Analysis of Productivity Commission's 'best in show' default superannuation model

Financial Services Council

27 July 2018

SYDNEY
Level 1
2 Martin Place
Sydney NSW 2000
P +61 2 9293 3700
F +61 2 9233 5847

MELBOURNE
Level 20
303 Collins Street
Melbourne VIC 3000
P +61 3 8621 4100
F +61 3 8621 4111

ABN 35 003 186 883
AFSL 239 191

www.ricewarner.com

Table of Contents

1. Executive summary

In response to the recently released Productivity Commission (PC) report into the efficiency and competitiveness of the superannuation system, the Financial Services Council (FSC) has requested Rice Warner provide analysis of the impact of the Productivity Commission's proposed *best in show* model for default superannuation.

Specifically, the FSC has asked Rice Warner to examine and discuss:

- The potential impact on the superannuation industry and member outcomes.
- The interaction of this *best in show* proposal with the strengthening of MySuper authorisation arrangements.
- Issues with aspects of the PC's proposal and how these could possibly be addressed.
- Alternative default superannuation models, including a National Default Fund system and international comparisons to systems in Chile and New Zealand.

1.1 Key insights

- The draft PC report assessing the efficiency and competitiveness of the Superannuation Industry has many sensible proposals that will drive improved member outcomes.
  - Requiring members to default into a superannuation fund only once when they enter the workforce will reduce the number of inefficient multiple accounts in the system.
  - Elevating the bar for MySuper will drive improved member outcomes and fund performance over time.
  - Rationalisation of the number of superannuation funds over time will be a positive as many under performing funds will be removed from the system.
  - Prompting the employee to select their own fund could drive an increase in member engagement in superannuation which would improve member outcomes.
- Though the proposed *best in show* list of 10 default provides some improvements over the current system, it also has the potential to cause significant and sub-optimal disruption throughout the superannuation industry as it could possibly:
  - Stifle innovation, as a differentiated strategy may not be rewarded.
  - See the 10 initially selected funds have a significant liquidity and scale advantage over other MySuper funds, making it difficult for another MySuper fund to be chosen in the future for the list.
  - Encourage funds to chase returns with disregard to risk if the funds believe they need a good short-term return to make the list of 10.
  - Discourage new entrants from establishing products that can obtain default status.
  - There is still a risk that most members will remain unengaged and will fail to monitor the first fund they join.
- It will be difficult to rank a list of up to 10 funds based on multiple criteria:
  - For example, it will be challenging for the panel to fill the last remaining places on the list if many funds on the cusp of making the best in show list have similar ratings against many of the criteria.
  - The PC needs to clarify what would happen in such a circumstance and indicate whether the list would be expanded to accommodate additional funds.

- The PC's proposed *best in show* model removes employers from the process of allocating default members. However, many larger employers are well equipped to choose a default fund for their employees. In many cases they can only secure discounts and tailored insurance if the employer plan remains the default. The lack of flexibility in the PC's proposed *best in show* model (to allow employers to select a default for their employees) could see the demise of employer plans to the detriment of many employees.
- Strengthening of the MySuper authorisation benchmarks will likely result in rationalisation and merging of funds over time without creating the significant disruption to the industry that the *best in show* model would cause. We note that this does not shift choice of default fund from employers but consider this can be achieved by nudging all young members for SME employers to make a fund selection from the full MySuper list.
  - Should these reforms fail to succeed in achieving the required objectives Government could then look to implement another model such as *best in show* to achieve the required changes.
- We recommend any *best in show* process refrain from relying on past performance as the key determinant for selecting the shortlist, though we note it may be useful for eliminating the bottom non-performing products from the process.
- A significant reduction in the number of default superannuation funds may have flow on impacts to the Australian economy, including the liquidity of the Australian equity market. In some scenarios, superannuation funds will be dominant participants in the marketplace, potentially reducing competition for assets through partnerships and joint ventures.
- Evaluation of the success of the MySuper system needs to be conducted over a longer period to prove its success in delivering value for money outcomes for members. If some form of the *best in show* list is to be implemented, delaying implementation until 2025 will allow for a reasonable comparison of the impact of MySuper on the system.

