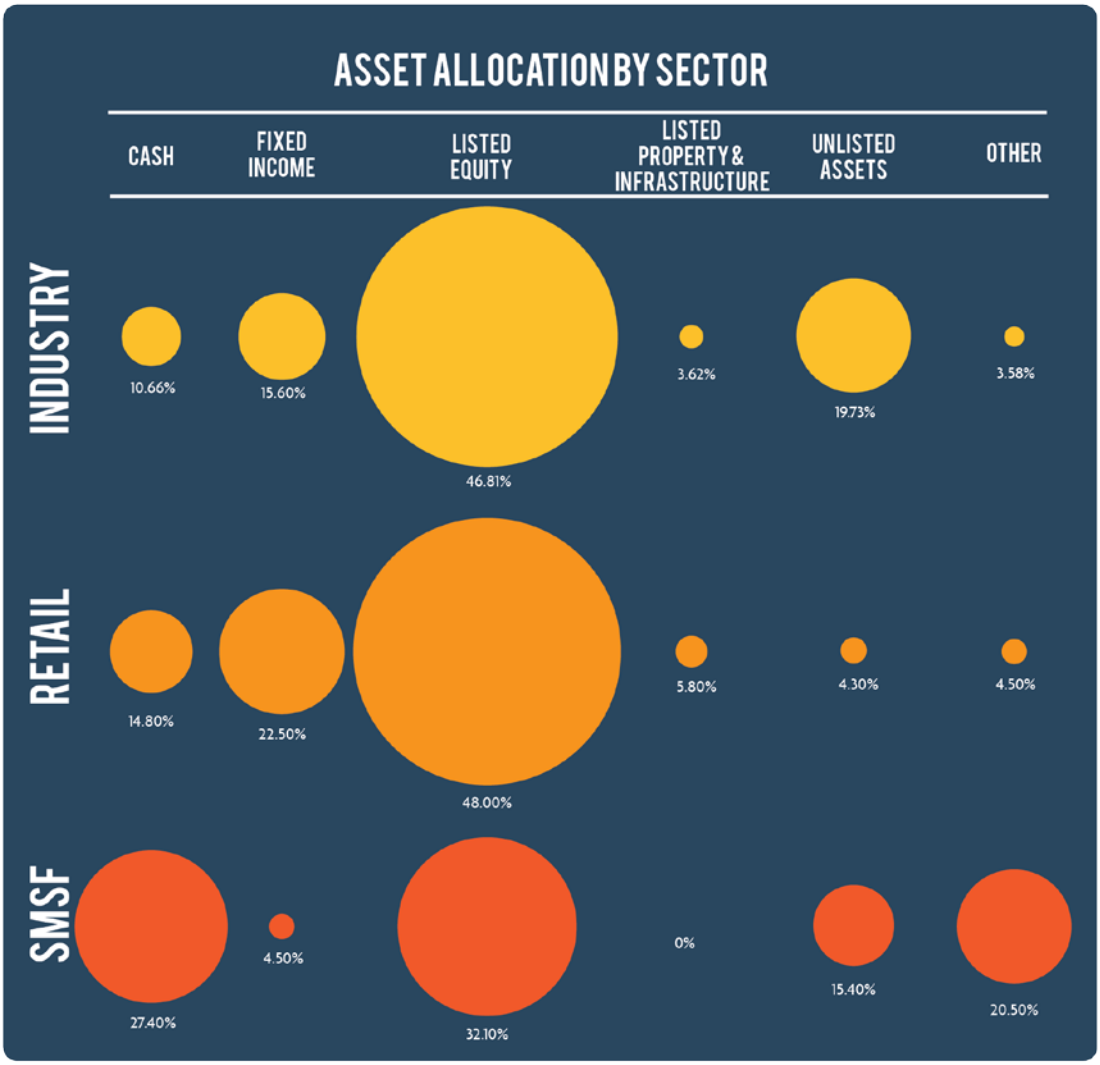
Approaches to asset allocation differ markedly between the sectors, reflecting trustee investment philosophy and expertise, business model and fund scale and structure. The not-for-profit sector has a higher allocation to unlisted assets than other sectors. Asset allocation is a key driver of sectoral performance differences. The higher allocation to unlisted assets in the not-for-profit sector bolsters performance over the long-term and provides diversification benefits.

[15] https://grattan.edu.au/report/super-sting-how-to-stop-australians-paying-too-much-for-superannuation/ p 45

[16] FSI, http://fsi.gov.au/publications/final-report/chapter-2/improving-efficiency/#P193_39044

[17] Grattan Institute, Super sting, 22

Figure 6 – Asset allocation by sector



Source: APRA, Quarterly Superannuation Performance, Dec 2015, ATO Self-managed super fund statistical report June 2014

1.6 Regulatory framework

The superannuation system is subject to extensive regulation ranging from compulsory participation to strict standards for the design of accumulation products. Much of it is motivated, in one way or another, to improving member outcomes. Regulation results in essentially two channels by which members are connected to products and providers: default and choice/advice.

Default funds are selected for inclusion as defaults funds in modern awards and enterprise agreements through a transparent, robust process administered by the Fair Work Commission. Most awards contain a list of funds from which the employer can select the default fund. Employers and employees who have an enterprise agreement have the option of agreeing on the inclusion of a default fund in their agreement.

If there is no default fund specified in the award or enterprise agreement, an employer can choose any MySuper fund as the default fund. Since 2005, most employees can choose a fund that is different to the employer's default fund.

While there is a cost associated with this regulatory approach to the selection of defaults, the cumulative evidence from two decades of performance data demonstrates it has delivered the most efficient component of the system, charging lower fees and delivering better net returns than other sectors. This is not coincidental. The design of default arrangements reflect the reality of member behaviour, and make the "do nothing" option an economically rational path.

By contrast, the choice/advice and SMSF components of the system are regulated based on the assumption that consumer-led competition drives efficiency. In reality this approach has exposed consumers to conflicted business models and encouraged competition-based factors other than net benefit to members. Members of these funds are unfortunately worse off than their counterparts who are protected by the default safety net. In fact, Australia's default funds are lower cost and have better net performance than the OECD average.

ISA agrees with the Commission's previous findings that a "quality filter" is critical to ensure that the best interests of members and of taxpayers are protected into the future. Unfortunately, efforts to further enhance the default system by incorporating specific performance thresholds remained stalled after legal action by for-profit super funds.

Moreover, the safety net should be broadened and strengthened because it is the members outside of that safety net who experience the poorest outcomes. The regulatory framework of MySuper has not improved the efficiency of default products because MySuper does not rule out all but the best products. It was always envisaged that this aspect of default regulation should occur in the Fair Work Commission process.

1.7 Outcomes – distributional analysis

Projected retirement outcomes

The outcomes achieved by Australians in terms of their retirement income vary significantly, with many low-income members failing to meet the comfortable retirement income benchmark, now and into the future. While outcomes will improve as the system matures, many Australians will not retire comfortably in the future unless the system is reformed.

Figure 7 shows the percentage of persons in each age cohort that are projected to receive retirement income – from all sources including the age pension, superannuation, and private wealth outside of super – that equals or exceeds the ASFA comfortable benchmark.

Figure 7 – Percentage of retirees achieving comfortable benchmark

Cohort	Overall	2015	2025	2035	2055
Single Male	50%	32%	46%	53%	56%
Single Female	38%	25%	28%	38%	47%
Couple (per person)	54%	36%	46%	56%	62%

Source: ISA RiceWarner Modelling

2. Objectives of superannuation

Key observations:

- The lack of specific, measureable policy objectives for our superannuation system will make it difficult to measure the efficiency of the system.

Recommendations

- ISA's recommended objective is: To deliver financial security and dignity in retirement to all Australians by providing regular income that is, when combined with any public pension and other sources of income, sufficient to secure a comfortable standard of living by reasonable community standards.
- The Commission should measure the economic impact of superannuation investment and the fiscal efficiency of government funding for superannuation.

As noted in the Issues Paper, the lack of a policy objective for superannuation makes it difficult for the Commission to measure the efficiency of the system. We agree that it is essential to know what the system is aiming to achieve in order to assess its efficiency in achieving it.

Since the Issues Paper was published, the Government has reiterated its intention to legislate the objective of superannuation as "to substitute or supplement the age pension".

The Commission has suggested the interim objective of "delivering the best outcomes for members and retirees". This objective rightly places the focus on member benefit, which is widely accepted to be the central priority of the system.

However, the drawback of the proposed objective is that it is not specific or measureable, even if compared to the Government's proposed objective. Recent years have seen some significant debates around superannuation, both in relation to the fairness of tax concessions and transfers, how savings can be used, and in relation to inadequate outcomes, particularly for women and other low-income earners. Determining "best outcomes" does not assist in assessing the competing priorities of individual members, or determining how limited government resources should be fairly and efficiently utilised. It might be advantageous for some to use the super system for wealth and estate accumulation, but it is not an efficient use of taxpayer expenditure to fund savings in excess of reasonable retirement income needs. While improvements in system efficiency might leave women retirees somewhat better off, it is important for the community to understand that on current settings, many women will not achieve a comfortable level of retirement income, based on all income sources.

Without a concrete objective outlining the level of retirement income that is sought, it is impossible to test how effectively limited private (including member) and government inputs are achieving the policy objective, and the extent to which all Australians are benefiting from the super system. A concrete objective will also better enable benchmarking of whether the system is becoming more or less efficient over time. The outcomes of this study are reliant on being able to undertake such an assessment.

In its submission to the Government's consultation on the setting of a policy objective for the superannuation system, ISA's proposed objective for Australia's superannuation system is:

> *To deliver financial security and dignity in retirement to all Australians by providing regular income that is, when combined with any public pension and other sources of income, sufficient to secure a comfortable standard of living by reasonable community standards.*

This objective has the benefit of being measurable and specific.

In addition to its primary role of providing for members' retirement, the super system should also be considered in terms of its role as a significant component of Australia's financial system and economy. Developing subsidiary objectives would provide an opportunity to define how the system can work most efficiently in these areas.

A key factor defining the role of superannuation in our financial system is the cost and sustainability of superannuation tax concessions. The Commission has noted in its Issues Paper that it does not seek to "develop criteria to assess the overall efficiency of superannuation tax concessions".[18] However, it is difficult to determine overall system efficiency without taking tax concessions into account. ISA submits that this review should benchmark the efficiency of superannuation tax concessions with regard to member outcomes, even if there is no expectation that this process is directed to policy reform.

Thought should also be given to the role of superannuation as a component of Australia's economic landscape. The manner in which the super system invests not only impacts members and retirees, determining the long-term compounded growth of member and government contributions, it also affects the Australian economy in a number of ways. Superannuation is a pool of national savings which can fund direct, long-term productive investment, as well as serve as a macroeconomic buffer to protect our economy from funding shortages and sentiment-driven volatility in global financial markets.

Direct investment by super funds in infrastructure, unlisted equity and unlisted property has the capacity to directly increase member net returns and lift Australia's productivity growth. In turn, a more productive economy benefits members and retirees by increasing employment levels and lifting living standards.

While the efficiency of investment outcomes is captured in long-term net returns, direct investment in productive capital assets is of such importance that it warrant measurement as a discrete element of the super system.

ISA's submission to the Government's consultation can be accessed here:
http://www.industrysuperaustralia.com/assets/Submission/ISA-comment-letter-on-Objectives-of-Superannuation.pdf

[18] Issues Paper, p25

3. Consumers and the competitive landscape

Key observations:

- Behavioural economics points to the fact that strong market regulation and consumer protection settings will enhance rather than impede sound member outcomes and system efficiency.
- While member education and engagement remains important for the superannuation industry, the lessons of behavioural economic theory and the evidence of suboptimal outcomes of many 'choice' members indicates that, like disclosure, member engagement on its own will not ensure efficiency and competition.
- Those consumers perceived to be "more engaged" typically fare worse in terms of their retirement savings, compared to the outcomes achieved by the members of (largely not-for-profit) default products. Stronger consumer protections are warranted for choice members.
- The system does not provide adequate default mechanisms for retirement benefits.

Key recommendation:

- In seeking to formulate indicators of competition, the primary indicator should focus on the outcomes achieved by members. We therefore think the primary indicator of competition is that choice members achieve outcomes that are comparable to those of default members.

3.1 Lessons from behavioural economics

We applaud the Commission for incorporating behavioural economics into its consideration. The decision to create a compulsory system of retirement savings occurred before behavioural economics emerged as a mainstream school of thought. However, the architects of compulsory super put in place a system which was intuitively consistent with what behavioural economic research subsequently revealed about the way consumers engage with their finances in the real world.

As noted in the Commission's Issues Paper, there continues to be an absence of strong consumer-led competition in the super system and there are a number of observable impediments to optimal decision making by consumers including "lack of financial literacy, myopia, loss aversion, reliance on mental shortcuts, a tendency to procrastinate and even general apathy".[19]

In addition to the factors identified by the Commission, product and system complexity plays a part.[20] Product pricing in particular is extremely complex, and many people don't understand the differences between products with literally hundreds of investment options, or the relationship between price and performance. Compounding this, the impact of poor choice does not become apparent for an extremely long time and because people don't buy products regularly there is little scope for experiential learning.

The Productivity Commission observes that many of the decisions consumers are required to make about superannuation are inherently complex, particularly during the accumulation phase. However it could be argued that consumers face an even more significant challenge at retirement, given:

- The complexity of retirement income products (after all, accumulation involves largely maximising risk adjusted returns, but retirement involves converting savings into a stable income for life that maintains its purchasing power; as well as maximising net returns)
- Interaction of superannuation with tax and welfare systems

[19] Issues paper p6

- Uncertainty regarding consumer needs during retirement

The search costs for engaged members who exercise choice are also very high.

These costs are high not just because of the effort and time involved in a complex decision that requires ongoing monitoring. In many instances, key information is unavailable or presented in a manner that is difficult to use. The Government is currently consulting on implementing a product dashboard regime for certain choice products. If implemented in its current form, the regime will only cover a fund's top ten choice options, leaving consumers to overcome substantial information asymmetries. It will therefore be important for the Commission to quantify the full search costs of choice, including the costs of product disclosure and financial advice.

Behavioural finance research is informing regulatory settings internationally. For example, a recent World Bank report[21] found that consumer participation in the market for compulsory defined contribution pensions is characterised by inertia. Ideally consumers would respond to factors like fees and returns, and choose to join the most welfare-enhancing product. They would then make rational portfolio choices in response to changing market conditions until they retire. However, the World Bank notes, there is "ample evidence" that most consumers do not behave in such ways.[22]

The World Bank finds the *strategic behaviour* of many pension funds is a key source of inertia and poor member choices: Many "providers invest excessively in marketing to attract and retain consumers".[23] These conclusions correspond with evidence that significant non-price based competition and agency issues occur in Australia.

After reviewing the features of the mandatory DC pensions, the World Bank concludes that a policy focus on competition and choice seems unlikely to enhance the welfare of many fund members.

3.2 Behavioural economics in the Australian superannuation context

The Issues Paper states that that the Age Pension and welfare safety nets affect the incentives of members to be engaged in their superannuation and that the default settings in existing employment arrangements discourage new competition. There is ample evidence that 'default' and welfare safety nets are actually a sensible policy response to member inertia and other factors identified in behavioural economics. These policies are not the cause of member inertia, but rather an appropriate response to it.

Behavioural economics points to the fact that strong consumer protection settings will enhance rather than impede sound member outcomes and system efficiency, particularly important in a system in which consumers are compelled to save.

Behavioural economics has been extensively used to analyse the perceived disengagement of members in the default sector in Australia. However, its lessons have been overlooked in understanding the outcomes of choice sector members.

Since the introduction of Choice of Fund legislation in 2005 and the subsequent Cooper Review, there has been a continuing assumption that consumers in the choice and SMSF segments of the superannuation system will drive competition, and therefore efficient outcomes, through their informed selection of better performing products.[24] It has been presumed that activity equates with rational decision making, driving competitive outcomes. This is also reflected in the Commission's Issues Paper, which states:

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[21] Impavido, G, Lasagabaster, E. and Garcia-Huitron, M. (2010) *New Policies for Mandatory Defined Contribution Pensions: Industrial Organization Models and Investment Products*, World Bank, Washington D.C.

