

4 May 2016

Superannuation  
Productivity Commission  
Locked Bag 2, Collins St East  
Melbourne VIC 8003

Level 7, 120 Collins Street,  
Melbourne VIC 3000  
GPO Box 9827, Melbourne VIC 3001  
DX 423 Melbourne

Telephone: +61 3 9280 3200  
Facsimile: +61 3 9280 3444  
[www.asic.gov.au](http://www.asic.gov.au)

Dear Sir/Madam

### **Superannuation Efficiency and Competitiveness**

I refer to the issues paper released by the Productivity Commission (the Commission) in March 2016 on Superannuation Efficiency and Competitiveness.

The Financial System Inquiry (FSI) recommended a review of the competitiveness and efficiency of the superannuation system by the Commission, to be undertaken in three stages. Ahead of the full implementation of MySuper reforms on 1 July 2017, the Commission has been tasked with initially developing the criteria to assess the efficiency and competitiveness of the superannuation system. This will be followed in the second half of 2016 with a Commission inquiry examining alternative models for a formal competitive process for allocating default fund members to products. Both of these stages will inform the final stage of inquiry, involving a review by the Commission of the efficiency and competitiveness of the super system.

The Australian Securities and Investments Commission (ASIC) appreciates the opportunity to provide a submission to the Commission on these important issues.

### **ASIC's role**

As the conduct and disclosure regulator, ASIC's role primarily concerns the relationship between trustees and individual consumers. ASIC aims to promote the confidence of consumers by:

- ensuring they receive appropriate disclosure;
- are dealt with fairly by qualified people when being provided with financial services;
- continue to receive useful information about their superannuation; and
- can access proper complaints-handling procedures.

Promoting confident and informed investors and financial consumers, and fair and efficient markets in the financial system, are strategic priorities of ASIC.

In this context, as a consumer-focussed regulator, there are issues that we wanted to raise for your consideration. This includes our work on fee and cost disclosure, initially flagged in ASIC's submissions to the FSI, as well as feedback about our experience with disclosure more generally and whether it enhances competition.

## **ASIC feedback**

### ***Summary***

ASIC's major points in response to the Commission's issues paper, covered in more detail below, are as follows:

- Disclosure initiatives, including shorter product disclosure statements (PDSs), product dashboards, and improved fee and cost disclosure, while useful for consumers, cannot deliver investor protection and effective competition on their own;
- In part, this is driven by consumer disengagement and behavioural factors constraining the effectiveness of these disclosure measures; and
- For similar reasons, alternative indicators, such as range of choice and user satisfaction, may be weak indicators of competition and efficiency.

We think that confirming the objectives of superannuation will be critical to the Commission's assessment of the superannuation system.<sup>1</sup>

### ***Comparability and competition***

Comparability on key aspects of a superannuation offering has the potential to enhance competition and efficiency in the system.

Existing disclosures, particularly those introduced as part of the recent Stronger Super reforms, are designed to promote product comparisons in superannuation. These disclosures include:

- PDS: many of the superannuation products are subject to the shorter PDS regime which simplifies disclosure and mandates the same headings and information in each 8 page PDS;
- Product dashboards: these have applied for MySuper (default) products since 31 December 2013. Dashboards provide basic information about the product and its returns, target returns, fees and costs, and risk in an easy to read format that must be publicly available on a fund website.

Further, as a result of Stronger Super reforms, the Australian Prudential Regulation Authority (APRA) now collects significantly more statistical information from superannuation trustees than it has done previously. This includes information about fees and costs, performance and investments made by superannuation trustees. This information is published by APRA on its website and should contribute to the transparency of the superannuation system.

However, many of the disclosure changes have only recently been introduced so their full impact on product comparability and competition is as yet unknown. Ideally, we

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<sup>1</sup> ASIC has recently made a submission to the Government's Objective of Superannuation Discussion Paper, dated 9 March 2016 which sought feedback on the objective of superannuation recommended by the FSI (to provide income in retirement to substitute or supplement the Age Pension). We broadly support this objective and the idea of setting objectives in superannuation more generally.

would need to test and/or measure consumer behaviour in response to understand how or if the provision of this information has in fact changed behaviour and in what ways.

One area that has been of particular focus to ASIC is the quality of fee and cost disclosure. As noted in ASIC's *Financial System Inquiry interim report: Submission by the Australian Securities and Investments Commission*, August 2014 (second submission) one of a number of potential barriers to fee reduction in the superannuation sector is the complexity and lack of transparent fee structures so that the inability to compare and lack of price discovery impedes rational and informed decision-making in the choice of superannuation funds (see second submission, paragraph 211).