This report was prepared and peer reviewed for the Financial Services Council by the following consultants.

Prepared by

Michael Rice
CEO
Telephone: (02) 9293 3707
michael.rice@ricewarner.com

Nathan Bonarius
Consultant – Market Insights
Telephone: (02) 9293 3722
nathan.bonarius@ricewarner.com

Peer Reviewed by

Tim Jenkins
Executive General Manager- Superannuation
Telephone: (02) 9293 3762
tim.jenkins@ricewarner.com

27 July 2018

2. Background

In May 2018, the Productivity Commission (PC) released its draft report assessing the efficiency and competition in the superannuation industry as the third stage in its inquiry into the superannuation system.

The first stage of the PC's inquiry into superannuation developed a framework for assessing the efficiency and competitiveness of the superannuation system. The second stage of the inquiry developed a set of alternative models for allocating members to default products. This draft report (the third stage of the inquiry) draws on the framework outlined in stage 1, and the feedback received from the draft report from stage 2 to assess the competitiveness and efficiency of the system.

In this report, the PC noted that a key deficiency of the superannuation system is the linking of default fund selection to employers (via the *Fair Work process* or *Enterprise Bargaining Agreements*). The PC believes that members should take their superannuation fund with them from job to job, and only be defaulted into a fund when they join the workforce (and then only if they don't select a fund themselves) (recommendation 1).

The second phase of the PC inquiry into superannuation developed four alternative models for allocating default members to products. These included:

- The employee choice model the PC have recommended (the *best in show* model).
- A model where the employer would be responsible for selecting the fund from either a short or expanded list of providers (*Assisted Employer Choice* option).
- A tender process where five to ten default funds would be selected based on agreed criteria.
- A fee-based auction model where one to five products would be selected based on their investment and administration fee rates. Second consideration was given to some additional criteria.

At the time, Rice Warner indicated its preference was for the *Assisted Employer Choice* option. However, this preference was conditional on the suggested employee protections being adequate. We believed that as this approach was closest to the current arrangements, it would provide the least disruption to the market.

In the third phase, the PC has recommended a *best in show* (recommendation 2) default superannuation model where employees who enter the workforce would be allocated to a superannuation product from a shortlist of 10 (if they do not select their own fund). As part of the report, the PC has also recommended that authorisation requirements for MySuper status be strengthened to improve member outcomes.

3. The Productivity Commission *best in show* default model

In its draft report, the PC has recommended various ways of strengthening the superannuation system by introducing stronger measures for MySuper which should eliminate under-performing default funds.

The PC recommends legislating to allow APRA to apply the MySuper outcomes test. Furthermore, the PC has recommended that authorisation rules for MySuper should be strengthened. This mechanism would drive significant further rationalisation.

The PC has also recommended[1] that new members to superannuation be allocated to default superannuation funds via a *best in show* structure. Under this system, a single shortlist of 10 superannuation products would be presented to all members who are new to the workforce or who do not have a superannuation account. Any member who fails to make a choice within 60 days would be defaulted to a product on the shortlist, via sequential allocation.

Members would not be prevented from choosing any other fund (including an SMSF).

An independent panel would be established to run a competitive process for listing superannuation funds on the shortlist[2]. The panel would run a selection process every four years.

The number of new members to the system is about 474,000 with annual contributions of about $1 billion[3]. While this is small in the context of the whole system, the diversion of these members to the *best in show* funds will remove cash flow for other funds. This effect would be expected to increase should the *best in show* funds receive increased rollovers from choice members attracted to the *best in show* label.