[22] Ibid, p 12

[23] Ibid, p 24

[24] Sy 2012, p 3

> That said, there is a cohort of people who are engaged in superannuation decisions, for example by managing their own superannuation fund, or by actively managing their investment in the choice segment of the superannuation market. Thus the nature and levels of competition may differ in different segments of the market.[25]

Yet the evidence points to a challenging conundrum for policy makers and economists with this view – as set out in Section 1, those consumers perceived to be "more engaged" typically experience worse outcomes in terms of their retirement savings, compared to the outcomes achieved by the members of (largely not-for-profit) default products.

The poorer average outcomes achieved by choice members are in no small part due to the willingness of many for-profit choice providers to exploit consumers, and research on these agency issues in retail funds is summarised in Section 4. The system architecture and the lower regulatory settings that exist around the choice sector have placed considerable responsibility on individual savers to manage these conflicts of interest and other risks; the evidence would suggest that too often they are not able to do so.

While member education and financial literacy remains important for the superannuation industry, outcomes of many choice members indicates that on its own engagement cannot ensure system efficiency and competition. It is now widely accepted that disclosure on its own is inadequate as a consumer protection measure. We would suggest that the same is true for engagement.

Strong consumer protection and default settings will always be needed in superannuation, but they are not needed just for default members – the evidence shows that stronger protections are needed for those who exercise choice. The compulsory nature of superannuation underscores the responsibility of the system to ensure members benefit from strong system protections. A quality filter for default funds should ensure that these funds compete on the basis of sustained net performance, and this should create a benchmark against which other sectors of the super system are compared.

Indicators of competition should focus on the outcomes achieved by members. The primary indicator of competition in the choice sector is that choice members achieve outcomes in terms of net performance that are at least as good as those of default members.

[25] Issues Paper, P6

4. Existing research regarding superannuation efficiency

Key observations:

- There is substantial research on the super system which identifies leakages and participant conduct issues which reduce member outcomes.
- This literature includes a number of key findings: (i) the superannuation industry is heterogeneous, (ii) some operating models deliver consistently better performance than others, and (iii) the profit motive of the trustee is a powerful indicator of the quality of a trustee. The choice and SMSFs sectors on average materially underperform the default and not-for-profit sector.
- Empirical evidence demonstrates that the facilitation of choice is costly in the context of the Australian super system. Trustees expend significant resources to facilitate choice. Choice affects the ability of funds to allocate assets optimally, and to achieve exposure to illiquidity. For many members, choice has meant they select and remain in underperforming funds.
- A significant level of SG non-compliance, inefficient distribution of tax concessions and the incidence of multiple accounts also hinder efficiency.
- Employers can increase the efficiency of connecting members to providers and products, and information disbursement, but also can have interests that differ from members.
- There are gaps in accurate and comparable data to support this study. Accurate, comparable publicly available performance and other material information for the choice and SMSF sectors would facilitate measuring inefficiencies.
- The delivery of retirement income from superannuation is underdeveloped. In measuring the efficiency of conversion of retirement savings into income, the Commission likely will need to create a benchmark by looking to other jurisdictions and literature on pension products, to ensure that future innovation is facilitated.

Key recommendations:

- The Commission should give regard to prior research and literature on the efficiency of the superannuation system.
- The Commission should identify improvements to official data collections to provide an accurate empirical basis for understanding the super system.

Substantial research has been conducted on the superannuation system. Existing research can help the Commission in a number of ways, including (i) it can inform the Commission regarding how the elements of the superannuation system actually operate (including the behaviour of members and industry participants) (ii) help focus the Commission on what empirical evidence is most important to collect, and (iii) when the Commission assesses the system's efficiency against a benchmark, existing research can help inform the Commission of areas and causes of underperformance.

This section summarises the key findings of this body of research, which identifies numerous sources of inefficiency, many of which are located in the SMSF and APRA-regulated choice sectors. A more detailed explanation of these issues is set out in Appendix 1.

4.1 Choice of fund does not seem to drive optimised member outcomes

The rationale for facilitating greater choice of fund by superannuation members was that they would drive competitive outcomes, lowering fees and enhancing net performance.

However, the outcomes achieved by members outside of the default system are typically poorer – with both the choice and SMSF sector consistently and significantly underperforming the (largely not-for-profit)

default sector. This evidence suggests that members who exercise choice do not understand that they are trading off control for lower returns.

The choice and SMSF sectors are characterised by higher fees, a greater variety of choices and more evidence of agency issues (summarised below).

In addition, there are system costs associated with the facilitation of choice, with funds having to increase their expenditure on marketing, product development, IT and administration.

4.2 Inefficiencies attributable to providers

Independent empirical research has identified many trustee agency issues which undermine the efficiency of the choice and SMSF sectors. This research has largely been undertaken to understand why the products offered by for-profit funds consistently underperform.

Retail funds pay significantly higher fees to related party service providers - There is evidence that trustees of retail funds have paid significantly higher fees to related service providers.[26] Given that 2015 APRA statistics indicate that 85 per cent of service provider expense is paid to internal or associated service providers in the for-profit super sector, compared to only 17 per cent in industry super funds, and 41 per cent in all APRA funds, this research should be updated.

Differences in asset allocation - Not-for-profit funds consistently make higher allocations to unlisted asset classes, including unlisted property and infrastructure.[27] This is in part due to most members in for-profit funds determining their own asset allocation typically on advice from financial advisers, who have been shown to gravitate towards Australian and international equities.[28]

Excessive fees for passively managed retail MySuper products - The advent of low cost MySuper products offered by retail providers has been largely achieved through a shift to passively managed equities.[29] While the jury remains out about the long term performance outcomes of these products, RiceWarner has highlighted concerns that profits are being made by some funds who are inflating investment fees for passive investments.[30]

Economies of scale - APRA research found that the performance of retail funds does not improve with fund size, observing that the structure of retail funds, in the sourcing and offering of their investment products, is less conducive to capturing the benefits of scale.[31]

Conflicted financial advice - Retail super funds use vertically integrated financial advice businesses to sell their products. Historically, advisers have been paid commissions which have compromised advice quality. Notwithstanding the FOFA reforms, retail funds can continue to pay commissions on life insurance sales and under grandfathered arrangements. As a result, commissions will continue to compromise member outcomes into the future.

Conflicted general advice - General advice about superannuation makes financial advice accessible to consumers who would otherwise be unlikely to obtain it. However, anecdotal evidence suggests that banks are cross-selling superannuation to banking customers via general advice channels, for example offering a

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[26] Liu, K. and Bruce R Arnold, 'Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets', *APRA Working Paper*, 12 July 2010, p 2; see also Ellis, K., Alan Tobin and Belinda Tracey, 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds', *APRA Working Paper*, October 2008

[27] Cummings and Ellis, 2011, APRA Working Paper, Risk and Return of Illiquid Investments, p 24

[28] Cummings, J.R. and Ellis, K. (2015), 'Risk and return of illiquid investments: A trade-off for superannuation funds offering transferable accounts', Economic Record, 91 (295), 463-76472

[29] SuperRatings, AIST, Fee and performance analysis, 2015 at 12

[30] RiceWarner, Superannuation Fees, FSI, p 30

[31] Cummings 2012 - 31

lower home loan rate to customers who agree to roll over their super to the bank-owned retail fund. This is also permitted despite the FOFA reforms.

Distribution of SMSFs by accountants - A further contributor to poor quality advice is that the FSR laws provided a broad exemption to registered accountants to recommend the acquisition of an SMSF without the need for an Australian financial services licence (AFS licence). While this anomaly was addressed as part of the FOFA reforms, and will no longer be available from 1 July 2016, the very poor long term performance of many SMSFs may signal the existence of similar agency issues in the provision of SMSF advice, and warrants regulator investigation.

Legacy products - A substantial proportion of assets in the superannuation system are legacy products. Independent analysis has demonstrated that legacy products are more costly than current products.[32] There is no publicly available data on the returns delivered by these products. Consideration of legacy products is important to the Commission's task because the sizeable allocation to legacy products affects the system-wide average rate of return. The Commission should also give regard to why significant assets remain in legacy products, including trustee inactivity, and that advisers can continue to receive commissions from clients in legacy products under the FOFA reforms.

Accrued default amounts - Accrued default amounts are defined in the SIS Act as amounts that are held in non-MySuper products in default investment options where the member has not made an investment choice. They represent default amounts that pre date the MySuper legislation. According to APRA, between 30 September 2013 and 30 September 2015, the total value of accrued default amounts decreased by 76.5 per cent from $220.6 billion to $51.9 billion and the number of number of member accounts that include an accrued default amount decreased by 74.8 per cent from 9.7 million to 2.5 million.[33]

The SIS Act requires that RSE's move their accrued default amounts to their MySuper product by 1 July 2017. Different sectors have undertaken to transfer their accrued default amounts at different rates. As at 30 September 2015, retail funds held 9.5 per cent of total assets in accrued default amounts, compared to 1.5 per cent for corporate funds, 0.4 per cent for public sector funds and 0.1 per cent for industry funds. APRA data shows that the vast majority of accrued default amounts held in corporate, industry and public sector funds were moved into a MySuper product by March 2014. Retail funds are taking much longer to transfer these funds.[34]

This delay in transferring accrued default amounts represents a significant inefficiency in the default system. As discussed there is a significant cost differential in the retail superannuation sector between their pre MySuper default products, which hold accrued default amounts, and their MySuper products. Therefore the time lag in moving these funds represents a significant cost to members.

4.3 Inefficiencies attributable to employers

Where there is no modern award that covers an employee, or where a modern award lists multiple funds, the decision as to which fund to use as a default falls to the employer. For those modern awards that do not list a default fund, the employer may select any fund, provided it complies with the relevant superannuation legislation.

The Productivity Commission (2013) and the Financial System Inquiry both rejected the idea that employers should be able to choose any MySuper product as the workplace default fund as a way to increase competition and reduce compliance costs.

[32] Rice Warner, Superannuation Fees, 2014.

[33] http://www.apra.gov.au/Super/Publications/Documents/1511-ADA-SF-1509.pdf p2

[34] http://www.apra.gov.au/Super/Publications/Documents/1511-ADA-SF-1509.pdf p4-5

Employer search costs - ISA conservatively estimates that the additional cost imposed on employers, should they be required to select a MySuper default fund unaided by a named list within a modern award, would be in excess of $160 million.

Bank bundling - There is clear evidence of banks offering employers benefits to switch to a retail superannuation fund owned by the bank.[35] While this is illegal, the enforcement mechanisms make this prohibition effectively enforcement in practice.

Corporate tenders - Corporate tenders have the potential to improve competition and efficiency in two main ways. A well-run tender can result in an employer replacing their default fund with a new fund which performs better for members. Secondly, the process results in the retention of the incumbent fund, but the employer extracts a better offering from that fund, particularly in relation to fees.

However, there are also a number of significant problems with the way corporate tenders operate. They can be costly for employers and funds. The experience of Industry SuperFunds is that in some cases, following a corporate tender process, the employer selects a fund with which they have an association. And that some tender consultants extract benefits from funds appointed as a result of tender processes. For example, Industry SuperFunds are aware of instances where a tender consultant (or a related entity of a tender consultant) receives a fee per member from the fund that wins the tender process, for instance to provide advice services to default fund members the fund. Finally, anecdotal evidence suggests that the practice of retail funds offering fee discounts as part of a corporate tender on the expectation that members will cease employment with the employer, enabling the fund to flip the member into a higher-fee fund without their informed consent continues to occur. There is no effective regulatory oversight of, or transparency for outcomes of corporate tenders.

Non-payment of SG - New ATO contributions data suggests that non-compliance with the SG is significant and affects the efficiency of the superannuation system. Analysis of detailed ATO data released in 2016 on superannuation contributions at the individual level indicates that, excluding salary sacrifice amounts, the SG payment rate for 2013-2014 was 8.4 per cent. This data set is the best available for accurate analysis of contribution levels. This figure indicates that the aggregate dollar value of unpaid SG for 2013-2014 alone may be as high as $6.2 billion.

4.4 Data gaps and inaccuracies

The accuracy of any assessment of the efficiency of the superannuation system depends in part on the accuracy of the data used.

There are gaps in system level and product level statistics.

It is not clear that there is high quality data about fees and net returns at the sector, fund and product level. APRA fund-level statistics should include detail on legacy products and all choice products, but there are some difficulties in reconciling APRA aggregate data and totals calculated on a fund-by-fund basis. We suggest that the Commission confirm with APRA that its system-wide averages include legacy and all other products, to enable an asset-weighted rate of return. The Commission should obtain a similar confirmation from the ATO about SMSF average asset-weighted returns, and combine these into a system-wide rate of return.

In addition, the Commission's task will require high quality, comparable data about the fees and costs charged by all superannuation products and investment options, as well as their net returns. Currently APRA's data collections do not include details around non MySuper products and options, for instance on gross returns, fees and costs, member and asset numbers.

[35] UMR, SME Employer Attitudes to Superannuation (February 2015)

In addition, the requirements for consumer disclosure of fees and costs are lower for retail fund platform based choice products, with no requirement to disclose embedded investment costs.

While the ATO has sought to improve the granularity and comparability of disclosures by SMSFs, there are still significant gaps and inconsistencies in their reporting requirements compared to the APRA regulated sector.[36] For instance, a driver of SMSF underperformance might be related party business investments in pursuit of tax reduction strategies. If this is so, it is critical that data captures the extent of related party investment, as it does in the APRA-regulated sector. [37]

4.5 Tax concessions

The value of superannuation tax concessions is substantial.[38]

The Financial System Inquiry concluded that "tax concessions in the superannuation system are not well targeted at improving retirement incomes". Commentary following the release of the FSI's Final Report has demonstrated widespread concern that the existing system of superannuation tax concessions is inefficient, unsustainable and inequitable and requires reform.

Recently announced measures by the Government will go some way to rebalancing the distribution of tax concessions however we would urge the Commission to include a measurement of the contribution of government fiscal support to superannuation in their study of the efficiency of the super system. This is particularly important to understand the distributional outcomes generated by the super system, by income, gender and age cohorts.

In addition, the tax treatment of SMSFs is markedly different from the treatment of the APRA regulated sector, advantaging this sector and undermining competition.

4.6 Retirement income – can it be delivered better?

We support an approach whereby efficiency is assessed by comparing existing system performance to a benchmark system. It is widely considered that the delivery of retirement income from superannuation will continue to evolve. As a result, the Commission needs to be cautious about their approach to measuring the way the retirement savings are converted to income, to ensure that innovation is facilitated. The Commission may be assisted by literature on other jurisdictions and optimal pension system design.

When entering retirement, the structure of our superannuation system means that retirees are faced with market risk, sequencing risk, and longevity risk. The Age Pension provides a floor to these risks, but it is below some measures of poverty.

The Financial System Inquiry observed that 'Superannuation assets are not being efficiently converted into retirement incomes due to a lack of risk pooling and over-reliance on individual account-based pensions.'[39]

Modelling by government actuaries indicate that superannuation members would be much better off if their risks were pooled.[40]

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[36] SuperRatings, AIST, Fees and performance analysis, 2015

[37] SMSF members enjoy tax advantages which are not available in the APRA regulated sector, however, the very poor performance outcomes in the SMSF sector gives rise to some questions regarding sole purpose test compliance

[38] According to the Treasury Tax Expenditure Statement 2015, the value of concessional contributions is $15,020m and the value of earnings concessions is $11,100m. While some have questioned these estimates, ATO Taxation Statistics 2013-2014, released on 18 March 2016, support substantially similar valuations to those in the Treasury Tax Expenditure Statement 2015. ISA estimates based on the ATO statistics are:

- $14,967m for concessional contributions
- $11,131m for earnings concessions

[39] FSI Final Report, Page xviii

The Issues Paper notes that lifecycle investment products may play a role in providing stability within retirement income delivery. However, stability is just one of several competing elements of the conversion of retirement savings into income, and it must be noted that lifecycle investment approaches deliver expected stability of returns at a significant cost in terms of income level.

A benchmark will need to weight a few considerations, some of which might be in tension with one another: for instance, maximising retirement income, ensuring income lasts for life, and ensuring the income is reasonably stable in terms of purchasing power. In an optimal system, some accommodation of a modest lump sum withdrawal should be allowed for. The interaction of the first and second pillars is also highly relevant to retirement income product structure and features.

