Submission to Stage 3 of the Productivity Commission Inquiry into

the competitiveness and efficiency of the Australian superannuation system

August 2017

Introduction

This submission is made by:

- Independent Fund Administrators & Advisers Pty Ltd (IFAA), a Brisbane based administrator of industry superannuation funds and managed investment schemes. IFAA has approximately $9.5 billion in funds under administration;
- QIEC Super – a profit for members industry fund established specifically for the benefit of all participants in the non-Government education sector, child and other care and community services in Queensland;
- Club Super – a profit for members industry fund established specifically for the benefit of employees in the sporting and recreational clubs and associated industries in Queensland.

IFAA, QIEC Super and Club Super appreciate the opportunity to make comment on the issues raised in the Commission Inquiry into the final stage of the Commission's Inquiry into the competitiveness and efficiency of the Australian superannuation system.

It is acknowledged that this inquiry is the final stage of the review process by the Productivity Commission, arising out of the Government's response to the Financial System Inquiry:

1. A study to develop criteria to assess the efficiency and competitiveness of the superannuation system (to be finalised by November 2016);
2. An Inquiry to develop alternative models for allocating default members to Funds (to be finalised by August 2017);
3. **An Inquiry to review the efficiency and competitiveness of the superannuation system (to commence after July 2017, after bedding down of the MySuper system). This will utilise the criteria developed in stage 1.**

1. Executive summary

Our response to the Stage 3 Issues Paper has been framed with consideration of our prior submissions to the Productivity Commission's (PC) requests for input on the two previous stages of this Inquiry. We have outlined in section 3, a number of significant concerns about the likely consequences of implementing some form of competitive default fund selection process.

We note that the process and time line for this Inquiry have changed from the original proposal and agree that accelerating the Inquiry should help to reduce the uncertainty in the industry and allow Funds to focus on improving outcomes for members.

The PC has indicated that it will be undertaking most of the extensive data collection itself, including via collection of data from APRA and private research firms, as well as surveys of funds and fund CEO's. As a result, this submission does not seek to provide data for the assessment of the competitiveness and efficiency of the system, but rather focuses on what we believe is likely to be the adverse outcomes of introducing a competitive model. That is, significant reduction of funds over the medium term, with consequent negative impact on competition and member outcomes.

2. Co-ordination of Government proposals

As we have highlighted in submissions to Government on other proposals, the Government is often progressing concurrent related initiatives. This is the case with:

- this PC Inquiry reviewing the competitiveness and efficiency of the superannuation system, as well as alternative default models. The PC is tasked with making recommendations to improve outcomes for members and system stability, and to reduce barriers to the competitiveness and efficiency of the system;
- the recently released draft Bill addressing enhanced Accountability and Member Outcomes.

Yet before the PC has completed this Inquiry, the Government has apparently formed a view on the competitiveness and efficiency of certain elements of the industry and what needs to happen to improve member outcomes, as per the Accountability and Member Outcomes Bill.

We note that insurance has been included in the revised Stage 3 evaluation. Concurrently, the Government has announced its intention to enact additional legislation that will make it easier for members to opt out of Insurance.

Clearly it would be preferable if the Government were to co-ordinate all of these related initiatives to ensure coherent outcomes are achieved.

3. Complexity and potential outcomes of the PC review

As we have outlined previously, we state our unambiguous support for efficiency and competition in the superannuation industry.

<u>Complexity of the PC review</u>

As we noted in our submission in response to stage 1, the PC review is extraordinarily broad in its scope. At that time, we recommended some simplification of the proposed criteria and indicators. It is acknowledged that the PC Stage 3 issues paper does reflect some reduction in the criteria (from 27 to 22) and indicators (from 115 to 89). However, notwithstanding this rationalisation, there remains a large amount of information the PC will be analysing across a multitude of measures, obtained from a range of sources, with a high likelihood of conflict between some measures. This will also require consideration and balancing of many quantitative and qualitative factors. As a result of assessing so many factors, we consider it will be very difficult for the PC to come to clear or indisputable conclusions in assessing the competitiveness and efficiency of the superannuation system.