Endorsements can see an increase in member switching, for example, the Barefoot Investor's book endorsed a Hostplus Indexed product leading to a significant increase in inflows. A Government endorsement as *best in show* would be expected to do the same. Similarly, funds pay research houses such as Superratings and Chant West for ratings which they include in their advertising. Although the impact of these ratings on member flows are difficult to measure, we would expect that a government best in show endorsement would have more impact than one given by industry.

The combined impact of improving MySuper standards and the *best in show* structure will lead to short-term disruption in the industry.

[1] PC Draft Report - Recommendation 2, page 460
[2] PC Draft Report – Recommendation 3, page 462
[3] PC Draft Report p432

RICEWARNER
Insight like no other

4. The impact of strengthening MySuper authorisation arrangements

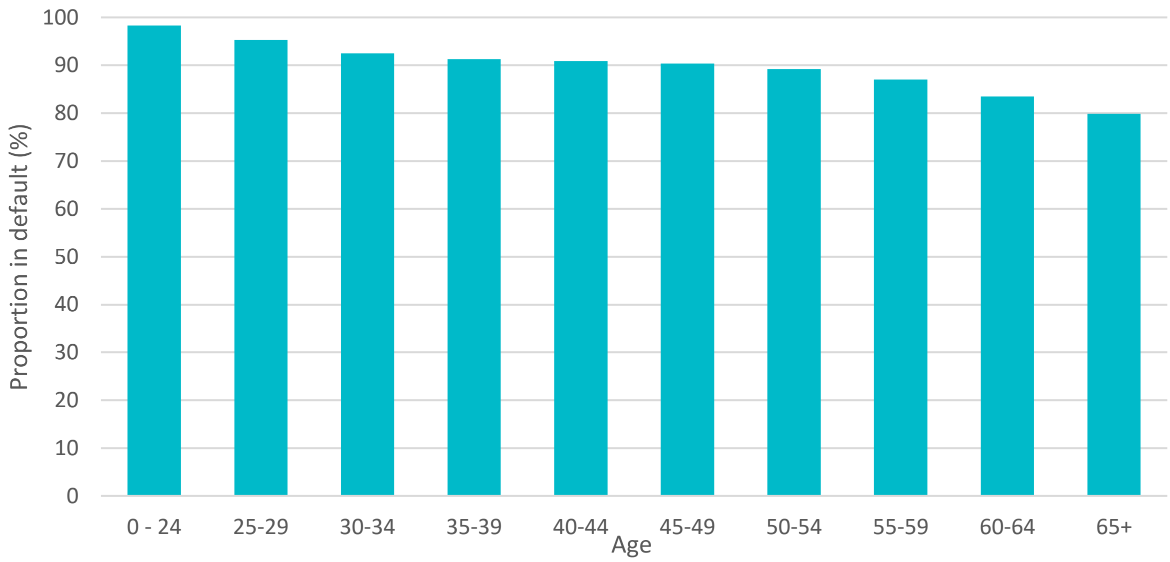
The PC has recommended[4] that the Government strengthen the authorisation rules to require funds to:

- Obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison against other products in the market, and determination of whether members' best interests are being promoted, at least every three years.
- Report to APRA annually on how many of their MySuper members switched to a higher-fee choice product within the same fund.

Funds that fail to meet this condition or consistently underperform their investment benchmark for five or more years (as determined by APRA) would have their MySuper authorisation revoked.

Rice Warner's *Super Insights Research 2018* shows that most superannuation fund members are invested in the default (MySuper) option (particularly at younger age groups). Graph 1 shows the proportion of each age group in the default option.

Graph 1. Proportion of each age cohort in default superannuation option (accumulation members only)



Source: Rice Warner Super Insights 2018

Given the high proportion of members in default options, strengthening requirements for MySuper authorisation will likely improve member outcomes over time. The proportion of people in default products reduces over time as people become more engaged with their superannuation. Note there are no default products in retirement.

Strengthening the requirements for MySuper authorisation will also drive increased rationalisation of default products over the coming decade and allow the impact of these proposed changes to flow through the market as the MySuper system matures. We recommend this be implemented prior to considering the merits of a *best in show* model that will limit the number of default funds in the market.