For purposes of the Commission's development of a methodology for measuring the efficiency of superannuation, and to ensure that future innovation in retirement income delivery is not impeded, the benchmark against which existing outcomes should be measured will need to be hypothetical rather than reflect some current product being offered. This hypothetical should be based on an evaluation by the Commission of the relative merits of a range of possible approaches. It certainly should not assume that a lifecycle approach is optimal. Many of the jurisdictions judged to have leading pension systems do not use individual accounts managed on a lifecycle basis. The Commission should evaluate options based on some concept of maximum retirement income for life that maintains purchasing power with relatively low variability of the income. Appropriate weightings should be applied to the level of income, longevity, and stability in terms of purchasing power. The Commission should ideally have regard to the existing literature on optimal retirement income product design (see section 5.2.2).

[40] See, Australian Government Actuary modelling prepared for the Financial System Inquiry, 10 October 2014 (showing that certain retirement income products including risk pooling outperformed an account based pension. The group self annuity plan performed best).

See also, UK Government Actuary, Modelling Collective Defined Contribution Schemes, December 2009 (finding that a "[collective defined contribution scheme] is expected to deliver a retirement outcome over the individual's lifetime that on average is 39 per cent higher than the corresponding DC outcome.")

Cf., Research commissioned by the UK Department for Work and Pensions, Modelling Collective Defined Contribution Schemes, Pension Policy Institute, November 2015 (finding that the "CDC produces better outcomes (a replacement rate of between 27% and 30%) than DC (a replacement rate of between 12% and 21%, assuming a 10% contribution rate). … The modelled CDC scheme has a narrower distribution of outcomes than DC.")

5. Measuring efficiency of the superannuation system

For most Australians, the superannuation system supplements the age pension to enable them to retire with a level of income which provides greater dignity and security in retirement. An efficient superannuation system would be one that maximises all inputs (notably, contributions from members and concessions and transfers from government) to deliver the maximum level of retirement income possible, including through strong net returns and products that efficiently convert savings into high, stable retirement income for life. The universal nature of Australia's super system is often commended; but improving the outcomes achieved across different incomes, between men and women and across different generations, remains a "work in progress".

Assessing the efficiency of a system or "productive activity" involves:

(i) determining the relevant inputs that the system converts into outputs – this requires knowing what is and what should be measured, and
(ii) determining whether that conversion of inputs into outputs is relatively good or bad – this requires a benchmark.

The deviation from the benchmark provides some indication of the efficiency of a system.

Significant public and private resources are contributed into the superannuation system and are either converted into retirement benefits, withdrawn as lump sums or accumulated as a residual estate. There are also some ancillary outputs (insurance, advice etc) and, as noted in Section 2, some very important secondary outputs including the capacity for super funds to enhance productivity and growth through capital investment, and contribute to national savings and financial stability.

With that in mind, we urge the Commission to prioritise the development of a methodology to measure the overall efficiency of the superannuation system. Central to this measurement is comparing the actual inputs and outcomes achieved against a set of benchmark inputs and outcomes of the system, including benchmark levels of adequacy. This will enable the study to understand whether Australians' retirement income might improve were the system operating more efficiently.

Once this overarching high level assessment has been undertaken, then different aspects of the system, for instance, compliance with SG, the "value add" provided by different types of funds or sectors and so on, can be assessed in more detail using some of the indicators and factors discussed in the Issues Paper under the topics of "operational," "allocative" and "dynamic" efficiency. However, the overarching measure of system efficiency will enable all those subsidiary elements and measures to be properly contextualised, weighted and thus more easily interpreted. In particular, the overarching measure will help identify where key areas of inefficiency are located to ensure priority is given to attending to the most material leakages.

We agree with the Issues Paper that efficiency can be "decomposed" into "technical", "allocative" and "dynamic" components. This approach allows the productivity of an organisation to be analysed on the basis of technical efficiency (achieving the maximum output available from a determined group of inputs), allocative efficiency (purchasing the best package of inputs given their prices and marginal productivities) and dynamic efficiency (whether technical and allocative efficiency improves over time).

However, we are concerned that an approach which starts with these more granular components of system efficiency may add a layer of unnecessary complexity, be hard to contextualise, and be difficult to apply to the very complex structures, different participants and processes which make up our super system.

This is evident even in the Issues Paper, which highlights the difficulty in readily assigning aspects of the super system to different efficiency components. For instance, while a traditional decomposition of technical efficiency would focus on cost reduction, such an approach is unlikely to be helpful in the analysis of the super system and so sensibly the Commission retains net returns as a preferred indicator.

Recognising the practical difficulties and methodological limitations of economic efficiency analysis is important because the Commission has been asked to develop a method of assessing the efficiency of a complex system that exists in the real world, on which real people — individually and as a society – rely.

The development of a method for assessing the efficiency of the superannuation system presents a difficult challenge for the Commission, because the ability to apply abstract concepts of economic efficiency measurement to superannuation will run directly into recognised limitations of the economic efficiency methodological toolkit, and criticisms of the method. In particular:

- The techniques for economic efficiency analysis have been developed for tractability, not realism.[41] It can be difficult for policymakers to determine how to use economic efficiency analysis for real world decision-making.[42]
- Economic efficiency analysis is based on an assumption that the objects of study exist in a closed system, ie, one with causal regularities (eg, whenever event or state *X,* then event or state *Y* occurs).[43]
- The techniques for economic efficiency analysis have been developed primarily for the analysis of firms rather than systems, with very simplified interactions, inputs, and objectives. Economic efficiency analysis generally is not applied to sectors where the "production function" is not as complex as Australia's superannuation system, where inputs are varied and/or not easily observed, and there are a range of outputs.

5.1 Practical considerations and methodological challenges

We would urge the Commission, in developing criteria and methodology to measure the efficiency of the super system to:

- Focus on empirical information, and build a framework to fit the facts rather than adopting a methodological approach that seeks to fit the facts to a theory
- Be expansive in considering possible relevant inputs and outputs
- Consider the existing availability of data, and work to improve areas where there are gaps or inconsistencies in available data (as set out in Section 4)
- Make express the judgments made about what inputs, outputs, and benchmarks are relevant and why (on which the Issues Paper obviously invites comments)
- Assess the outputs in terms of distributional outcomes of retirement income by gender and income, as well as by age cohorts, as a means of measuring the extent which aggregate and distributional outcomes change over generations

5.2 Suggested approach to measuring system efficiency

The Issues Paper invites input on the methodological approach to be adopted by the Commission in studying the efficiency of the super system.

ISA urges the Commission to prioritise the development of a methodology to measure the overall efficiency of the superannuation system. Central to this measurement is comparing the actual inputs and outcomes

[41] See, e.g., Mäki, Uskali, On the method of isolation in economics, Recent developments in economic methodology, Vol. 3. Davis, J. & J.B. Davis, eds. (2006); see also Mäki, Uskali, Realistic realism about unrealistic models. *Oxford handbook of the philosophy of economics*, eds. Harold Kincaid, and Don Ross (2009), 68-98, at 81-85

[42] See, e.g., Bromley, Daniel, The Ideology of Efficiency: Searching for a Theory of Policy Analysis, Journal of Environmental Economics and Management (1990)

[43] See, e.g., Lawson, Tony, *Reorienting Economics* (2003)

achieved against a set of benchmark inputs, outputs and outcomes of the system, including benchmark levels of adequacy. This will enable the study to understand whether Australians' retirement income might improve were the system operating more efficiently, including in a distributional sense, and where key areas of inefficiency are located to ensure priority is given to attending to leakages.

The first step in such a process would involve determining and measuring (i) inputs, (ii) outputs, and (iii) establishing a benchmark for these and the overall system performance. Our views on these elements are outlined below.

Figure 8, which is a graphical depiction of our proposed methodology depicts key inputs and outcomes and aligns them with areas of known inefficiency against the various inputs and outcomes of the system, and is based on the literature and research on system inefficiencies referred to in this submission..

5.2.1 Actual and benchmark inputs

This section sets out ISA's view about the inputs that are relevant to an overall assessment of system efficiency. We will first identify the way that actual current inputs might be measured, and then propose how these might be benchmarked against more optimal settings.

Relevant actual inputs (or resources allocated to superannuation) to be measured (including where relevant distributional breakdowns) include:

(i) Member contributions (broken down by SG, salary sacrifice, concessional voluntary, after tax and in specie separated to the extent possible). This would presumably be able to be obtained from the ATO.

(ii) Government contributions (tax expenditure and transfers, eg Low Income Super Tax Offset). Again, this data should be available from the ATO.

(iii) Member "search costs." Typical costs will not be uniform and will depend on the distribution channel by which a member is connected to providers and products, and the type of products in which the member is invested, with costs increasing as the member assumes greater responsibility for their selections. This input should include all financial advice costs and SMSF Trustee costs. Actual costs could be modelled based on actual costs (where available) and estimated costs.

(iv) Government regulatory and related costs. Significant public resources are expended developing law and regulation, as well as enforcing it, and this input could be estimated based on the costs incurred by regulators and government in supervising the superannuation system.[44]

(v) We also propose that net investment performance should be treated as a system input- the "value-added" contributed by product providers. This would be calculated based on aggregated sectoral gross returns, less indirect costs and direct fees. It would be beneficial to obtain/extrapolate detailed breakdown of all components of net returns to allow analysis of fund operational efficiency – for instance gross investment returns, fees (broken down by fee type), costs, expenses (including breakdown of types of expenses – i.e. marketing). Alternatively, net returns could be treated as an interim output. However, as already recognised by the Commission, net performance is a critical component of the performance of

[44] Recognising that the cost of law, regulation and enforcement is an input does not mean we question the need for strong regulation. We support strong regulation, because the cost is justified. It is possible that more regulation is required for some systems than others. Superannuation is one such system because consumers are at higher risk (due to compulsion, information asymmetry, cognitive limitations, among other factors). It is also the case that system design and market conduct can impact regulatory costs. For instance, the regulatory cost of permitting conflicted remuneration structures in financial advice have been very significant. While regulation may incur cost, in financial market regulation, it is certainly the case that less or no regulation can prove to be significantly more costly.

the super sector, and thus it is important that it be discretely measured and tracked to understand the extent to which net investment performance can be enhanced.

(vi) Other system costs, such as employer costs. Again, this will not be uniform across the economy, but some assumptions will be made regarding the costs borne depending on their involvement in selecting a default. For instance, conducting a tender incurs significant cost if a third party consultant is engaged.

Some inputs are currently not optimal. **ISA proposes that the following be considered in terms of benchmarking inputs:**

(i) Benchmark member contributions would be similar to actual, but adjusted to assume full compliance with SG. Other actual member contributions (broken down by salary sacrifice, concessional voluntary, after tax and in specie) should be included.

(ii) Government contributions (via tax concessions and transfers) should be based on actual contributions. Analysis of "efficiency gaps" might invite some analysis of the efficiency of targeting of government support, having regard to the distribution of outcomes across income, gender and age cohorts.

(iii) Member "search costs." Optimal search costs should be premised on the lower costs associated with a strong safety net of default settings. A safety net that covers more people and that has stronger protections for those who are considering exiting. This will ensure that measurement can capture the extent to which member search costs are offset by improved outcomes.

(iv) Government regulatory and related costs should be benchmarked against regulatory costs but modelled based on long term stable policy and regulatory settings and less incidence of agency issues.

(v) We propose that benchmark or optimal net returns be based on the actual net returns received by a cohort of funds with a track record of strong long-term net performance. The benchmark system should assume all members would have their superannuation managed by trustees which achieve the net performance outcomes of this cohort.[45]

To measure net performance we propose (i) historical long term average returns of a cohort of funds with strong long term net performance for back-casting, and (ii) for projections, the expected average long term returns for a portfolio of assets that reflects the portfolios of the selected cohort of funds. Each asset class in the basket would have a long-term expected rate of return and correlation, which would be amalgamated. The reason we would not use risk adjusted returns is not because risk is ignored, but because it is not necessary due to the nature of the measurement being conducted. Over the long term, the periodic volatility should be reflected in the average. It is therefore unnecessary to use a volatility adjusted ratio, or attempt to define which risks would be included.

As the net performance of the benchmark funds will be an input into the overall model, the distribution of expected returns in the stochastic analysis would be informed by historical volatility of the portfolio, as well a number of expert judgments about what the future distribution of probabilities should be. Put another way, the impact of volatility would be captured in the stochastic analysis.

(vi) Consistent with our proposed benchmark for member costs, optimal employer and other costs should be premised on an assumption that an effective quality filter is applied, such as

[45] The Grattan Institute used a similar approach in *Super Savings*

the stalled Fair Work Commission process, with broader coverage and stronger exit protections, which minimises the costs on employers in selecting default arrangements.

5.2.2 Actual and benchmark outputs

5.2.2.1 Primary output – retirement income provision

For most Australians, and certainly most Industry SuperFund members, their superannuation savings combines with the Age Pension to deliver a higher standard of living than if they were solely dependent on the Age Pension. The primary system output that should be measured is the provision of income attributable to superannuation in retirement. However, actual current output also includes many members who withdraw lump sum benefits (particularly those with modest balances) and some who retain residual estates in their super, either through conservatism in drawdown/spending in retirement or to provide a bequest.

Section 4.6 sets out some considerations in relation to measuring the efficiency of conversion of retirement savings into retirement income.

We suggest that the Commission measure the actual system output in terms of payment of average annual retirement income for life attributable to superannuation for certain age cohorts in aggregate and for different income quantiles, weighted by probability of being alive.

For historical periods, actual benefit payments should be used where possible, categorised by income stream, lump sum and residual death benefits.

The projections would also need to be subjected to stochastic testing to determine the sensitivity of the income level, stability, and longevity to assumptions around investment, longevity, and inflation.

Therefore, to summarise, the calculation of actual provision of retirement income – the primary output of the superannuation system – would involve historical analysis and a group projections model, with the groups built around income/wealth, gender, and age cohort. These groups would need to be simulated into the future, which would involve allocating them to industry segments, applying tax and transfer settings, and applying future net returns expectations, with income streams and other benefits paid based on observed behaviour by group.[46]

5.2.2.2 Benchmarking the primary system output of retirement income provision

The formulation of a benchmark for the primary system output of provision of retirement income is important, because as has been widely acknowledged, Australia's super system is still transitioning from a focus on accumulation to a focus on retirement income. As noted by both the Cooper Review and FSI, aspects of the current system of converting savings into lifelong retirement income are not operating as well as they could. Future innovation in retirement income provision and establishing better default and regulatory arrangements in retirement should further improve member outcomes.

In order to construct a benchmark for efficient delivery of regular and stable retirement income for life attributable to superannuation, we suggest that the Commission develop group projections to create benchmark settings for the way retirement income products convert savings into the highest level of reasonably stable retirement income that lasts for life.

These considerations, of (i) level of income, (ii) stability of income, and (iii) lasting for life, compete. For instance, greater stability can be achieved – by individuals – only by changing investments to more conservative assets, as is the case in lifecycle products. However, reducing risk retards expected returns,

[46] ISA has spent nearly two years with Rice Warner developing a group projections model to do this. ISA can brief the Commission on this model.

and thus the level and longevity of retirement income. Aside from individual approaches, there can be group-based or collective approaches.

Therefore to test the efficiency of income conversion, the benchmark could be developed by first creating prototypes of a broad range of possible approaches to or structures for the delivery of retirement income (for instance, lifecycle investment, deferred annuities, group self annuitisation, target pension plans, and others), testing each prototype, and using the results to arrive at benchmark weightings for the above considerations. As noted in Section 4, the Commission may wish to refer to the body of relevant literature on optimal pension plan design relevant to this aspect of the study. [47]

Combining the benchmark inputs with the prototype retirement income delivery approach, the model would enable comparison of actual outcomes in terms of provision of retirement income against a benchmark for efficient provision of retirement income.

As noted above, measuring the outputs relevant to the policy purpose of superannuation involves measuring retirement income and measuring the level of dignity and security achieved, and the distribution of outcomes. We suggest that actual and optimal outcomes then be assessed against a tangible benchmark. Analysts tend to use budget benchmarks for the purpose of assessing superannuation adequacy. [48] In the current study, use of a tangible benchmark is particularly important to aid analysis of distributional outcomes, by income cohorts, gender and age cohorts.

We submit that the ASFA comfortable benchmark is a broadly supported and reasonable benchmark.