The second submission also noted our review work undertaken in 2013/2014, which culminated in the release of ASIC Report 398 *Fee and cost disclosure: Superannuation and managed investment products*.

In the report we highlighted a number of inconsistent fee practices and reporting that have the effect of hindering accurate fee and cost disclosure for investors. Among these are issues with the inconsistent treatment of management costs associated with investing through external investment structures, different practices used to disclose performance fees and significant variations in disclosure in relation to the fund's insurance offering (see second submission paragraph 212 for a more detailed list).

Since this time, ASIC has done a considerable amount of work in providing guidance and relief to the superannuation industry to try and address some of these fee and cost disclosure issues. In November 2015, ASIC updated its primary fee and costs disclosure guide, Regulatory Guide 97 *Disclosing fees and costs in PDSs and periodic statements* (RG 97) and provided industry with an instrument of relief which clarified the disclosure requirements in Sch 10 to the Corporations Regulations 2001.

In particular, ASIC has:

- Modified the definition of indirect costs to clarify that this must include the costs of investing through interposed vehicles and over the counter derivatives;
- Clarified for indirect costs that superannuation trustees are expected to make reasonable estimates where they do not know or ought to know a cost; and
- Highlighted the buy/sell spreads that often apply in addition to other fees and costs by requiring a more detailed note to the existing worked dollar example of fees and costs in the PDS to demonstrate its impact on a withdrawal of \$50,000.

These changes will take effect from no later than 1 February 2017 for PDSs, and we consider in addition to other clarifications of the regulatory requirements and ASIC guidance that they will help improve the consistency and accuracy of fee and cost disclosure. In turn, we think that in the future this will allow members to better compare funds and for funds to more fairly compete on fees and costs.<sup>2</sup>

<sup>2</sup> See ASIC's second submission to the FSI, paragraph 215 for our comments that the initial implementation costs of reform may result in higher fees at present. The full benefit of the reforms may take time to eventuate. Anecdotally, however, we have observed that the introduction of lower cost MySuper products has increased fee competition within the superannuation sector. Submission available at: <http://download.asic.gov.au/media/2613736/asic-submission-to-the-financial-system-inquiry-interim-report-published-26-august-2014.pdf>

We do not consider, however, that the work that we completed means that further improvements cannot be made to fee and cost disclosure. The following is a brief summary of some areas that still need further attention:

- Currently superannuation funds often compete on headline fees – for example, the final figure used in the worked dollar example of fees and costs in the PDS. It is this figure that is often quoted on comparison websites. However, some superannuation trustees may be generating profit from other fees such as the buy/sell spread which is not directly factored into the final figure in the worked dollar example. ASIC is aware that the US and the UK have also had to contend with this issue.<sup>3</sup>
- There are currently different disclosure requirements between super funds and managed funds. The main difference being that super funds must include in their indirect costs all transaction costs that are not charged to members by way of a fee, such as a buy/sell spread fee. Managed funds do not include transaction costs in management costs, but rather mention in additional notes that transaction costs are payable and give an estimate of these. Many super funds invest in managed funds, meaning that they must make a reasonable estimate of all the managed funds' costs, including transaction costs. Without transactions costs being included in the managed funds' management costs this requirement is harder to meet.

Further, when superannuation members invest their super through a platform arrangement the trustee of the platform can give the member the PDS for the underlying products offered, which in most cases are managed funds. Members considering investing through platforms will have to compare a PDS of a managed fund with a PDS of non-platform super funds. This comparison is made more difficult by the fact that the fee disclosure in the managed fund's PDS is different from a super fund's PDS. ASIC has sought to address this concern by encouraging the provision (in relation to each option available through a platform) of disclosure that covers the fees and costs (including transaction costs) of both the platform level and the underlying managed investment scheme level together as one figure.

As an additional comment on comparability, life insurance costs are not required to be disclosed in a comparable way in a PDS and premiums do not appear in the worked dollar example. In drafting our revised RG 97, feedback from industry suggested that this is an area that could benefit from greater clarity. Although insurance costs can be difficult to quantify, at present there is potentially less transparency around insurance costs than there is in relation to other fees and costs in superannuation.