[4] PC Draft Report – Recommendation 4, page 467

Analysis of APRA data included in Rice Warner's *Superannuation Market Projections Report 2017* shows that the number of funds in the market has decreased over the past 10 years. There are about 65 MySuper products that can be selected by public offer and are not employer specific, and this is trending lower. Projections included in the report also indicate that the number of funds will continue to decline over the coming decade.

The reduction in funds across the market originates from the winding up of many Corporate funds. Many small Industry funds have also merged into larger funds. Table 1 shows that over the past decade:

- The number of Corporate funds is just under 19% of the number a decade ago.
- The number of Industry Funds has reduced from 79 to 46 (a 42% decline).
- The number of Retail funds has reduced from 168 to 98 (a 42% decline).

Against this trend, the number of SMSF arrangements continues to grow, by approximately 70% in the last decade.

Table 1. Number of Superannuation funds in 2007 and 2017

Market segment	10 years ago 30 June 2007	Today 30 June 2017*
Not-for-Profit Funds		
Corporate Funds	291	55
Industry Funds	79	46
Public Sector Funds	37	33^
Subtotal	407	134
		Retail Funds
Retail Funds	168	98
Subtotal	168	98
		Small Funds
Small Funds#	355,473	598,599
Subtotal	355,473	598,599
Total superannuation market	**356,048**	**598,831**

*Sourced from APRA *Quarterly Superannuation Performance June 2017* with adjustments.

^ Includes non-APRA regulated funds.

Includes small APRA funds (with fewer than five members), single-member ADFs and Self-Managed Super Funds.

It is expected that mergers will continue to occur at a similar rate over the coming decade. The number of funds in the industry has reduced by 60% in the last decade and this will likely be repeated in the next decade, even without legislative change.

Looking forward five years, Rice Warner forecasts there will be:

- Continued winding-up of Corporate funds.
- Thirty-One Industry funds remaining, most of which will have good scale for their market.
- Continued rationalisation of small Public Sector funds.
- Mergers of many Retail funds largely due to product rationalisation.

Table 2 contains a five-year estimate (going forward to June 2022) of the number of funds in the superannuation market. The projection shows a reduction of large funds from 232 to 131 over this period.

Table 2. Estimate of the number of funds at June 2022 by size*

Fund size ($m)	Corporate	Industry	Public Sector	Retail#	Small APRA
0 – 500	0	0	0	-	1,200
500 – 1,000	1	2	2	-	0
1,000 – 5,000	3	5	4	-	0
5,000 – 10,000	2	7	2	-	0
10,000 – 20,000	1	6	6	-	0
20,000 – 50,000	1	5	5	-	0
>50,000	0	6	2	-	0
Total	**8**	**31**	**21**	**71**	**1,200**

Source: Rice Warner Superannuation Market Projections 2017 (released December 2017)
* A number of funds have been reclassified to provide a better breakdown of the market (refer to separate Assumptions and Methodology Report).
# A breakdown of the number of retail funds by size is more difficult to quantify as there are a large number of legacy products feeding into similar investment pools.

Increasing the standards for MySuper authorisations would put sufficient pressure on funds to drive additional consolidation over the next decade and improve member outcomes. Increasing pressure on rationalisation of funds via a mandated high standard (rather than a maximum number of default funds) will ensure rationalisation and increased mergers without unnecessary disruption to the industry.

The proposed *best in show* model for allocating members to default funds would result in additional mergers as funds not included in the shortlist would find it difficult to grow membership (and achieve the required scale) without a reliable flow of default members.

5. The role of the employer in default superannuation

Under the current default system, many employers are required to choose a default superannuation fund from the superannuation funds listed in the relevant award or enterprise bargaining agreement. In 2012 the Government legislated to require the Fair Work Commission to select the default funds for each award every four years. The Fair Work Commission would select funds based on a default superannuation list, with the list to be selected by an expert panel within the Fair Work Commission.