5.2.2.3 Secondary factors or outputs

In addition to the primary social purpose of superannuation, there are secondary factors important to beneficiaries and to the interests of the community and the government. These include members' best interests, sustainability, investment, national savings, financial stability, risk allocation and management, and regulation and safeguards among others. Outputs relevant to these factors also should be identified and considered.

As noted in the Issues Paper, consideration of negative outputs may also be appropriate. While efficiency analysis is sometimes limited to certain sought-for outputs, there are often other outputs that are not sought, but arise nonetheless. We agree that by including negative outputs, efficiency analysis becomes

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[47] See, e.g., Cui, de Jong and Ponds, Intergenerational risk sharing within funded pension schemes, Journal of Pension Economics and Finance, January 2011 (finding that "well-structured intergenerational risk sharing via collective schemes can be welfare-enhancing compared to the optimal individual benchmark, and that the expected welfare gain for current members is not at the expense of older and future members." Although plans that can adjust both benefits and contributions are superior, plans that only can adjust benefits with fixed contribution rates (as would be expected for Australia) are welfare-enhancing.); Beetsma & Bucciol, Risk Sharing in Defined-Contribution Funded Pension Systems, Netspar Discussion Paper, November 2011; Gollier, Intergenerational risk-sharing and risk-taking of a pension fund, Journal of Public Economics (2008) (finding that "In a funded system with individual pension accounts, the absence of any intergenerational sharing of individual portfolio risk implies that workers face high uncertainty on their future pension wealth. … a better intergenerational risk-sharing scheme makes it socially efficient to raise the collective risk exposure in order to take advantage of the large equity premium. When risks are exogenous, the only benefit of intergenerational risk-sharing is to make pension benefits safer, without changing the mean performance of savings. In our model, risks are endogenous since the fund has the freedom to reallocate its reserves between a risk-free asset and a risky asset. A better intergenerational risk-sharing raises the demand for equity."); and Blommestein, Janssen, Kortleve and Yermo, Evaluating the Design of Private Pension Plans: Costs and Benefits of Risk-Sharing, OECD Working Papers on Insurance and Private Pensions No. 34 (2009) (discussing a broad range of risk sharing plans, including hybrid DB plans).

[48] See, e.g., Burnett, et al, Measuring Adequacy of Retirement Savings, Melbourne Institute Working Paper No. 5/14, March 2014 (stating that "A key issue is the specification of target retirement income levels. For the purposes of this article we use a benchmark widely used in Australia for retirement income provided by the Association of Superannuation Funds of Australia (ASFA) (2012).")

See also, Saunders, Updating budget standards estimates for Australian Working Families in September 2003, Social Policy Research Centre, February 2004 (explaining that "The principal advantage of a budget standard is that the assumptions and judgments on which it is based are made explicit, and this transparency provides a valuable basis for informed debate on questions of the adequacy of living standards.").

We also note that ASFA's budget-standard benchmarks have been found to correspond to mean incomes of retirees in HILDA surveys.

Lastly, Burnett et al (2014) also rejected the use of replacement rates for assessing the adequacy outcomes of the superannuation system ("Our analyses also suggest that the income replacement ratio has some limitations as an indicator of retirement savings adequacy. Most importantly, the income replacement ratio tends to be higher for low-income groups and lower for high-income groups, despite the latter group having higher consumption levels. This suggests that the income replacement ratio should be supplemented by other measures of savings adequacy to obtain a more comprehensive view of income or consumption during retirement.").

more realistic, and the endeavour of the analysis becomes finding some mix of inputs and some method of conversion of inputs into outputs that achieves the objective of the system (or maximises the beneficial outputs) while minimising or eliminating the negative outputs.

Below are proposed relevant outputs to be measured for (i) the primary social purpose of superannuation, (ii) secondary factors that are not likely to be captured otherwise, and (iii) negative outputs.

Secondary outputs

Some secondary factors or outputs would be included in the primary social purpose analysis, or revealed when comparing the superannuation's system performance against benchmarks. These factors include members' best interests, sustainability and risk management. Other secondary factors are not outputs, such as regulation. The secondary factors that are outputs, but would not be included in an analysis of the primary objective, and therefore would be relevant for separate analysis, include:

- The degree to which superannuation is invested in ways that enhance broader economic performance or wellbeing – for instance, through fixed capital investment, increased employment or productivity. The community and government have an interest in the manner in which superannuation invests that is separate from the interests of any individual member. The relationship between investment and national wellbeing is not well understood, but some straightforward outputs are possible:
  - Employment attributable to superannuation investment. There might be reasonable links between the flow of funds into certain asset classes in certain sectors, and employment in that sector, which could be estimated.
  - Productivity growth attributable to superannuation investment. There are reasonable links between capital formation and productivity growth and between the flow of funds into certain asset classes and capital formation. Therefore, it should be possible to estimate the capital formation, and therefore the productivity growth, attributable to superannuation.[49]
- The degree to which superannuation contributes to national savings.
  - Treasury has sought to estimate the contribution of superannuation to national savings. In addition, there are "natural experiments" available in the history of superannuation that would enable greater empirical rigour to be applied to these estimates.[50]
  - The follow-on effects of the contribution to national savings have been less explored. These could include reductions in Commonwealth borrowing costs and domestic investment volatility.[51]
- The degree to which superannuation contributes to financial stability. The measurement of financial stability is an evolving area, though there are some indicators.[52] Whether these indicators are sufficiently mature, and the manner in which superannuation could affect them is sufficiently well understood to measure, remains an open question.

[49] Note that not all activity that the superannuation industry considers to be "investment" results in capital formation. For example, the purchase of ordinary shares in the secondary market is "investment" even though this activity results in no capital formation.

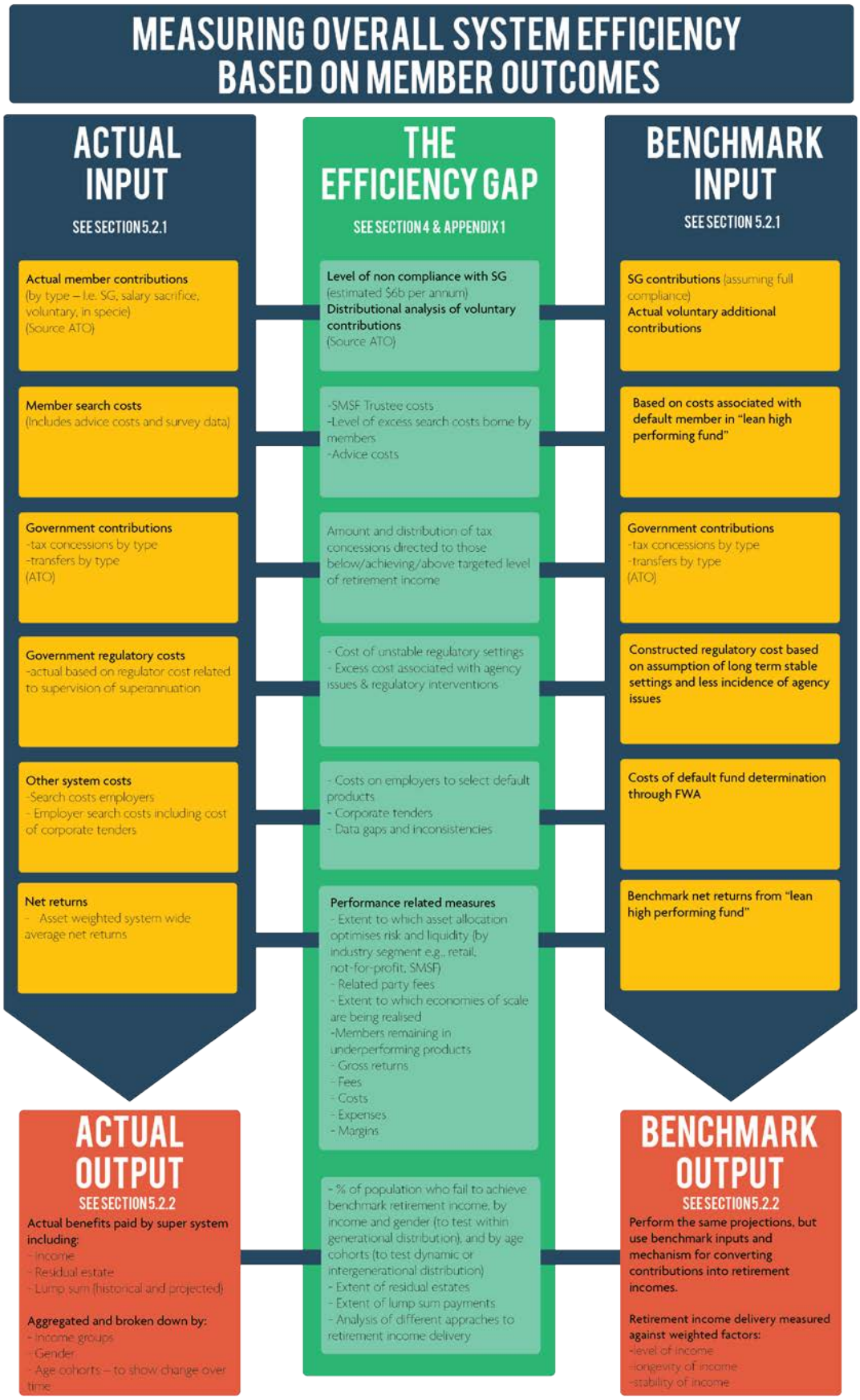
[50] In particular, analysis by Shanker and Vidler (2014) examined voluntary contributions amongst two groups of employees on different compulsory rates within the same superannuation fund to determine whether individuals make voluntary superannuation contributions according to independent preferences representing how much people believe their overall savings should be, they found that an increase in the compulsory rate seems to be carried over entirely into an increase in total contributions; either because individuals make voluntary contributions without any consideration of how much their overall savings ought to be, or because the compulsory rate influences the subjective evaluations of savings preferences (effectively anchoring bias). These results suggest that compulsory savings may be offset by savings reductions elsewhere to a lower degree than previously believed (and perhaps not at all).

[51] However, to the extent that superannuation has encouraged the financial sector to create financial assets rather than facilitate the creation of capital, superannuation might have had little effect on investment volatility. Instead, it might have had a positive effect on financial services profit, and the volatility of the price of financial assets.

[52] See generally, Proceedings of the IFC Conference on "Measuring financial innovation and its impact", Basel, 26-27 August 2008, IFC Bulletin No 31, July 2009. In particular, Gadanecz and Jayaram, Measures of financial stability – a review, Bank of International Settlements.

- Risk management. Participants in superannuation face risks: agency risk, investment risk, sequencing risk, longevity risk, political risk, and others. The efficiency with which many of these risks are identified and eliminated (or credibly mitigated) should be reflected in the primary measure of retirement income.
  - Life and TPD insurance in superannuation should be considered because they represent a reason for retiring, or no longer being able to work. Exiting the workforce due to death does not align with a consumption smoothing approach to retirement benefits (unless some provision is made for an estate to address residual liabilities after death), but does align with dignity and security taking into account that many Australians have dependents in some form or another.
  - Measuring the efficiency of life insurance and other forms of insurance in superannuation could be performed by simply comparing premiums paid to benefits received for the system as a whole. A more sophisticated analysis might look at the expected benefits payable per dollar of premium to certain cohorts (eg, with cohort grouping based on age, gender, and occupation), and determine whether certain cohorts are effectively subsidising others due to a failure to fairly price risk. The question then becomes whether the transaction costs of more tailored pricing are justifiable.

Figure 8 – Measuring overall system efficiency – member outcomes



Negative outputs

We are not aware of substantial research in this area, but there could be possible negative social and individual effects of superannuation. Some possible negative effects could include: (i) increasing inequality between men and women, old and young, well-paid and otherwise, and (ii) lower levels of social cohesion, and greater levels of a sense of individual entitlement.

5.2.2.4 A focus on certain inputs

While systemic inputs and outputs could be compared in aggregate, ISA submits that the Commission should also consider the efficiency of certain inputs in isolation. In particular, the inputs of key stakeholders in the system should be isolated. Chief among these is the concept of fiscal efficiency and member efficiency.

Fiscal efficiency would assess efficiency of the direct and indirect government fiscal support to superannuation. It would evaluate the degree to which direct contributions made by government (eg. the Low Income Super Contribution and co-contributions) and indirect contributions or expenditures (eg. tax concessions) translate into retirement income support that is well-targeted. The Commission should measure whether such government support was effectively adding to retirement income that raises individuals to a benchmark level of income (in which case it is efficient on its face) or was going to those who would be well above such a standard without the government support.

ISA preliminarily analysed the fiscal efficiency of the existing tax and transfer settings in our submissions to the tax white paper.

Member efficiency would seek to isolate the efficiency of the conversion of member contributions by age into lifetime retirement income. This would involve determining the degree to which contributions made by employers on behalf of members deviates from members' their legal entitlements, and the efficiency of the benefit delivery conversion of contributions actually made on behalf of members.

5.2.3 Interpretation of differences from the benchmark

Where observed ratios of inputs to outputs differ from a benchmark, the question then is – what are the causes of the gap?

In the first instance, interpreting the gap could proceed by looking at the gap in two ways.

First, comparing the observed inputs to the benchmark elements (eg. if the system wide net returns vary substantially to the benchmark net returns, this would be a key driver of the gap between system performance and benchmark system performance).

Second, seeking to understand the behaviour of the participants who practically influence the areas where the system is not as efficient as it could be. As noted above, the literature should provide an informative departure point for this analysis.

Member behaviour almost certainly does play a role, but more as a victim of inefficiency rather than a protagonist.

> The problem, as discussed by Impavido et al (2009), is that the limited capacity of individuals to choose what is best for them means that competition and markets rarely work effectively within pension systems – leaving too much power in the hands of pension providers. The problem is only exaggerated where pension providers are commercial financial institutions. Conflicts of interest can therefore exist between the fiduciary duty to

act in the interest of the pension fund members and beneficiaries and making profits for shareholders.[53]

Section 4 and Appendix 1 of this submission provide an overview of this research and other evidence of system inefficiency. The interpretation of gaps relative to the benchmark should also be informed by the prior work of APRA researchers and others, many of which bear on the conflicts of interest present in operating entities. In practice, this would mean that the Commission, if it were measuring the system and found that there was underperformance in net returns, should refer to, and perhaps extend and refresh, the type of research projects undertaken by APRA on the incidence of related party transactions at above-market prices; deviations in asset allocation from that which is expected to generate the highest long term risk adjusted returns (and why); the advice and distribution environment that results in members remaining in underperforming funds.

5.2.3.1 Negative test

We respectfully submit that the negative test is unlikely to provide any additional substantive content to the Commission's analysis.

The danger with the negative test, at least as we have seen it used, is that there are conclusions drawn without justification by reference to evidence.[54]

In practice, there is a risk that the negative test is presumptively deregulatory. The Commission's Issues Paper notes that there are features of markets that might create barriers (eg. economies of scale) other than policy, but most of the questions about barriers raised by the Commission relate to barriers caused by regulation or policy. Even the acknowledgment that some markets might have intrinsic (ie. non-policy) barriers continues the presumption that markets form naturally and can generally be expected to deliver efficient outcomes without significant regulation.