Further, there is no information about insurance at all in the product dashboard. In the MySuper (default) context, certain types of life insurance must be offered by superannuation trustees on an opt-out basis, but members can usually purchase more cover if they wish. Some basic levels of insurance may be offered without health checks. Insurance is often a key benefit of superannuation and a significant feature of many of these products.<sup>4</sup> However, the lack of comparable information about

<sup>3</sup> See for example <http://finops.co/investors/private-equity-funds-coming-clean-with-expenses-fees/>

<sup>4</sup> According to ASIC's Report 413 *Review of retail life insurance advice* in 2014, approximately \$13.1 billion in total inflows of new and in force premiums went through superannuation. The total figure for



insurance (in relation to premiums, but also more broadly) may be having an impact on the level of competition in relation to insurance in super.

Better disclosure of fees and costs has the potential to have a broader impact than might initially be anticipated. Better disclosure of fees and costs may improve trustee decision making and behaviour as trustees are likely to have more regard to fees and costs when making decisions about the fund, including investment decisions. For example, by having greater regard to fees and costs trustees may invest more passively than they would otherwise or choose to invest in less costly investments that are expected to have similar risk/return characteristics. In this regard, improved disclosure could reduce the risk of distortion that may be caused by trustees being able to under-disclose fees and costs.

However, there is a potential danger that the way in which disclosure is focussed on fees and costs could lead to less investment in certain assets such as real property assets that have high transaction costs, even if the anticipated returns justify investment.

While ASIC considers that having comparability of fees and costs is important, the level of fees and costs should not be the sole criteria by which a fund is judged, or the competitiveness and efficiency of the superannuation system is considered. Net investment returns, along with retirement income and the provision of ancillary product services such as insurance, might also be considerations when setting assessment criteria.

Also important is the level of risk taken to generate a particular return or for the level of fees and costs charged. Low fees and high returns at the risk of a complete loss of capital may not be ideal in a compulsory superannuation system.

While downward pressure on fees and costs may be generally positive, ASIC is conscious that service providers, such as administrators, do need to be adequately funded if the superannuation system is to work smoothly and without risk of experiencing major administration errors. In the course of our work, we find that generally more than 50% of the breaches from superannuation trustees relate to errors and issues in administration. These can range from errors in unit pricing to basic failures to provide required disclosures to members in time.

### ***Consumers – behavioural economics and financial literacy***

ASIC has attempted to get the best possible comparable fees and costs disclosure for consumers. We do anticipate that this would have some impact on competition. However, as flagged in the summary to this submission, disclosure initiatives cannot deliver investor protection and effective competition on their own.

In ASIC's submission to the FSI, we recognised the limits to the effectiveness of disclosure in driving good consumer outcomes and noted that in some cases mandated information may not improve market outcomes and may simply represent a cost for providers.

ASIC believes that there is potential to improve regulatory design with a better understanding of consumer behaviour and decision making. Any analysis of the

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the life insurance industry (including superannuation) was \$44.2 billion. See Figure 1, page 10, based on Plan for Life data Group Total Inflows *Life Insurance Statistics, March 2014*. Report available at: <http://download.asic.gov.au/media/2012616/rep413-published-9-october-2014.pdf>

effective operation of the Australian superannuation market should therefore take into account if and how behavioural factors may be impacting demand side behaviour and market outcomes.

Evidence and research from behavioural sciences shows that systematic biases and use of decision making short cuts impact on consumer outcomes, as does context and environment. For example, people tend to prefer the status quo (inertia), which may result in a consumer staying in a particular fund because moving is perceived to be too difficult.<sup>5</sup> Further, consumers may overvalue immediate costs and benefits relative to future costs and benefits and this may hinder their ability to make appropriate decisions that are based in the distant future – this is a key issue in a long-term product like superannuation and a factor that has influenced the design of Australia's compulsory superannuation system.

That consumer decision making in financial services markets tends to be particularly prone to error, is not surprising. Financial products are typically complex and involve assessing risk and uncertainty. Because they also tend to be purchased infrequently, they permit relatively limited opportunity for learning through feedback.

### ***Consumer Engagement***

Despite the fact that most people would now have choice of fund and could exercise portability rights, superannuation is a compulsory system, where employers still often have to select a fund for their employees. While exact numbers are hard to estimate, we understand there are a significant number of disengaged participants in the current superannuation system.<sup>6</sup> As a consequence of this, solely relying on disclosure to produce the comparability (and therefore competition) that will ultimately influence fees and costs and product features may prove problematic. We note that relatively low levels of switching (as one measure of engagement) are common across many financial services and other similarly complex products.

Further, it cannot be assumed that member engagement is continuous throughout a members' lifetime - engagement is often dynamic and generally increases with age and account balance. This could mean there is more member-driven competition as members get older with larger balances. Self-managed superannuation funds (SMSFs) play a significant competitive role particularly in the older member demographic.