This raises concerns given that this Inquiry's conclusions will form the basis of potential PC recommendations to replace the existing default fund system with some form of competitive default fund model, as flagged in stage 2 of the Inquiry.

<u>Potential adverse consequences of introducing a competitive default model</u>

We have serious concerns about the potential outcomes and consequences of a potential move to a competitive default model. Specifically, we consider:

- the majority of 'unsuccessful' funds under a competitive default process would effectively be condemned to negative growth due to being barred from receiving default contributions (which is the major source of new monies), while still being subject to normal outflows. This would have a significant adverse impact on the viability of these funds, and over the medium term, the impact is likely to have terminal consequences for these funds (assuming they remain 'unsuccessful' in future competitive default processes). It also raises concerns about the impact on the existing default MySuper members, in a declining fund;
- further to the above point, a competitive default model which results in one, or a small number of 'winners', is likely to result in a significant reduction of funds in the system over the medium term, with a consequent reduction in competition;
- the expected significant reduction in funds across the industry in the medium term will reduce the likelihood of the small number of remaining funds meeting the needs and preferences of all members, including those that value a customer intimacy / high service model. The landscape of the superannuation industry may ultimately resemble an oligopoly, which would greatly reduce diversity and competition in the market and is likely to result in poor member experiences.
- if a competitive default model results, in the medium term, in a small number of large funds, this will increase concentration risk in the industry. There would also be significant operational risk in managing multiple mergers across the industry, which may impact system stability;

- similarly, any major consolidation of funds within the industry is likely to result in a corresponding reduction in service providers servicing the smaller number of funds within the superannuation system. This represents a systemic risk and will increase concentration risk amongst an expected smaller number of major service providers such as administrators, insurers and asset consultants. This outcome would reduce competition in the service provider market, with adverse cost impacts expected, to the detriment of members;
- a periodic competitive default process will encourage funds to focus on short term outcomes in the hope of maximising their chances of success, whereas the focus of Trustees should be on long term outcomes;
- any competitive default model that results in a limited number of 'winners' will mean such 'successful' funds will need to be in a position to 'scale up' to accept potentially a large pool of new default members from across the industry. This may limit the realistic bidders to be only a small group of large public offer funds, who would have such capacity. This arrangement would unreasonably disadvantage small funds. This is in contrast to the existing default model, which allocates only the default members covered under particular awards or industrial agreements. This system allows all funds to target and service the default members within their jurisdiction;
- Considerable expense and effort will be required on the part of tenderers to bid for default fund status. Such costs (which are not incurred under the existing default model) may be considered unproductive and will ultimately be borne by members. The costs associated with this process may again put small funds at an unfair disadvantage.
- As has been seen in the Chilean experience, the number of participants in auctions has steadily fallen and it can be argued that while the fees paid by members of the successful fund has fallen, and indeed fees across their system have fallen, the level of service and net returns appear to also have fallen. This suggests a competitive model drives outcomes to base levels. The result in Chile appears to have been a reduction in competition and outcomes for members.

In our view, any one of the alternative competitive models put forward by the PC would represent a major overhaul of the superannuation system, although it is acknowledged that the announced limitation of any competitive default model to 'first timers' would mitigate the impact on existing funds in the short term.

The very real threat to the ongoing existence of many funds (in the medium term) under a competitive model would be despite the fact that these funds may be operating efficiently and effectively in serving the interests of their members, but may have failed to meet the shortlist of 'successful' funds. We note that the PC has indicated that competition is not an end in itself, but only an intermediate objective insofar as it drives efficient outcomes for members. We question whether a competitive default model will produce such outcomes for members.

<u>Potential conflict between likely outcomes and system objectives</u>

In our view, the likely outcomes outlined above would be at odds with objectives 2 and 4 of the PC's stated system objectives, outlined below.

1) The superannuation system contributes to retirement incomes by maximising long term net returns on member contributions and balances over the member's lifetime, taking risk into account.