[53] Ashcroft & Stewart, *Managing and Supervising Risks in Defined Contribution Pension Systems*, International Organisation of Pension Supervisors, Working Paper No. 12 (2010)

[54] For example, a key assertion in the negative test included in Treasury's submission to the Financial System Inquiry was that "superannuation trustees allocate funds within a highly contested investment market." This may or may not be true. The basis for the position was not explained. The many studies of the problems with manager selection, and market failures in the relationship between investment advisers or funds managers, on the one hand, and funds or trustees, on the other hand, were not addressed and distinguished. As a result, the merits of the negative test could not be evaluated

6. Response to questions

SYSTEM EFFICIENCY OBJECTIVES	
Within the current policy settings, what are the objectives against which the efficiency and competitiveness of the superannuation system should be assessed? How prescriptively should the objectives be expressed?	ISA acknowledges that there is a separate Government process to legislate an objective for the superannuation system and the Government's announcement about this as part of the 2016 Budget. As the discussion about the legislated objective of the system is not yet settled, we endorse the Commission's proposal to formulate an interim objective, and to focus this on member outcomes. However, without a tangible retirement income or adequacy target, the Commission's efforts to measure system efficiency will be hampered. We submit that the Commission should include ASFA's comfortable standard of retirement income to enable effective benchmarking of the system: **See Sections 2 and 5.2**

THE COMMISSION'S APPROACH TO ASSESSMENT	
Do you agree with the broad approach of combining performance benchmarks with a test of barriers to efficient or competitive outcomes in the superannuation system?	ISA submits that the primary task for the Commission is to measure overall system efficiency based on key system inputs and outputs, measured against benchmarks. Subsidiary indicators can assist in interpreting any gap that exists between actual and benchmark system performance. **See Section 5.2** Research by APRA and academics has documented a range of practices which impede system efficiency and reduce member outcomes which may assist the Commission's formulation of efficiency barriers. **See Section 4 and Appendix 1** However we do not support the negative test methodology as explained in **Section 5**
How should the unique features of the superannuation system (identified in section 2) be taken into account in developing criteria and indicators for assessing its competitiveness and efficiency? Are there other possible approaches?	The Australian super system is complex, with a range of participants, and variable inputs and outputs. It is unique internationally in its reliance on private delivery and market based structure. The lessons of behavioural economics and APRA and academic research can assist in understanding drivers of inefficiency. While the Commission notes the lack of demand-led competition, choice and SMSF members are presumed to be driving competitive outcomes. Evidence shows that the choice and SMSF sectors consistently underperform not-for-profit funds, which make up the bulk of the default sector. System features and participant conduct should be taken into account in developing criteria and measures and reinforce the need to adopt a 'top-down' approach to measuring efficiency as proposed by ISA. **See Sections 3, 4, 5 and Appendix 1**

THE COMMISSION'S APPROACH TO ASSESSMENT (cont'd)	
To what extent do different data reporting formats make it difficult to compare SMSFs and APRA-regulated funds, and hence to assess the performance of the superannuation system as a whole?	Problems with data reporting are deeper than merely differing formats for APRA regulated funds and SMSFs. Accurate, consistent, comparable performance data is important for assessing different sectors and the system as a whole, yet significant data gaps, inconsistent disclosure and data reporting regimes apply to choice products and SMSF funds. Significant inconsistencies and gaps exist, including in the APRA statistics on choice products. ASIC requirements also exempt platform-based products from disclosure of embedded investment costs. There is also no data on the performance of legacy products, which comprise 30 per cent of personal superannuation assets, or sector-wide accurate breakdowns of types of benefit payments to understand factors such as lumps sum withdrawals, residual estates, income stream and other forms of benefit. While relevant agencies have been working to address these data quality issues, they are unlikely to be resolved in time for this current study, and will not address gaps and inconsistencies in past data publications: **Section 4.4 and Appendix 1**
Which of the existing cross-country composite measures of pension system performance would be most relevant to this study and why? What are the challenges in using those measures to assess the efficiency and competitiveness of Australia's superannuation system? What measures and criteria are comparable across different countries?	Some insight can be gained from considering existing international studies of pension system performance. However, there are very distinct aspects of the Australian system which impact the validity of comparisons including the fact that it is mainly defined contribution, the market structure and costs imposed in facilitating choice and highly retailised distribution, the reliance on private providers, the relative immaturity of the system, and the structure of government support and fiscal efficiency/sustainability. None of the international studies are able to measure the actual performance of the Australian system in the detail which this study warrants. **See Section 5** for our proposed methodology for overall measurement of the Australian super system.
Which of the existing composite measures of Australian superannuation fund and/or product performance would be relevant to this study and why?	Existing studies might assist in informing the Commission on aspects of the system which are working more or less efficiently. However, as above, none measure the actual performance of the Australian system. See **Section 5** for our proposed methodology for overall measurement of the Australian super system.

THE ROLE OF COMPETITION IN SUPERANNUATION	
What are the key ways in which competition can improve efficiency in the superannuation system?	ISA strongly submits that caution is warranted in terms of any future assumptions regarding the benefits of competition in the super system. To the extent that effective competition exists, it is mainly in the default system and derives from funds competing to qualify as default providers. Efforts to further enhance the existing default process through an increased focus on net performance remains stalled following legal action by bank-owned funds. In the absence of strong consumer competitive pressures, stronger regulatory protections are needed, particularly in the choice and SMSF sectors, to drive better member outcomes and improve system efficiency. See **Sections 1, 3 and 4**
Is there sufficient emphasis on competition in the regulation of superannuation?	The existing regulatory framework provides for competition in the form of wholesale competition for default status (see above) and through choice of fund, at the individual member level. However, members who exercise choice of fund generally experience worse outcomes than members of default funds. This applies to both members of APRA-regulated choice funds and SMSFs. This is one of the most significant causes of inefficiency in the system and suggests a need for a rethink of the assumption that activity and engagement will automatically translate into efficient and competitive outcomes. Stronger safeguards are needed for those who depart the default system. **See Sections 1 and 3**
Are there any current circumstances where competition is not delivering efficient outcomes and why?	The default system is the most competitive (on merit) and efficient component of the system. The choice and SMSF sectors are largely neither competitive nor efficient because providers compete on matters other than merit and because consumers are unable to create demand side pressure or manage agency issues with for-profit superannuation trustees and employers: **See Sections 3 and 4**
What are the key sources of economies of scale? What are the ways of realising economies of scale, in addition to fund mergers? Are there any parts of the system that may be operating with diseconomies of scale? What are the best indicators for measuring the current realisation of scale economies, and the scope for future increases?	APRA analysis has repeatedly shown that not-for-profit funds have been more successful in realising economies of scale for the benefit of members than for-profit funds: **Section 4 and Appendix 1**. In addition, a lack of scale is likely to be a factor contributing to the sustained negative performance of the SMSF sector. ISA proposes that the key indicator of realisation of scale is through observation of net performance; however it is also important to track gross returns, fees/expenses and margins over time. The comparison of the performance of industry segments over time will also be an important indicator of realisation of economies of scale. See **Section 5.2**

ASSESSING COMPETITION IN THE SUPERANNUATION SYSTEM	
What are the key outcome-based indicators of competition in the superannuation system?	We submit that assessment of competition should be based on outcomes rather than subjective indicators (ie. member self-assessment of engagement or switching levels) which might indicate engagement but not necessarily effective competition. The key outcome-based indicator of competition at a system level is the number of members/amount of assets that are in funds that match the benchmark for strong net performing funds. **See section 5.2**
Market definition **For each of the levels in the vertical supply chain (figure 3), who are the relevant consumers, and which market participants within or outside of the superannuation system are the most likely source of competitive pressure?**	The impact of factors highlighted by behavioural economics can flow through the vertical supply chain – as demonstrated by APRA research which has shown that agency issues (failure to pass economies of scale, uncommercial terms for related party service providers) in retail super funds have gone unchecked. As noted in the FSI[55], funds competing to serve as default funds is a key source of merit based competitive pressure in the system. **See Sections 1 and 4**
For each of the levels in the vertical supply chain, is there evidence of competition on factors other than price, and if so what are they (for example, performance, investment options, any additional features)? What drives this choice?	Significant competition occurs on factors other than merit including cross selling, more investment options, control and tax minimisation. Within the vertical supply chain, the key driver of efficient outcomes is the conduct of trustees. Notwithstanding trustee duties, past research has shown the existence of agency issues in the for-profit sector. The continuing high levels of outsourcing to related third parties in the for-profit sector may flag ongoing inefficiency in this area. **See Section 4 and Appendix 1**
On what factors and features do default funds compete in corporate tenders? What factors are relevant for the assessment and selection of platform service providers by funds?	Well-run tenders typically focus mainly on performance and fees, as well as insurance, investment strategy, administration and services to members and employers. Particular employers may also require funds to address other issues, for example corporate governance. While corporate tenders have the potential to increase competition, problems including cost, lack of transparency, conflicts of interest and flipping need to be addressed. There is no effective regulatory oversight of corporate tenders. **See Section 4.3 and Appendix 1**

[55] Financial system Inquiry, Final Report, Chapter 2

ASSESSING COMPETITION IN THE SUPERANNUATION SYSTEM (Cont'd)	
What is the degree of substitutability between different types of superannuation funds and products? How can this be evaluated or measured?	There is a high degree of heterogeneity among superannuation products, particularly in relation to the level of choice offered. Ultimately, however, the goal of retirement income products is to deliver maximised, stable income that lasts throughout life. It is unclear the extent to which consumers make informed decisions in terms of the trade-off between control and choice vs increased cost. It can be expensive and difficult for SMSF members to move into an APRA regulated fund, creating a barrier to switching. APRA regulated funds cannot hold business real property, in specie contributions or leveraged real property. There are also substantial barriers due to the more generous tax arrangements for SMSFs. See **Section 4.4 and Appendix 1**
What is the relative contribution to member fees from the various participants through the vertical value chain?	Within the current legal framework of superannuation, trustees bear ultimate responsibility for ensuring product construction is in the interests of beneficiaries. The cost components of a product will differ depending on the features of the product, structure of the fund and business model of the trustee. To enable a tracking of overall and segment expense components, ISA would urge the Commission to include a breakdown of trustee expenses (ie. administration, investment management etc.) and to understand how they differ between segments, and their impact on different account balances and across age cohorts. **See Sections 1 and 5.2**
Criteria and indicators **How would you measure the effectiveness of regulation in promoting competition within the superannuation system?**	The default sector is more highly regulated and more competitive and efficient, while the choice and SMSF sectors are subject to less regulation and are less efficient. ISA submits that the Commission should measure the cost of regulation as an input to system efficiency. See **Sections 4, 5.2 and Appendix 1**
How would you measure the extent of competitive pressure from the SMSF segment on the rest of the superannuation system?	All APRA regulated funds experience significant competition from SMSFs for members. However, ATO data demonstrates that the SMSF sector has not driven competitive outcomes, at least not in terms of performance. The profile of SMSF members is increasingly made up of younger members with lower superannuation balances. Forty-four per cent of SMSFs have experienced zero or negative annual average returns for the seven years to 30 June 2014. Member outcomes in terms of net performance is the key measure of sectoral performance/merit based competition. See **Sections 1 and 4**

ASSESSING COMPETITION IN THE SUPERANNUATION SYSTEM (Cont'd)	
Can levels of transparency on aspects such as conflicts of interest and details of reporting to members (for example, as income stream equivalents) be used as a measure of competition?	ISA supports rigorous transparency and disclosure to members and the market. However, disclosure has been demonstrated to be an insufficient and inadequate mechanism for driving consumer led competition, as acknowledged by the Stronger Super Review and the FSI. So while we support clear and transparent reporting, we question its use as a measure of competition.
What are the most reliable and relevant assessment criteria and indicators for measuring the competitiveness of the superannuation system?	The key measure of competition should be member outcomes. **See section 5.2**
What are the barriers to efficiency-enhancing competition in the superannuation system? In particular, what are the policy impediments to competition? How can the impacts of these barriers be measured?	The two fundamental barriers are the inability of consumers to drive competition and agency problems that affect for-profit funds and employers. The impact of these can be measured in terms of the relative underperformance of the choice sector, including both APRA regulated funds and SMSFs. ISA does not agree that regulatory settings are a barrier to competition. The key policy impediments to competition include the stalling of the FWC process which would enable an updating of default funds to screen funds according to quality including net performance, inadequate safeguards for choice products and SMSFs, the existence of SMSF-specific investment rules which make it difficult for members who have left the APRA-regulated sector to return to it and inaccuracies and gaps in performance data for platforms. Section 5 of our submission discusses how these factors might be measured. **See Sections 1, and 4 and Appendix 1**

ASSESSING OPERATIONAL EFFICIENCY OF THE SYSTEM	
Do you agree with the proposed objectives for operational efficiency? If not, what should they be?	ISA supports the inclusion of risk and liquidity optimised returns on member savings (not just contributions) as a key focus of this study, within the overarching approach that we propose. We agree that maximised provision of retirement income is a key objective, however note that efficiency of delivery of retirement income requires the balancing of the competing considerations of level, longevity and stability of income. There can be tension between each of these considerations so an approach that favours lifecycle investment is likely to greatly compromise level and longevity of income. **See sections 1 and 4.** We agree that a further objective is delivering ancillary services at minimum cost, having regard to quality and service **See Section 5.2**

ASSESSING OPERATIONAL EFFICIENCY OF THE SYSTEM (Cont'd)	
<u>Benchmarking</u> **What are the most reliable and relevant assessment criteria and indicators for benchmarking operational efficiency of the superannuation system? What are the evidence requirements and current gaps in using your proposed criteria and indicators?**	The most relevant and reliable indicator of operational efficiency is the efficient delivery of retirement income, and a key input to that (in operational terms) is maximising long term net performance. **See Section 5.2** ISA includes in its submission an overview of a number of significant gaps in official data to support such measurement. **See Section 4.4 and Appendix 1**
What are the appropriate benchmarks against which the operational efficiency of Australia's superannuation system should be measured? Are there countries that have superannuation systems that could provide an appropriate benchmark?	ISA proposes a benchmark for efficient retirement income that appropriately balances level, longevity and stability of income; with net performance benchmarked against a cohort of funds with strong and sustained net performance. **See Section 5.2**
What types of fees are relevant to assessing the competitiveness and efficiency of the superannuation system? How should these fees be measured? What data sources are available and to what extent are these comparable with one another?	All fees and direct and indirect costs are relevant. Existing publicly available sources do not capture all indirect costs for choice products or all fees and costs for SMSFs. This makes it difficult to measure or compare fees and costs for these segments with fees and costs for default funds. These data quality issues need to be addressed and kept in mind when undertaking analysis. **See Section 4.4, 5.2 and Appendix 1**
What are the best measure(s) of (post-fee) risk adjusted rates of return? How comparable are these measures?	ISA proposes a benchmark based on a cohort of funds with strong long term performance. **See Section 5.2**

ASSESSING OPERATIONAL EFFICIENCY OF THE SYSTEM (Cont'd)	
What aspects of operational efficiency cannot be reliably measured using a benchmarking approach? How could this assessment incorporate aspects such as service quality?	In ISA's view the significant aspects of operational efficiency are captured in the overall measure of system and segment performance, both in terms of efficient conversion of savings into retirement income and net performance. In our view 'service' can be benchmarked, however the cost of additional services must be included.
What are the advantages and disadvantages of using techniques such as data envelopment analysis over conventional approaches such as simple benchmarking of a single criterion?	Data envelopment analysis is significantly driven by the assumptions made. ISA prefers an approach that contextualises aspects of system efficiency within an overarching measurement of the system. **See Section 5.2**
<u>Barriers to operational efficiency</u> **What elements of regulation have the greatest effect on the operational efficiency of the system and which aspects of operations are affected? How could those impacts be measured?**	The Issues Paper notes that market characteristics and participant conduct also have a bearing on operational efficiency. As noted above, in ISA's view the regulation of the choice and SMSF segments fail to address significant market failure and results in sub-optimal outcomes for the members in those funds and for the system overall. The regulatory settings around default fund status create a 'quality filter' which ensures funds are competing on the basis of net performance, demonstrated by the sustained outperformance of the default sector. See **Sections 1 and 4**

ASSESSING ALLOCATIVE EFFICIENCY	
Do you agree with the proposed objectives for allocative efficiency? If not, what should they be?	We agree that a key system focus should be on ensuring that the resources in the super system are allocated to their highest value uses. Our submission sets out evidence that the savings of many members are not put to their highest value use – with many members remaining in products and funds which consistently underperform. The key allocative efficiency objectives of the super system should be that members are allocated to highest performing funds over the long term, which are efficient in their conversion of savings into retirement income. **See Section 5.2** ISA strongly supports a focus on the extent to which the super system is investing in an optimal manner, to improve member outcomes and drive productivity growth in the broader economy. **See Sections 1, 2 and 5.2** Another issue is the extent to which the system is permitting excessive lump sum withdrawals, wealth accumulation or bequests, with a key objective to reduce their occurrence.
<u>Benchmarking</u> **What are the advantages and disadvantages of using benchmarking to assess the allocative efficiency of the superannuation system? Which aspects of the system most lend themselves to such assessment?**	ISA supports the use of benchmarking to assess elements which fall under allocative efficiency. Behavioural economic theory and research demonstrates that in Australia and internationally, consumers are not able to drive optimal outcomes, in the absence of strong system settings to guide good outcomes, and strong consumer protections. **See Section 3**
Which criteria and measures are most relevant to assessing the allocative efficiency of the system, and how should they be interpreted? What are the evidence requirements and current gaps in using your proposed criteria and indicators?	The key indicators of allocative efficiency would be number of members/amount of assets in underperforming products, the extent to which system assets are optimally invested, the incidence of lump sum withdrawals and bequests, and the extent to which tax concessions are allocated to optimise member and taxpayer outcomes. **See Section 5.2**
<u>Barriers to allocative efficiency</u> **How can the magnitude and cost of principal–agent problems be assessed?**	ISA submits that member outcomes and sectoral performance differences are the key guides to assessing principal-agent problems. **See Sections 1, 4 and 5**