Following concerns around conflicts of interest, in 2014 the Federal Court ruled that the expert panel within the Fair Work Commission was not correctly constituted under the *Fair Work Act 2009.* Since this decision the process for allocating default funds has effectively stalled.

Allowing the employer to select the default fund for their employees has several benefits. Whilst SME businesses have little interest in their employees' superannuation arrangements and perceive the Superannuation Guarantee to be a tax/compliance matter, a large employer has a natural incentive to pick an appropriate fund for their employees. This occurs because larger employers are motivated to provide outcomes that will satisfy their employees and help with retention.

Many larger employers are still well equipped to choose a default fund for their employees. In many cases they can only secure discounts and tailored insurance if the employer plan remains the default. The lack of flexibility in the PC's proposed *best in show* model (to allow employers to select a default for their employees) could see the demise of employer plans to the detriment of many employees.

It may be convenient for the majority of employees in a large business to have the same superannuation fund as it would allow the employer to easily provide information to employees regarding their superannuation member benefits and performance. However, given technological advances (particularly the advent of SuperStream) it is no longer a significant administrative burden for an employer to make superannuation contributions into a number of different superannuation funds.

Removing the *Fair Work Commission* process (including removing the selection of superannuation funds from awards and *Enterprise Bargaining Agreements*) and allowing employers to select the employee default from a list of MySuper funds (Section 12.3, page 439-441) could improve outcomes for members as there would be increased competition for default members. Strengthening the authorisation arrangements for MySuper certification would ensure improved member outcomes under such a system.

Removing the FWC process would not be disruptive as most employers and members would remain in their current fund. Consequently, any change for MySuper funds would be gradual.

We agree with the PC that the Fair Work Commission's process to allocate default funds puts constraints on the ability of funds to compete for employers and members[5]. If the bar is set higher for MySuper products, the Fair Work Commission process could be removed or modified.

The following sections of this report outline our issues with the proposed *best in show* model and our views on how rationalisation of funds could be achieved in the superannuation market (without significant disruption). A comparison to alternative default models is also included (namely a National Default Fund model and the default superannuation fund models of Chile and New Zealand).

[5] PC Draft Report –page 27

6. Potential impacts of the *best in show* model

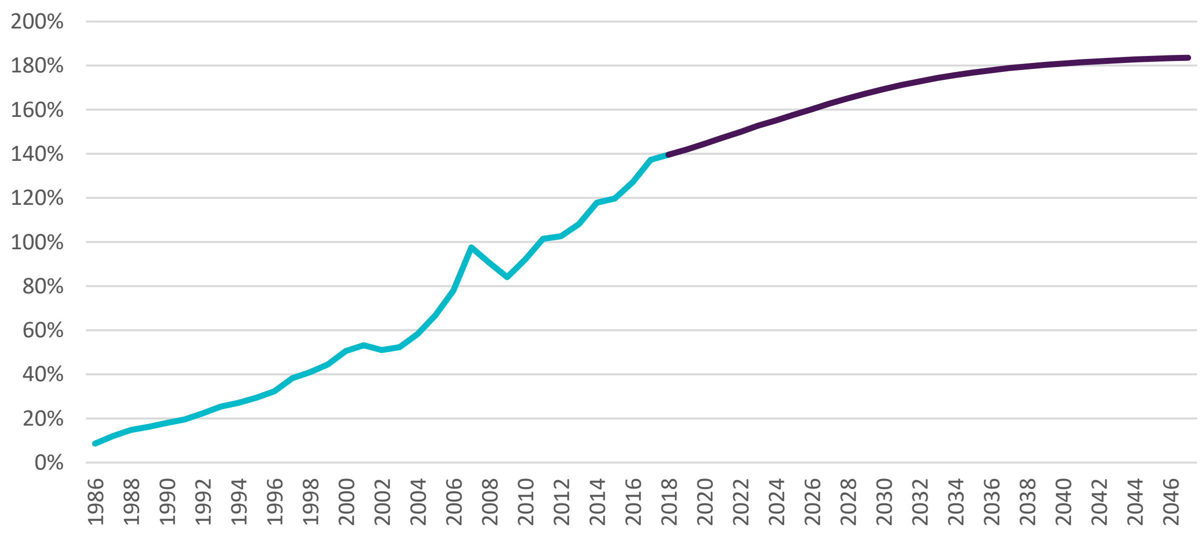
6.1 Potential impact on the Australian economy