Appropriate engagement also needs to be defined. While current assumptions suggest that more engagement is better, this may not always be the case. Not all member engagement will lead to greater efficiency and to the right type of competition. On the other hand assumptions cannot be made that members that do not switch from default

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<sup>5</sup> Transferring between funds is becoming easier and the timeframes for such transfers have been reduced from 30 days to 3 days. However, many consumers will still find themselves in multiple funds as a result of their employment arrangements. Consumers still need to take some active steps to consolidate their superannuation.

<sup>6</sup> In superannuation, engagement tends to be measured by how often a member of a fund takes some form of action (such as calling a call centre, changing investment options, increasing insurance). However, many members may read the PDS for their product and decide the default (MySuper) fund is appropriate for them. Thus, to the trustee, there is no outward sign of their engagement and they may be categorized incorrectly as disengaged members, which may not strictly be the case.

options in default funds, which might seem to be disengaged are in fact disengaged – some have made a choice that the default is the most appropriate product for them.<sup>7</sup>

Even assuming engagement, a long-term study of Australians' financial literacy suggests that adult Australians have varying levels of financial knowledge and proficiency, and that a range of shifting factors correlate with differences in financial literacy levels - including age, financial attitudes, household income, education and occupation. For example, 22% of people were unsure how to assess the performance of a superannuation fund or managed investment scheme.<sup>8</sup>

To compound this issue, investors also report being overwhelmed by the volume of material available and the difficulty in assessing the validity of the available information.<sup>9</sup>

In some instances, consumers may use information given to them in a way that was unintended. In a broader financial services context, studies into disclosure of conflicts of interest have found that the disclosures (although mandated) can be interpreted as a sign of honesty. In other cases, the consumer feels obliged to follow the advice provided as rejection following conflicts disclosure may signal a lack of trust.<sup>10</sup>

In addition to behavioural biases and cognitive constraints, it is possible that the rational preferences of consumers may not align with Government objectives for the superannuation system. For example, a consumer may wish to leave a large bequest on their death, even if the Government does not consider one of the objectives of the system as being about intergenerational wealth transfers.

Further, some members leave the APRA-regulated superannuation system and establish an SMSF. We have seen a number of APRA-regulated funds starting to compete with the SMSF sector on product features. For example, some APRA-regulated funds now offer member directed investment options, which aim to provide some of the flexibility in investment choice of the SMSF sector, without the member having to move their superannuation monies to an SMSF.

If consumers are currently faced with complex decisions about how they will fund and manage their retirement, some consideration could be given as to whether an efficient system needs to be so complex.

<sup>7</sup> Butt, Adam and Donald, M. Scott and Foster, F. Douglas and Thorp, Susan and Warren, Geoff, Delegation, Trust and Defaulting in Retirement Savings: Perspectives from Plan Executives and Members (July 31, 2015). CIFR Paper No. 065/2015; FIRN Research Paper No. 2638998. Available at SSRN: <http://dx.doi.org/10.2139/ssrn.2638998>.

<sup>8</sup> See ASIC's *Financial System Inquiry: Submission by the Australian Securities and Investment Commission*, April 2014, paragraphs 708 to 711 and the discussion of the *ANZ survey of adult financial literacy in Australia*, The Social Research Centre, ANZ, 2003, 2005, 2008 and 2011, <http://www.financialliteracy.gov.au/research-and-evaluation>. This research by ANZ was updated in 2015 and the figures from 2015 have been included in this submission. The updated ANZ research is available at: <http://www.anz.com/resources/3/1/31cbc1fd-9491-4a22-91dc-4c803e4c34ab/adult-financial-literacy-survey-full-results.pdf>. ASIC's submission is available at: <http://download.asic.gov.au/media/1311553/ASIC-submission-to-the-Financial-System-Inquiry-4-April-2014-1.pdf>

<sup>9</sup> See ASIC's April 2014 submission to the FSI, paragraph 722, citing unpublished research from Roy Morgan for ASIC, commissioned in 2008.

<sup>10</sup> Loewenstein, G., Cain, DM., and Sah, S. (2011). The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest, *American Economic Review*; Papers and Proceedings, 101:3, 423-428.

The FSI recommendations supported by the Government, most relevantly recommendation 11 on the development of comprehensive income products for retirement (CIPR), provide a potential opportunity to improve competitiveness and the product options available to consumers in the retirement phase.