ASSESSING ALLOCATIVE EFFICIENCY (Cont'd)	
Should the criteria and indicators for assessing the extent and magnitude of principal– agent and governance problems focus on outcomes or inputs and process, such as best practice governance principles, or a combination of both?	As above, ISA submits that member outcomes and sectoral performance differences are the key guides to assessing principal-agent problems.
What existing measures of governance could the Commission draw on, and what are their strengths and weaknesses?	ISA submits that member outcomes and sectoral performance differences are the key guides to assessing fund governance.
What are the most important behavioural biases and cognitive constraints affecting the key superannuation saving, investment and withdrawal decisions of users? What are the best assessment criteria and indicators for examining the magnitude and effect of those biases and constraints? What are the key gaps in the evidence to enable such assessment?	Behavioural economics has been used to explain the behavioural biases and cognitive constraints of default fund members. ISA's submission argues that its lessons are equally applicable to the many consumers assumed to be 'engaged' who are in the choice and SMSF sectors, selecting or remaining in products with consistent underperformance. The key measure of member biases and constraints are the outcomes achieved by members who depart the default system and the extent to which they enhance their retirement outcomes. **See Sections 1, 3 and 5.2** These outcome based measures are more revealing and reliable than subjective measures.
What are the best assessment criteria and indicators for examining the extent to which the outcomes for users are optimal with respect to the current taxation settings?	ISA proposes that the Commission measures the extent to which tax settings are fiscally efficient. We submit that distributional analysis of outcomes is important given that superannuation is universal and receives significant government funding. **See Section 4.5**

ASSESSING ALLOCATIVE EFFICIENCY (Cont'd)	
Do you agree with the proposed objectives for dynamic efficiency? If not, what should they be?	ISA proposes that the Commission should measure overall system efficiency against a benchmark. The inclusion of analysis of outcomes for different age cohorts will provide the basis for understanding the extent to which Australians' retirement outcomes are improving over time, in real terms and against benchmark. This should be the key objective for dynamic efficiency. To the extent that there are improvements in efficiency or innovations, these will be revealed in overall system outcomes. Ultimately an innovation is worthwhile only if it improves member outcomes over time. We do not agree that lifecycle investment allocations indicate dynamic efficiency. **See Section 5.2** We support that the setting of long term stable system settings, which improve member outcomes (across gender, income and age cohorts) should be an objective of the system.
<u>Benchmarking</u> **What are the most reliable and relevant assessment criteria and indicators for measuring the dynamic efficiency of the superannuation system? What are the evidence requirements and current gaps in using your proposed criteria and indicators?**	ISA proposes that the overall measurement of system outcomes, including distributional analysis by gender, income and age cohorts, provides the most reliable and relevant indicator of dynamic efficiency. However, more granular analysis of the extent to which key inputs are being utilised more or less effectively to improve member outcomes will be important to understanding the key drivers or obstacles to improving system efficiency. This would include an examination of all key inputs including member contributions, tax concessions and transfers, net performance outcomes. **See Section 5.2**
<u>Barriers to dynamic efficiency</u> **What are the key impediments to dynamic efficiency and how could they be measured?**	While ISA's submission has identified key issues with member engagement, given the poorer outcomes experienced by those members who seem "more engaged', improvements in engagement on their own won't drive competition or system efficiency. Addressing the significant inefficiencies which have been the subject of research and are set out in **Section 4 and Appendix 1** of this submission will be needed to improve the efficiency of the system over time.

7. APPENDIX 1

Existing research regarding superannuation efficiency

This Appendix provides a more detailed explanation of the summary of existing research on superannuation system efficiency provided in Section 4.

As noted in that section, existing research can help the Commission in undertaking this study and in particular in understanding some likely reasons why the system is underperforming.

7.1 Many members who choose experience poorer outcomes, not better ones

To date, the focus on behavioural economic analysis of superannuation has focused on members in default funds, with the assumption that members who depart these funds are more engaged in superannuation decisions and able to drive competitive outcomes, with SMSF members often offered as an example.

It is only recently that the hypothesis that engaged members, especially those in SMSFs, have better superannuation outcomes can be tested. The evidence now available does not support this view.

The evidence points to a challenging conundrum for policy makers and economists – those consumers who are perceived to be "engaged" have typically suffered reduced retirement savings, compared to the outcomes achieved by the members of (largely not-for-profit) default products. This is in no small part due to the willingness of some providers to exploit consumer irrationality to sell products which offer many choices and customisation, and lots of control, but come at a significant cost to members' retirement outcomes. The system architecture has placed considerable responsibility on individual savers to manage these agency issues; the evidence would suggest that they are generally not well suited to do so.

The average SMSF has delivered an average annual net return of 3.09 per cent over the seven years to 2014, compared to 1.93 per cent for retail funds and 3.57 per cent for not-for-profit funds.[56] Longer term data shows that the average for-profit fund (which comprises 80 per cent of the APRA-regulated choice sector) has returned an average net return of 4.6 per cent over the 10 years to 30 June 2015, compared to 6.23 per cent for the average not-for-profit fund (which comprises 80 per cent of the default sector) over the same period.

7.2 Super Savings

The Grattan Institute's report, *Super Savings*, also found that the choice sector was the locus of most of the inefficiency in superannuation.[57]

Super Savings estimated that inefficiencies in the super system resulted in excess costs of about $5 billion per year (these costs include administration costs and investment costs).

The essential insight of the Grattan Institute's report is that there is a set of funds that consistently perform well and at a relatively low cost. The report calls these "lean, high performing funds." Despite this, the bulk of superannuation assets and flows come to rest in funds that don't have these charactistics.

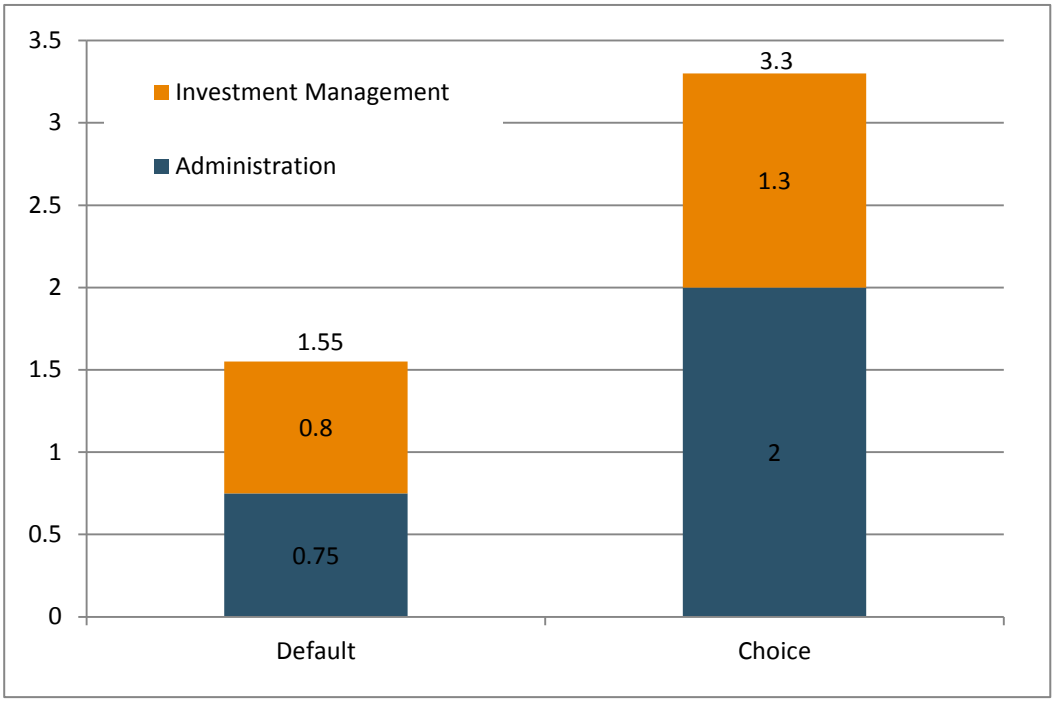
[56] Seven years is the longest period for which reliable returns data are available for the SMSF sector.

[57] Super Savings, Grattan Institute, 2015

Grattan estimates that total potential savings (administration and investment) are $3.3 billion in the choice segment ($1.3 and $2 billion respectively) and $1.55 billion in the default segment ($750 million and $800 million, respectively).

We note that 19 of the 20 funds making up the "lean, high performing funds" benchmark group are not-for-profit funds.

Figure 9 – Excess costs Identified by Grattan Institute by sector, $ billions



Source: Grattan Institute, Super Savings, pages 18 and 29.

While the overall findings of *Super Savings* are informative, there are some concerns with the methodology used, which we would encourage the Commission to avoid:

- In estimating the cost savings, the Grattan benchmark "lean fund" investment fee is constructed by adding up the lowest fees for particular asset classes and then weighting them based on existing APRA system-wide asset allocations. This raises significant issues over the accuracy of the composite fee estimate because system-wide APRA asset allocation does not represent an optimal allocation for a default fund. Not-for-profit funds have a significantly higher asset allocation to illiquid investment such as infrastructure which deliver consistently higher net returns but are more labour-intensive and hence more costly to manage. Using the Grattan method of constructing a composite fee based on the 20th percentile single asset class fees, and weighting them based on the asset allocation of large industry funds, raises the lean benchmark from 43 basis points to about 55 basis points. This is still an aggressive methodology, but cuts the estimated inefficiency in the default fund space arising from investment fees from around one billion to around $500 million.
- Constructing the "lean fund" fee based on fees on individual asset classes rather than actual balanced portfolios means certain important costs in portfolio management are ignored in the benchmark. These include the cost of portfolio construction, monitoring, liquidity management and adjusting asset exposure relative to a strategic balanced benchmark. Insofar as the "lean, high performing funds" have average fees for their balanced portfolios around 20 basis points above the Grattan hypothetical-composite fee, these costs might be important.

7.3 The cost of choice

In addition to the cost of poor choices, the facilitation of choice in the superannuation sector has proved costly to the system. Many research studies have documented the added costs associated with the advent of choice mechanisms. While at the time that Choice of Fund was introduced it was envisaged that it would lead to the lowering of fees and boosting of returns, the reverse has transpired. As foreshadowed by Vidler (2007), it has tended to place cost pressure on lower cost not-for-profit providers rather than price pressure of more costly for profit providers.[58]

Some of the costs associated with choice include:

Additional product development, management and compliance costs. For-profit funds on average offer 244 investment options, while not-for-profits on average offer 11 options.[59] This suggests that competition is based on breadth of product range and options, rather than benefit for the member.[60]

Additional marketing, promotional and administrative costs. Since the advent of Choice, funds across the industry have (rationally) invested significantly greater amounts on marketing, sales and member engagement to retain existing members and to attract new members. Rice Warner attributes a 5bp increase in fees system wide as a result of increased marketing activity resulting from Choice.[61] As explained by the Grattan Institute, "When many funds are taking similar steps, few funds gain market share, so average costs rise. And the extra services may not provide much real value to account holders."[62]

Excessive liquidity in portfolios, which reduces net returns. A super fund that seeks to invest optimally and for the long term will reasonably seek a substantial allocation to illiquid assets. APRA research attributed 35bps of not-for-profit outperformance to the liquidity optimisation of their portfolios. Providing choice impairs the ability of a fund to make long term investments in illiquid assets due to (i) increased liquidity *requirements* and (ii) increasing liquidity *risk.*

Liquidity requirements involve holding sufficient liquid assets to honour obligations as they are due without incurring unexpected costs. Liquidity needs in a choice environment are higher than otherwise would be the case.

Liquidity risk is even more important because managing it involves a fund holding liquid assets substantially in excess of levels needed to honour ordinary course requirements. Managing liquidity risk involves holding liquid assets at a level that would enable the fund to withstand a growing band of future redemption possibilities, as well as major shocks. As policy and marketing reinforce pressure on members to be engaged and to switch, the risk that funds must anticipate grows, reducing their capacity to make long term investments that benefit members.

7.4 Too many members have multiple accounts

Multiple accounts continue to be a feature of the superannuation system, and demonstrate that consumers are unlikely to drive system efficiency. According to the ATO, as at 30 June 2015, 45 per cent of people have more than one superannuation account.

This includes over four million lost accounts in ERFs which hold over $5 billion in assets. As noted below, ERFs run by for-profit providers are expensive. There is no legal obligation on ERFs to re-connect members with their lost superannuation and no commercial incentive to do so given the fees they charge.

[58] Vidler, 38

[59] Cummings 2015

[60] Super savings 30

[61] RW, FSI Fee Report, July 2014, 24

[62] Grattan Super Savings 12

Until recently, AUSfund, the only not-for-profit ERF, conducted extensive cross fund matching searches to match members' ERF accounts with active superannuation accounts. However, concerns expressed by ASIC have curtailed AUSFund's ability to undertake cross fund matching without obtaining member consent. This is impractical given that AUSFund members are by definition, disengaged.

Since the passage of the Stronger Super reforms a number of measures have been introduced to reduce the incidence of multiple accounts, including ATO consolidation of small inactive accounts and more effective matching of lost super with active member accounts through the MyGov website.

In 2014-2015, the ATO reported that it was holding $16.2 billion in lost super.[63] The recent rollout of SuperMatch 2 by the ATO has somewhat improved the process of finding lost super, but there is still scope for more effective processes to return these funds to their true owners. For example, the member's consent to transfer funds is still required.

7.5 The cost of the for-profit sector

APRA guidance makes clear that trustees are responsible for the investment strategies of a fund (not just products) and that this responsibility persists regardless of member investment choice, including where a financial advisor is involved.[64]

Super fund trustees also are responsible for the business and distribution strategy of a fund including if that strategy results in fund members being placed in an underperforming product or mix of products.

A number of studies have analysed the performance differences between for-profit and not-for-profit providers. For-profit orientation is consistently associated with behaviours which reduce performance.

7.5.1 For-profit providers pay higher fees to related party providers

Many super funds in the Australian system rely on outsourcing for provision of services to the fund, including funds management, administration, actuarial services, custody, and insurance.

Research has tested the extent to which trustees use related party service providers to deliver value for members, or due to conflicts of interest in for-profit super funds, pay higher fees to related party providers. As noted by APRA:

> "When we consider whether the fund has been established on a not-for-profit basis, or as a retail commercial endeavour, we find that the trustees of retail funds pay significantly higher fees to related service providers."[65]

These practices may persist. Current 2015 APRA statistics indicate that 85 per cent of service provider expense is paid to internal or associated service providers in the for-profit super sector, compared to only 17 per cent in industry super funds, and 41 per cent in all APRA funds.

[63] ATO, Annual Report 2014-2015, 54.

[64] See, Australian Prudential Regulation Authority, Superannuation Circular No. II.D.1 Managing Investments and Investment Choice (2006) (stating that "APRA would be concerned if a trustee held the view that a financial adviser's involvement in the member's investment choice relieved the trustee of the duty to formulate and implement appropriate investment strategies for the fund.")

[65] Liu, K. and Bruce R Arnold, 'Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets', *APRA Working Paper*, 12 July 2010, p 2; see also Ellis, K., Alan Tobin and Belinda Tracey, 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds', *APRA Working Paper*, October 2008

Figure 10 – Proportion of expenses provided to internal, associated or non-associated service providers, 2015

Fund Type	% Internal	% External - Associated	% External – Non-associated	Total % internal & Associated
Industry Super Fund	9%	8%	83%	17%
Retail Super Fund	27%	58%	15%	85%
All APRA Regulated	15%	26%	64%	41%

Source: APRA

7.5.2 For-profit funds structure their businesses in ways that impair net returns

Research has also shown that not-for-profit funds consistently make higher allocations to unlisted asset classes, including unlisted property and infrastructure. This enhances diversification and returns for their members.