2) The superannuation system meets member needs, in relation to information, products and risk management, over the member's lifetime.

3) The superannuation system provides value for money insurance cover without unduly eroding member balances.

4) Competition in the superannuation system should drive efficient outcomes for members through:

   - a market structure and other supply and demand side conditions that facilitate rivalry and contestability;
   - suppliers competing on aspects of value to members

5) The efficiency of the superannuation system improves over time.

4. Input to the PC Inquiry

The issues paper refers to the Inquiry being in relation to the superannuation system and makes the point that this is broader than the industry. However, we note that the PC's listed sources of information are focussed on the industry (ie. APRA, funds) rather than the broader system.

We consider that the PC should also directly seek input from service providers including administrators, custodians, investment managers, insurers, actuaries, etc. to gain another perspective on competition and efficiency in the superannuation system.

5. Comments on elements of PC issues paper

The PC issues paper acknowledges that it will undertake most of the data collection itself. Our remaining comments address those matters raised in the paper where we feel we can add value, noting that funds and fund CEO's will also be asked to complete a survey to provide further information to allow the PC to complete its evaluation.

a) The operation of the existing default system

The PC has raised the question how the system can ensure members are not defaulted to long term underperforming products. This immediately raises the question of how to define underperformance. If underperformance refers only to net investment returns, then we agree that chronic long term underperformance would represent a problem, but consider this may be addressed via the proposed 'outcomes' test flagged in the recent Bill released for comment by Government. However, appropriate consideration also needs to be given to whether members receive a service premium in return. This is recognised in criteria E2 of the issues paper. This is appropriate because members may be prepared to accept higher fees and costs if it provides them with higher returns or greater access to information and advice. It is unclear how the PC intends to balance quantitative and qualitative factors in assessing the competitiveness and efficiency of the system, and sectors within it, but we consider that striking an appropriate balance will be critical in undertaking a credible assessment.

As we have outlined in previous submissions, the existing default fund model which operates through the industrial relations system, involves employer and member representatives negotiating in good faith to optimise member outcomes in the selection of default funds. This happens at no, or minimal, cost to the fund and its members. In some cases, membership of the selected default fund can qualify the members for a higher level of employer contribution, or provide access to customised insurance that specifically caters for the needs of members in that particular industry. Such members are clearly advised of their ability to opt-out of insurance if they do not require it. This is considered to be in the best interests of those members. Any move to a competitive model would remove any negotiation between the industrial parties and may result in members not gaining access to the above-mentioned benefits, which would be to the disadvantage of those members.

The existing default model does create incentives for funds to maximise long term net returns. Firstly, Trustees are accountable to their members and generally speaking, the better the net returns delivered, the better the outcomes for members will be. This is likely to reduce requests to rollout of that fund. Additionally, due to competition in the superannuation industry, strong investment performance is recognised in crediting rate surveys, and is often utilised in fund marketing campaigns. It should also be recognised that past performance is not a reliable indicator of future performance, so even a fund which may have outperformed over say 10 years, may not outperform over the next 10 years. Therefore, a competitive default process that rewards default status to funds which may have historically outperformed over a particular timeframe, may not result in members of that fund benefiting from outperformance over the period ahead. Instead, there may be an incentive for Funds to gamble on higher returns in the short term to compete in a competitive default process, with aggressive investment strategies potentially having longer term costs to members due to expected volatility.

b) Fees and costs

The paper notes the impact of fees and costs on low account balances, and asks what can be done to minimise erosion. At the commencement of the MySuper regime, the Government specifically abolished member benefit protection, and required Trustees to treat all MySuper members equitably, which means all MySuper members must be subject to the same fees and costs, irrespective of balance. This outcome, which can result in MySuper small account balances being subject to erosion, is a direct result of Government Policy. In the absence of legislative change, there is no scope for Trustees to undertake initiatives to change this position for MySuper members.

c) Is disclosure facilitating comparison between funds by members

It is noted that the following information is currently available to allow members to compare the features and performance of various funds:

- MySuper dashboards. These provide a simple basis for basic comparison of key MySuper quantitative metrics, but could be improved by providing scope for qualitative comparison factors, e.g. ratio of Customer Support Officers to members, service response times, etc.
- Product Disclosure Statements. These key disclosure documents provide a useful summary of the features and fees and costs of each product. Due to ASIC

discouragement of adding discretionary content, there is very limited scope for funds to promote the qualitative aspect of their offering.