Use of appropriate default settings might assist. Defaults recognise and harness common behavioural biases, such as inertia, which often result from too much information or choice being given.<sup>11</sup> Well-designed defaults can produce better outcomes for consumers.

Defaults in superannuation are not a new concept with employers selecting default funds for their employees if they do not make a choice of fund. Stronger Super reforms saw the Government consider these default arrangements and impose additional requirements on those who offer default (MySuper) products such as a requirement to offer basic insurance on an opt out basis, or to have a diversified investment mix, as well as some restriction on the charging of fees and costs.

However, it is essential that any work on defaults in the superannuation and post retirement space is carefully designed and ideally tested before implementation. Evidence shows that defaults tend to be sticky, and given the import of these decisions it is necessary to ensure that a default model does not result in perverse or unintended consequences either for consumers or for the broader market.

As the conduct and disclosure regulator, ASIC is looking at where consumers are most vulnerable in the current superannuation system. Generally, this involves considering situations where consumers are defaulted into particular arrangements without making an active choice, particularly transfers without consent. These scenarios include:

- Being moved from the current fund to a new fund altogether as part of a successor fund transfer; or
- Being moved out of a division of a fund when employment with a particular employer ceases – with the consequence that the consumer is often moved to a higher fee paying division of the fund.

There are also occasions where consumers will find that their insurance cover ceases at a particular point (for example, account balance drops below a designated amount) but the consumer has not realised this. Alternatively, in other situations consumers may be paying for insurance cover they do not require.

ASIC may be able to take regulatory action to help protect consumers in some instances. This can include issuing stop orders where disclosure is defective, imposing infringement notices, or requesting corrective disclosure in other cases (such as the content of significant event notices).

In many cases where consumers could be considered vulnerable, trustees have in fact met minimum disclosure requirements, but the messages often do not result in active steps being taken by the consumer to address the situation.

To assist consumers in being more actively engaged, ASIC also leads the National Financial Literacy Strategy. This provides a practical framework for action to guide and encourage all those with a role to play in improving financial literacy for

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<sup>11</sup> See ASIC's second submission to FSI, paragraph 94.



Australians. ASIC has an active role in assisting consumers with access to information (and calculators) across a variety of topics, including superannuation, on ASIC's MoneySmart website.

### ***Additional feedback***

User satisfaction is listed in the Commission's issues paper as a criterion for benchmarking allocative efficiency. Satisfaction can have a weak link with other outcomes, as many consumers lack the ability to assess the quality of longer term financial outcomes and instead rely on other proxies (such as ease of process and likability of those they deal with) in their assessment. For example, in an ASIC shadow shopping study of retirement advice, 86% of shadow shoppers stated they had received good quality advice. In contrast, ASIC considered just 3% to be good and 58% to be adequate.<sup>12</sup>

Offering members many choices, both in terms of investment choices within a product or fund may be a useful indicator of competition. However, having a high level of choice might inhibit efficiency and drive up costs. A lot of the choice is framed as innovation or as meeting an identified need, but this may not always be the case. This type of competition may be driving funds towards product differentiation.

As superannuation is a long term investment, one of the challenges for the Commission is to assess the likely quality of competition and efficiency over the length of a term that matters to current consumers. It may be difficult to determine whether there is more competition and whether that competition has in fact caused the better outcomes for members.

In ASIC's view, questions relating to relevant consumers should also take into account employers. Employers are a critical feature of the superannuation landscape and can influence large numbers of consumers by making choices in relation to default superannuation arrangements for those employees who do not exercise choice of fund. In effect, employers are a form of consumer as well, with differing levels of financial literacy. This year, ASIC has started to include information for employers about superannuation on ASIC's MoneySmart to help them make better informed decisions when selecting a default fund.

We note the Commission's queries about barriers to entry, including whether some of these barriers are regulatory (see Table 1, page 17). There are regulatory obligations that may be seen by some as barriers to entry but are established for good reason. For example, prudential requirements to hold certain levels of reserves, or disclosure requirements to keep members informed, are important to the security of the system and the protection of members.

### **Contact**

Thank you once again for the opportunity to make a submission to the Commission.

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<sup>12</sup> ASIC Report 279 *Shadow shopping study of retirement advice*, available at: <http://download.asic.gov.au/media/1343876/rep279-published-27-March-2012.pdf>

If you have any queries, or would like to discuss this matter further, please contact Ms Alex Purvis, Senior Manager, Investment Managers and Superannuation

Yours faithfully

**Gerard Fitzpatrick**  
Senior Executive Leader  
Investment Managers and Superannuation