APRA tested the investment performance of funds over the period 2004 to 2010 to determine if illiquid assets made a difference to fund performance and member returns.[66] The study found that among 139 retail and not-for-profit funds, not-for-profit funds achieved an average net risk adjusted investment outperformance of 144 basis points per annum, of which around one quarter could be attributed to a higher share off illiquid assets.

In contrast, for-profit funds make a significantly lower allocations to unlisted, illiquid assets, and research has repeatedly concluded that this is not related to fund size, member age or cash flows:

> "larger retail funds do not use their scale to increase their allocation to illiquid assets"[67]

This is in part due to most members of for-profit funds determining their own asset allocation, typically on advice from a financial adviser, who have been shown to gravitate towards Australian and international equities.[68]

The decision by trustees of for-profit funds to delegate asset allocation to their individual financial adviser distribution channels for choice members is a conscious decision about business structure and investment philosophy.

Member net returns and thus system efficiency are enhanced by business models that facilitate higher levels of illiquid investment.

Certainly, comparisons with the Future Fund's investment philosophy and strategic allocation emphasise the importance of large-scale, long-term investors exploiting the liquidity premium.

7.5.3 For-profit providers charge higher fees for investment management

The advent of low cost MySuper products offered by retail providers has been largely achieved through a fundamental shift in investment portfolio construction, with large allocations to passively managed equities. While the jury is out about the long-term performance outcomes of these products, ratings agency SuperRatings has highlighted concerns that profits are being made by some funds who are inflating investment fees for passive investments. As they noted in 2015:

[66] Cummings and Ellis, 2011, APRA Working Paper, Risk and Return of Illiquid Investments, p 24

[67] C & E 2015 470

[68] C & E 2015 472

"We are concerned that substantial profits are being made by some funds charging excess investment fees for their passive investment products. Whilst we believe there is a place for passive investment products, they must be appropriately priced to ensure that the net benefit to the member is reasonable and competitive."[69]

Similarly, in their report for the Financial System Inquiry on fees in superannuation, RiceWarner noted that several retail funds have introduced passive portfolios but have not passed on the cost savings to their members. [70]

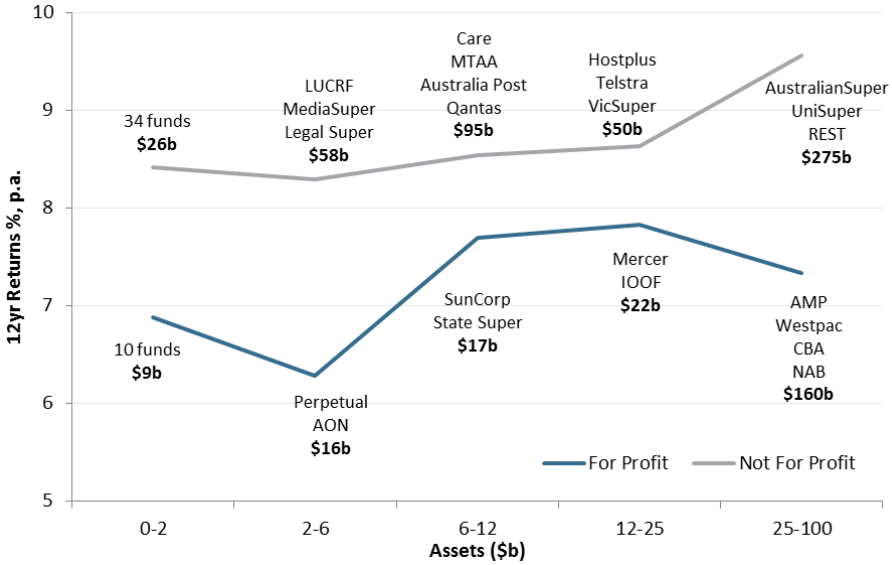
7.5.4 Many for-profit funds fail to realise economies of scale and pass benefits to members

The Issues Paper raises the potential scope for economies of scale to further improve system efficiency. Research undertaken by APRA has shown that a key determinant of economies of scale being realised benefit members is the profit orientation of the fund's trustee.

APRA research compared the impact of fund size on gross returns, investment expense and operational expense, and found that "…the performance of retail funds does not improve with fund size" noting that "[t]he structure of retail funds, in the sourcing and offering of their investment products, is less conducive to capturing the benefits of scale."[71]

Figure 11 displays average rates of return for the 12 financial years from 2004 to 2015 for superannuation funds grouped by profit orientation and size in assets.[72] Average performance improves with increased scale for not-for-profit funds. The pattern for retail funds is mixed with a significant decline in returns for the largest retail funds. Average outperformance by not-for-profit funds increases from 1.5 per cent among smaller funds to 2.2 per cent for the largest funds with assets over of $25 billion. Smaller not-for-profit funds are more likely to harness economies of scale for their members than larger for-profit funds.

Figure 11 – Fund level average return, by profit orientation, 2004-2015



Source: APRA (2016) Fund level performance data and profile

[69] http://www.superratings.com.au/media/mediarelease/27042015

[70] RiceWarner, Superannuation Fees, FSI, p 30

[71] Cummings 2012 - 31

[72] Funds are grouped as fund families, with asset-weighted average returns calculated for all retail funds within the same conglomerate.

The issues Paper questions the existence of competition pressure in the "value chain" (p18). However, consistent with APRA research methodology, in the structure of the superannuation industry, the fund trustee is essentially the 'gatekeeper' that determines whether cost savings and other scale benefits are captured by the trustee for the benefit of members, captured by the trustee for the benefit of parties other than members, or captured by a service provider in the "value chain."

7.5.5 For-profit sales model and financial advice regulation

The majority of members of choice products are there as a result of financial advice. Historically, retail for-profit super funds engaged financial advisers to sell their products in return for commission based remuneration. In addition to the compromising effect which these structures have had on advice quality, past advice practices have been an efficiency drag on the super system due to the high and compounding cost of commissions and of poor product recommendations. Notwithstanding the FOFA reforms, carveouts for life insurance commissions on individually advised life insurance within superannuation and grandfathered conflicted remuneration means that commissions will continue to compromise member outcomes in the choice and SMSF sector for many years to come. Indeed, grandfathered commissions are a powerful incentive for advisers to leave clients in underperforming products.

General advice about superannuation makes financial advice accessible to consumers who would otherwise be unlikely to obtain it. However, anecdotal evidence suggests that banks are cross selling superannuation to banking customers via general advice channels, for example, bundling business banking products and super for employers, and offering a lower home loan rate to customers who agree to roll over their super to the bank-owned retail fund. Exemptions in FOFA for balanced scorecard arrangements (that include wealth product revenue targets) mean that sales of super products by bank branch staff can be incentivised.

A further contributor to poor quality advice is that the FSR laws provided a broad exemption to registered accountants to recommend the acquisition of an SMSF without the need for an Australian financial services licence (AFS licence). While this anomaly was addressed as part of the FOFA reforms, and will no longer be available from 1 July 2016, the very poor long-term performance of many SMSFs signals the existence of similar agency issues in the provision of SMSF advice, and warrants regulator investigation.

7.5.6 Legacy products

Legacy products are products provided by the retail sector that are closed to new members.

A substantial amount of assets in the superannuation system are in legacy products. Legacy products are more costly than current products, but returns data is not available. Consideration of legacy products is important to the Commission's task because the sizeable allocation to legacy products will affect the system-wide average rate of return. The Commission should also give regard to why significant assets remain in legacy products.

Rice Warner estimates that around 30% of personal superannuation assets are held in legacy products.[73] Rice Warner also found that the fees charged for legacy products are higher than those charged for other superannuation products.

[73] Rice Warner, Superannuation Fees 2014

Figure 12 – Fees by superannuation segment, Year to 30 June 2014

Retail segment	Legacy proportion	Total segment fees	Legacy fees	Contemporary fees
		% per year		
Corporate Master Trusts	25	1.08	1.94	0.83
Personal Superannuation	30	1.64	1.95	1.51
Retirement Income	15	1.61	2.02	1.52

Source: Rice Warner, FSC, Superannuation Fees Report 2014

Eligible rollover funds (ERFs) are a type of legacy product. Superannuation funds can transfer lost and inactive members to these funds. ERFs run by for profit providers charge high fees. The average fee on an account in a retail ERF as a percentage of assets is 2.18 per cent.[74] This amounts to $1,090 per year on an account with a $50,000 balance.

7.6 Employers

Workplace distribution of "pillar two" products is the norm in advanced economies for a good reason – it is very efficient and pillar two has a strong nexus with employment and industrial relations because contributions are occupational or wages-based.

There are costs and risks with providing substantial discretion to employers in respect of product selection. Although many employers will seek to act in the interest of their employees when it comes to superannuation, they also have other interests.

For-profit financial institutions have sought to exploit conflicts between employers and employees by offering employers inducements to direct employees into for-profit super funds.

7.6.1 Employers in superannuation

Where there is no modern award that covers an employee, or where a modern award lists multiple funds, the decision as to which fund to use as a default falls to the employer. For those modern awards that do not list a default fund, the employer may select any fund, provided it complies with the relevant superannuation legislation.

The Productivity Commission review of default funds (2013) examined the role of employers in the system. The Productivity Commission considered but rejected the proposal that employers should have the discretion to choose any MySuper product as their default product, even if additional safeguards were attached to this discretion.

The Commission's reasoning included that employers:

- Receive none of the direct benefits of a fund's high performance, and therefore might have little incentive to invest time and effort into making choices that are in the best interests of their employees
- Could choose a fund solely on the basis that it has the least onerous administrative requirements
- Might face high search costs when trying to make an optimal choice, especially when choosing from a large pool of potential funds, and especially when they lack information and expertise

[74] Rice Warner, Superannuation Fees 2014 at 27

- Could choose a fund that has additional benefits specific to them, such as access to financial products for their organisation
- Might be driven by concerns about any legal repercussions of choices they make, rather than the best interests of their employees

The Financial System Inquiry also rejected the idea that employers should be able to choose any MySuper product as the workplace default fund as a way to increase competition.

The Inquiry supported this view by noting that otherwise banks could leverage their banking relationship with the employer to secure employee super contributions into what may be sub-optimal products.

Subsequent evidence has borne out concerns that employers could be induced to choose a default fund that benefits them. There is now clear evidence of banks offering employers benefits to switch to a retail superannuation fund owned by the bank. A 2015 survey of 550 small and medium businesses conducted by researchers UMR found that:

- Twenty-six per cent of employers surveyed said that a major bank had approached them about transferring their employees' default superannuation to the bank's own retail fund in the last year.
- Just under half those approached reported their bank offered them benefits to change funds.
- The most common offers made by the banks involved a direct benefit to the business rather than employees, such as discounts on business banking and insurance products. Some employers also reported being offered tickets to sporting events.
- Thirty-three per cent of employers offered benefits reported they were persuaded to switch to a superannuation fund owned by their bank, and more than fifty-seven per cent reported that they were still considering switching.

Section 68A of the SIS Act provides that it is unlawful for banks to offer business banking deals and other discounts and benefits to persuade employers to switch their employees' default fund to a fund owned by the bank.

It is difficult in practice to enforce this prohibition, and there is no capacity for ASIC to obtain civil penalties against banks for a breach of s 68A.

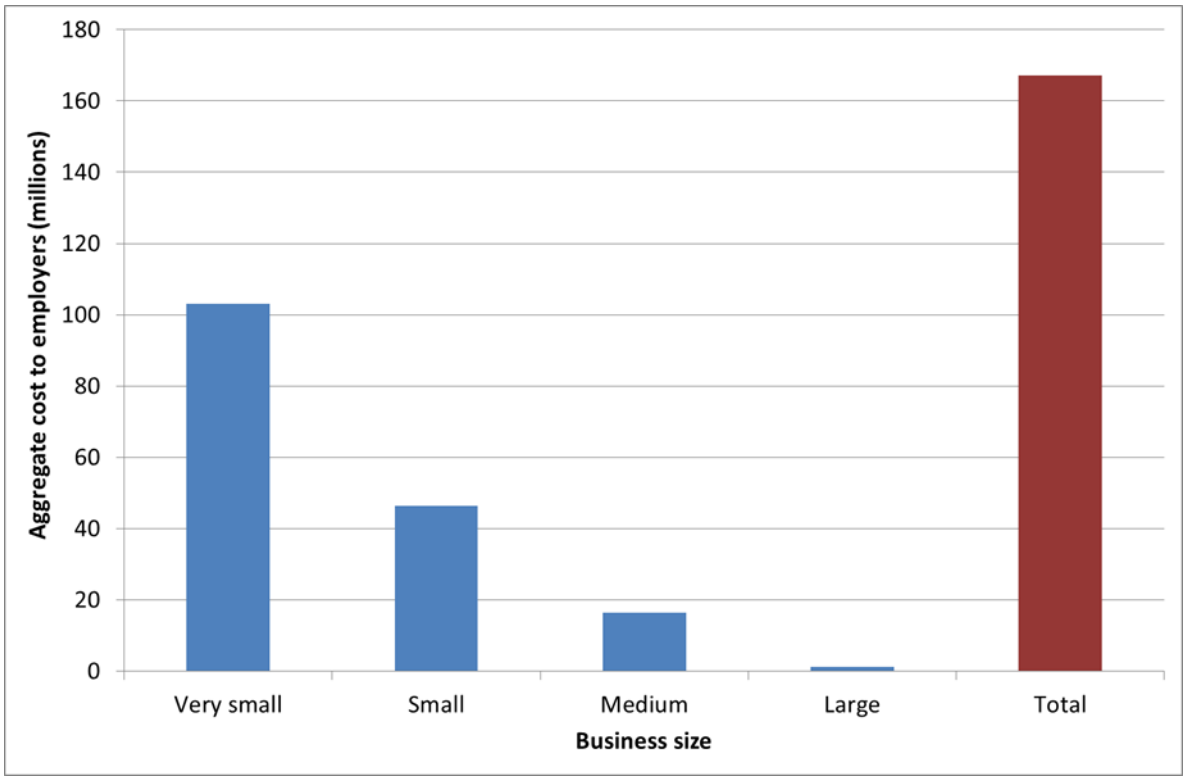
The main remedy available would be for an employee to take civil action to pursue damages. However, given that such arrangements are generally commercial in confidence, employees would typically not be able to obtain evidence of these practices. Even if an employee could overcome this obstacle, it is unrealistic to expect an individual to investigate their employer's banking arrangements, or initiate legal proceedings against a bank.

There is no legal obligation on employers to choose a default fund that is in the best interests of their workforce, and no regulatory supervision of how employers undertake this task in practice. The Productivity Commission concluded in 2013 that it was unable to design an appropriate test that would not place an undue burden on employers, while at the same time safeguarding the best interests of employees who derive their default superannuation product in accordance with modern awards.

ISA estimates that the additional cost imposed on employers, should they be required to select a MySuper default fund unaided by a named list within a modern award, would be in excess of $160 million.

This is a conservative estimate, as it assumes that an employer takes only four hours to undertake due diligence and select an appropriate workplace default fund from authorised MySuper products. A conservative maximum cost of $50 per hour is allocated to cover the employers search costs. This cost includes direct and indirect costs such as an allocation for the employer's time and opportunity cost. Small to very small businesses will bear the bulk of the cost.

Figure 13 – Estimated cost to employers to select MySuper default funds



Source: ABS (2012) Counts of Australian Business Cat. 8165 ISA analysis (2014)

7.6.2 Corporate tenders

The Commission has suggested that corporate tenders increase competitiveness, particularly in relation to fees. The Issues Paper specifically asks for information about the factors and features in which default funds compete in corporate tenders.

While tenders may increase competitive outcomes, there is no assurance that the competition is around delivering the best outcome for members. There is no supervision of tender processes or outcomes, such as by the Fair Work Commission, and poor transparency of outcomes for affected members or the public.

There is some evidence in practice of conflicts of interest being resolved in favour of parties other than members.