In addition, there are concerns that despite the objective of Regulatory Guide 97 to provide for greater transparency and comparability in relation to fees and costs, this may not be fully realised. The RG97 regime appears to allow greater scope for interpretation on various elements, and allows for certain asset classes and investment structures to be treated in different ways, thus potentially opening the door to greater inconsistency than under the existing disclosure regime.

- Fund websites. The amount of information available on websites is generally very extensive and subject to a large degree of discretion as to content, making comparison difficult.
- Rating agency comparators. Only the most diligent and financially literate member is likely to access and analyse this information.

It is noted that the Accountability and Member Outcomes Bill also proposes extension of the scale test to become a broader outcomes test, with results to be published, allowing further comparison.

In reality, complexity, combined with ongoing changes to the rules of the superannuation system is overwhelming to many people, and we consider only a small minority actually undertake the detailed research of all available information to make fully informed decisions. We believe this will continue to be the case even if the proposed publication of results of the outcomes test eventuates.

d) Is competition currently evident across the system

There is currently very real competition existing in the superannuation industry. Funds actively promote favourable investment performance and rating results. Agencies such as SuperRatings issue annual awards, where the best performing funds are recognised across different facets of fund operations (investments, member servicing, marketing, governance, insurance etc), and an overall ‘Fund of the year’ is awarded. Funds also monitor their relative ratings on various measures each year to get an indication of where they sit relative to industry benchmarks, and seek to improve year on year. On an ongoing basis, funds are also actively investigating initiatives and enhancements to their product and service offering. For example, many funds:

- have introduced online limited advice functionality;
- continually improve the ability for members to self service via ongoing improvement to online portals;
- regularly improve the features of their insurance offering at optimal cost. In some cases, enhancements are negotiated with insurers at no additional cost to members;
- have introduced tools to facilitate members searching for and consolidating other super accounts, via integration with the ATO SuperMatch 2 tool.

This process of continual improvement evidences Trustees acting in the best interests of members, but also evidences a high level of competition in the industry. As above, funds conduct active campaigns to maximise rollins via the SuperMatch facility. Improvements in fund features and service offerings improve the ability to attract and retain members.

Conversely, competition is not strong across all sectors of the system. For example, low levels of competition exist in the superannuation administration market, where major barriers to entry exist. As the rules governing the superannuation industry are so complex and subject to regular change, major investment is required in system infrastructure and specialist industry knowledge. If a competitive default model was to further concentrate the administration market in the hands of a few major players, this would strengthen their market power and reduce price competition, to the detriment of members.

e) What are some of the major impediments to efficiency and competition in the system?

As we have acknowledged in previous submissions, there is certainly a place for appropriate levels of regulation in the superannuation industry. We recognise that the best interests of members must be actively promoted, via regulators implementing an appropriate prudential and disclosure regime, as well as Trustees executing their fiduciary duty.

However, we consider that the complexity and interaction of the various elements of the system, as well as the constantly evolving legislative and regulatory landscape, are major impediments to member engagement and achieving optimal efficiency and competitiveness in the industry. For example, we believe the combination of the above dynamics is a major factor in inhibiting member comprehension of superannuation, which contributes to disengagement. This serves to dampen demand side competition in the system.

At the fund and service provider level, configuring systems, procedures, staff training, disclosures to comply with the ever changing regulatory landscape is a major and growing component of cost within the industry, with these costs ultimately being borne by members. We suggest that the Government should have a greater appreciation of the cost impacts on members when introducing further regulatory change, and be aware of the risk of over regulation.