The experience of Industry SuperFunds is that the probity of tender processes vary considerably, usually related to employer size. Small, medium and large employers in the private and public sectors run corporate tenders. For example, over the last 12 months, one Industry SuperFund noted that they had participated in tenders by companies ranging in size from a small private sector employer with less than 80 employees, up to a large public sector employer with over 6,000 employees.

Some employers elect to engage a tender consultant. The market for tender consulting includes diverse participants, ranging from the largest accounting and consulting firms to small financial advice practices. There is also a market for consultants engaged to appoint a tender consultant. Importantly, the incentives of the consultant are not necessarily aligned with the employer, much less the employees. It is not uncommon for tender consultants to receive benefits from funds.

Well-run tenders typically focus mainly on performance and fees, as well as insurance, investment strategy, administration and member services. Particular employers may also require funds to address other issues, for example corporate governance.

Corporate tenders have the potential to improve competition and efficiency in two main ways. A well-run tender can result in an employer replacing their default fund with a new fund which performs better for members. Secondly, and more commonly, the process results in the retention of the incumbent fund, but the employer extracts a better offering from that fund, particularly in relation to fees.

However, there are also a number of significant problems with the way corporate tenders operate:

- The process involves significant costs for both the employer and the fund. For example, one large Industry SuperFund reports having to submit tender documents that run to 140 pages.
- In some cases, following a corporate tender process, the employer selects a fund with which they have an association. For example, the fund is part of a corporate group which is also a key client of the employer or provides banking services to the employer.
- As noted above, research commissioned by ISA in 2015 found clear evidence of banks offering employers benefits to switch to a retail superannuation fund owned by the bank. The existing law does not protect members from this practice.
- Some tender consultants extract benefits from funds appointed as a result of tender processes. For example, Industry SuperFunds are aware of instances where a tender consultant (or a related entity of a tender consultant) receives a fee per member from the fund which wins the tender process, for instance to provide advice services to default fund members.
- The practice of retail funds offering fee discounts as part of a corporate tender on the expectation that members will cease employment with the employer, enabling the fund to flip the member into a higher-fee fund without their informed consent has been widespread, particularly in relation to large employers with high staff turnover, such as large retailers. This practice was banned under the MySuper reforms, but anecdotal evidence indicates this practice continues to occur.

The criteria to assess the efficiency and competitiveness of the superannuation system developed by the Productivity Commission should measure:

- The cost to employers of their role in the superannuation system
- The cost to outcomes on members of the agency issues in relation to employer involvement in the superannuation system identified by the Commission in 2013. This could be premised on the extent to which a default selection delivers superior outcomes to the benchmark fund
- Measure the costs to employers and funds of corporate tenders, and determine whether tenders result in better member outcomes than other default arrangements
- Quantify the costs of conflicts of interest that distort the outcomes of tender processes

Better transparency of outcomes will be required to enable such assessments to occur.

7.6.3 SG Compliance

Existing research indicates SG non-compliance by employers is significant and affects the efficiency of the superannuation system.

ISA analysis of detailed ATO data released in 2016 on superannuation contributions at the individual level indicates that the SG payment rate for 2013-2014 was 8.4 per cent once salary sacrifice amounts are excluded. This would indicate that the aggregate dollar value of unpaid SG for this period was $6.2 billion. In coming months, ISA will release more detailed analysis that builds on this data and includes the ratio of unpaid SG at the individual level and personal characteristics of individuals who do not receive their full SG entitlement.

We note that this outcome differs somewhat from the general assessment of SG compliance described in the most recent ATO annual report. In that document, the ATO suggested that voluntary compliance by employers is high because "Total employer superannuation guarantee contributions as a proportion of total salary and wages were 9.79 per cent, against the base rate of 9.25 per cent for 2013-14." However, the ATO seems to include salary sacrifice payments under total employer superannuation guarantee contributions.

The experience of Industry SuperFunds is that small and medium-sized businesses are less likely to pay SG and that high-risk industries include construction, cleaning and hospitality.

It is difficult for individual employees to recover unpaid SG:

- Employees cannot rely on their payslip to confirm that their SG has been paid because wages are typically paid weekly, fortnightly or monthly, but most employers actually pay SG quarterly. As a result, the figure on the payslip is hypothetical.
- If an employee does manage to identify that they have not received SG, the primary recourse is the Australian Taxation Office (ATO). The ATO dedicates little resources to this endeavour.
- There is ambiguity regarding whether individuals for whom SG or salary sacrifice arrangements have not been made have standing to enforce payment.

The ATO holds data about the amount of SG paid at the individual level. Enhanced data analytics by the ATO would enable a more accurate assessment of SG compliance.

The Commission should incorporate this data into its assessment of system efficiency as suggested in Section 5 of this submission.

7.7 Data quality

The accuracy of any assessment of the efficiency of the superannuation system depends in part on the accuracy of the data used.

As noted in Section 5, we suggest the Commission undertake a system wide analysis of efficiency, and then interpret the gap in efficiency between the observed output and the benchmark output by reference to existing research and such other discoveries the Commission makes during its work.

This requires high quality data about inputs (such as SG contributions), and net returns, among other things.

In our view, there are some serious gaps and inconsistencies in data available on system wide outcomes, on choice products and on SMSF products.

It is not clear that there is high quality data about fees and net returns, particularly in the choice segment. APRA fund-level statistics should include legacy products and all choice products, but there are some difficulties in reconciling APRA aggregate data and totals calculated on a fund-by-fund basis. We suggest that the Commission confirm with APRA that its system-wide averages include legacy and all other products, to enable an asset-weighted rate of return. The Commission should obtain a similar confirmation from the ATO about SMSF average asset-weighted returns, and combine these into a system-wide rate of return.

However, even if system-wide asset weighted rates of return can be calculated, the Commission's task of understanding why this rate of return does not meet a benchmark (assuming that it does not) will require high quality, comparable data about the fees and costs charged by all superannuation products and investment options, as well as their net returns. The Commission will need to understand the underperformers to undertake further consideration of why these underperform.

High quality data about all products and options does not currently exist because the requirements for consumer disclosure of fees and costs and obligations to report fees and costs data to APRA are different for MySuper products, choice products and SMSFs. In addition, legacy products do not provide this information. Less robust disclosure requirements for choice investment options enable funds to conceal the true fees and costs of these investment options.

APRA-regulated superannuation funds

APRA-regulated superannuation funds are required, under the Financial Sector (Collection of Data) Act 2001 and its reporting standards, to provide data to APRA. The data is defined in the set of reporting forms and instructions. Some forms are subject to audit requirements.

APRA does not currently collect or publish product-level information about fees and costs or performance for choice investment options, most of which are offered by the retail sector. However, APRA has proposed requiring funds to report detailed information about fees, costs and returns for all investment options that hold non My-Super assets that represent more than five per cent of total assets of the RSE within which the investment option is located, or less than five per cent of total assets of the RSE within which the investment option is located, but are greater than $200 million.[75]

APRA acknowledges that this will apply to a much larger proportion of Choice investment options than the Government's approach to implementing choice product dashboards and says that this 'is important for its prudential supervision of superannuation.'[76]

Nonetheless, there are gaps in APRA's current and proposed data collection for choice products.

Currently there is no official, public record of most fees in retail choice products. This means any Commission analysis could be required to rely on voluntary disclosures to research houses such as RiceWarner, SuperRatings and ChantWest and on these research houses to produce comparative performance data.

In addition, the consumer disclosure of indirect costs in non-MySuper products is not consistent following ASIC's decision to modify the law to exempt platform-based super funds from having to disclose fees embedded in platform structures in PDSs. Not-for-profit funds do not use platform structures, and disclose all embedded costs.

APRA is continuing to consult on its approach to disclosure of fees and costs for choice investment options.

Self-managed superannuation funds

The ATO publishes statistics on the SMSF sector, and has been making efforts to improve the comparability of that data. However, in the last report they continue to flag that their SMSF reporting is not directly comparable because the data collected is not the same.[77]

SMSFs are required to lodge annual returns with the ATO. The ATO uses data reported by SMSFs to produce quarterly and annual SMSF statistical reports. Significant problems with the data continue to limit confidence in the capacity of analysts to measure the performance of SMSFs and to compare this with the APRA-regulated sector. In reporting SMSF data, the ATO itself has frequently stressed that care should be taken in comparing SMSFs numbers with non-SMSF sectors, due to data limitation and differences in methodologies.

Some of the specific data issues with SMSFs are listed below:[78]

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[75] APRA Draft Reporting Standard SRS 702.1 *Investment Performance (Non MySuper Investment Options*).

[76] APRA, Letter to all RSE licensees, 11 December 2015.

[77] https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2013-14/?page=23#Investment_performance

- The ATO releases data on the estimated aggregate performance of the sector, but does not provide a detailed explanation of the basis of the estimation.
- The ATO releases a breakdown on the performance of SMSF by size, and publishes information on the numbers of members, but not the amount of assets, in each category. This information is important to enable analysis of asset weighted analysis of SMSF sectoral performance.
- Valuation and accounting practices: SMSFs were only required to value all assets to their market value from 2012-13 onwards. On the other hand, APRA funds must report assets at market value. This means that ROAs of SMSFs might have been incorrectly reported in previous years.
- Inconsistent treatment of tax: APRA funds tend to make full provision for income taxes on an accruals basis while SMSFs are not required to do so. In many SMSFs, tax is calculated on a cash basis.
- Estimation and recording of true costs:
  - SMSFs costs have been determined based on SMSFs' annual tax return. Since 2013 the ATO started to collect non-deductible expenses for SMSFs. However, this means that prior to 2013, the ATO's collections only captured tax-deductible expenses. Relying exclusively on tax-deductible expenses to identify operating costs would understate the costs of SMSFs.
  - Opportunity costs: ATO data does not capture the time and efforts of trustees in operating SMSFs. These costs are more likely reflected in APRA funds.
  - Invisible costs: These costs can arise when assets are held in an external investment structure, and investment fees are expensed within the structure and only net returns are distributed. While this will not affect the net return calculation, the ATO has expressed concern that fees embedded in the investment structure will not be taken into account in operating expense calculations because the calculations only capture expenses actually occurring within the SMSF. This can occur in both SMSFs and platform-based APRA funds.
  - Establishment costs: These costs are incurred by SMSF members, but not captured in operating expenses because of their capital nature.
- Tax differentials: Super funds do not have to pay income tax on investment earnings in respect of retirement phase assets. This means that identical investments will result in higher net after-tax returns in the retirement phase than in the accumulation phase. SMSFs have a proportionately higher number of member accounts in the pension phase. SMSFs also in practice employ discretion to allocate capital gains to members in the retirement phase.
- Statistical models: For their *Quarterly Statistics*, besides the June figures (using figures from SMSF annual returns), the ATO uses a statistical model to arrive at the quarterly estimates.

In developing criteria to assess the efficiency and competitiveness of the superannuation system, the Productivity Commission should require accurate, consistent reporting of performance data, including reporting of all fees and direct and indirect costs, for MySuper products, choice products and SMSFs.

7.8 Tax concessions are poorly targeted

Superannuation tax concessions are a core element of public policy supporting superannuation and a substantial input into the system. Central to any study of the efficiency of the superannuation system is an assessment of the extent to which tax concessions are efficiently targeted to the policy objective.

[78] https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2013-14/?page=53#Appendix_2___Data_issues

The value of superannuation tax concessions is substantial. According to the Treasury Tax Expenditure Statement 2015, the value of concessional contributions is $15,020 million and the value of earnings concessions is $11,100 million.[79]

While some have questioned these estimates, ATO Taxation Statistics 2013-2014 released on 18 March 2016, support substantially similar valuations to those in the Treasury Tax Expenditure Statement 2015. ISA estimates based on the ATO statistics are:

- $14,967m for concessional contributions
- $11,131m for earnings concessions

7.8.1 Existing tax concessions are poorly targeted

The Financial System Inquiry concluded that "tax concessions in the superannuation system are not well targeted at improving retirement incomes". Commentary following the release of the FSI's Final Report has demonstrated widespread concerns that the existing system of superannuation tax concessions is inefficient, unsustainable, inequitable and requires reform.

We also note that the Government has recently announced changes to the taxation of superannuation. We believe these changes will reduce the inequity and inefficiency of the system (though more can be done). However, as these are not legislated, and will be influenced by the makeup of the next Parliament, we recommend that until changes are legislated the Commission should use existing system settings.

Figure 14 provides estimates of the distribution of the main superannuation tax expenditures in 2013-2014. The distribution of the concessions indicates that males receive nearly twice the value of tax concessions received by women. Individuals in the top tax bracket receive on average multiples of the value received by individuals in lower tax brackets. Tax expenditures favouring those who have the means to retire very comfortably without government support are inefficient because they direct scarce resources to those who least need the increased incentive to save and who least need the fiscal contribution.

Figure 14 – Distribution of Superannuation Tax Expenditures by taxable income, 2013-14

	Concessional contribution concessions		Earnings concessions	
Females	**Total $m**	**Av per person $**	**Total $m**	**Av per person $**
a. Less than or equal to $18,200	-$127.46	-$198.84	-$392.60	-$351.94
b. $18,201 to $37,000	$258.03	$191.72	$424.40	$262.46
c. $37,001 to $80,000	$2,876.76	$1,308.24	$2,067.30	$941.57
d. $80,001 to $180,000	$1,759.03	$2,529.61	$1,455.50	$2,301.60
e. $180,000 or more	$419.23	$5,076.04	$648.20	$8,038.39
f. No Income tax return	$112.16	$182.22	-$396.50	-$243.09
All Females	$5,297.75	$949.53	$3,806.30	$523.40
Males				
a. Less than or equal to $18,200	-$97.49	-$205.78	-$411.90	-$499.61
b. $18,201 to $37,000	$162.62	$168.63	$374.30	$323.04

[79] Some have suggested that an expenditure tax benchmark rather than comprehensive income tax benchmark should be used to value these concessions. However, this is not logical as Australia's existing approach to taxation of income from capital is on an income tax basis, not a consumption or expenditure basis.

	Concessional contribution concessions		Earnings concessions	
c. $37,001 to $80,000	$3,095.90	$1,250.32	$2,458.60	$994.46
d. $80,001 to $180,000	$4,450.05	$2,746.35	$3,299.00	$2,238.78
e. $180,000 or more	$1,868.82	$6,591.47	$2,138.10	$7,723.71
f. No Income tax return	$189.49	$286.75	-$506.70	-$289.36
All males	$9,669.39	$1,492.45	$7,351.40	$923.90
Unknown Gender				
f. No Income tax return			-$26.70	
Grand Total (millions)	$14,967		$11,131	
Treasury TES 2015	$15,020		$11,100	

Source: ISA calculations from ATO Taxation Statistics 2013-14 Tables 24 and 25

Although high income earners benefit significantly from tax concessions, many low income earners are detrimentally affected. Based on current settings (which assume the abandonment of the LISC) people in the bottom income decile pay more tax on their superannuation savings than they do on ordinary income.

A large proportion of the population have inadequate superannuation balances, and will rely on the age pension in retirement. Yet, these cohorts receive relatively little help through super tax concessions to boost their retirement outcomes.

In contrast, a much smaller proportion of the population receive generous levels of tax concessions despite the fact that they will not call on the age pension in retirement.

It is inconsistent with the longstanding principles underlying superannuation, and inefficient, to provide tax expenditure support to those who would retire very comfortably without them and will not rely on the age pension.

This points to a misallocation of concessions within the system where concessions are not being directed efficiently, namely to where the opportunity to improve retirement outcomes is greatest and there is scope to reduce reliance on the age pension.

We urge the Commission to include the contribution of government fiscal support to superannuation in the measurement of superannuation system efficiency.

7.8.2 Tax concessions and SMSFs

A number of tax concessions are only available to members of SMSFs. These include:

- The ability to make in specie contributions in the form of assets other than money, including listed shares, other securities and business real property.
- The ability to make personal superannuation contributions using the capital proceeds of the sale of small business assets combined with CGT exemptions.
- A fund can apply for a capital gains discount of 33 per cent for capital gains on assets held for over one year, effectively reducing the tax on this income to 10 per cent.

Unlike members of APRA-regulated superannuation funds, members of SMSFs can also establish a limited recourse borrowing arrangement to fund investments.

These settings result in competition by SMSF service providers other than on value or price. For example, many advisers compete on the tax benefits of SMSFs and spruik their role as a vehicle to accumulate wealth, borrow to invest in residential property and conduct estate planning.

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