Overall, some consolidation of superannuation funds is likely to be positive for members who will benefit from fee reductions, improved investment performance and service improvements. However, the impact on the superannuation market and the broader Australian economy is less certain. Historically, estimation of this impact of market concentration has been done through the *Herfindahl Index*. Assuming that funds are allocated proportionally to fund size, under a scheme in which 15 providers remain the index suggests nearly a doubling in market concentration (from 0.039 to 0.076) though still below the threshold of 0.15 for an unconcentrated industry but above the 0.01 threshold for a highly competitive industry[6]. While material, this change would still leave a market with significant competition relative to other Australian sectors which are moderately concentrated such as Banking (0.16)[7] and Retail Supermarkets (0.18-0.22)[8].

Despite this competition, a concentration of assets will likely result in increased liquidity risks for fund managers. As funds under management increase and the number of funds decrease, effecting a material shift in asset allocation will become increasingly more difficult for domestic managers as greater volumes need to be traded. Thus, in the case where fund concentration rises, this trading may become more difficult and consequently costlier.

Rice Warner's Superannuation Market Projections Report 2017 shows that the funds under management in superannuation will continue to grow as a proportion of the economy over the next 15 years. Graph 2 shows that superannuation assets as a proportion of GDP will reach more than 180% of GDP by 2046.

Graph 2. Historical and projected superannuation assets as a percentage of GDP (2017 dollars)



Source: Rice Warner Superannuation Market Projections 2017 (released December 2017)

[6] Standards for market concentration as defined by US government agencies: https://www.justice.gov/atr/horizontal-merger-guidelines-08192010#5c

[7] Herfindahl index for banking: https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/FlagPost/2010/November/Market_concentration_in_the_banking_sector_-_household_loans

[8] Herfindahl index for groceries: https://www.accc.gov.au/system/files/Grocery%20inquiry%20report%20-%20July%202008.pdf

Given the projected size of the market and expected rationalisation under *best in show* default model, funds may find markets oversaturated in the future. This is particularly pertinent here in Australia given the relatively small equity market, comprising less than 2% of global market capitalisation despite having a very large pool of superannuation assets (by international standards). Consequently, there exists a limited opportunity for domestic investment, particularly in smaller popular asset classes such as listed Australian equities. This may lead a smaller group of large superannuation funds to increase their overseas investments at the expense of the domestic economy.

Many large superannuation funds are establishing their own investment management operations. Again, as the size of funds increase, and the number of funds decrease over time, this concentration of institutional investors could be a powerful force in the economy. For example, if these large institutional investors take an increasing share of key infrastructure assets, this might lead to a concentration of power – and perhaps monopoly pricing.

As the superannuation industry grows, more commentators want to see its assets used to support other parts of the economy (and to an extent these calls already occur). With a smaller group of superannuation funds that hold more assets we will see a concentration of investment mandates in the future which could increasingly be called upon to be used for investments in the national interest or for strategic assets.

Calls to amend the sole purpose test will need to be monitored as, although some investments may have strategic benefits to the economy, mandating business operations beyond those allowed under the sole purpose test could lead to sub-optimal investment selection and lower returns for members. This will occur should funds invest in strategic assets which, while providing additional benefits to members, for example, cheaper mortgages or better administration services, are an investment of the fund and may provide lower returns.

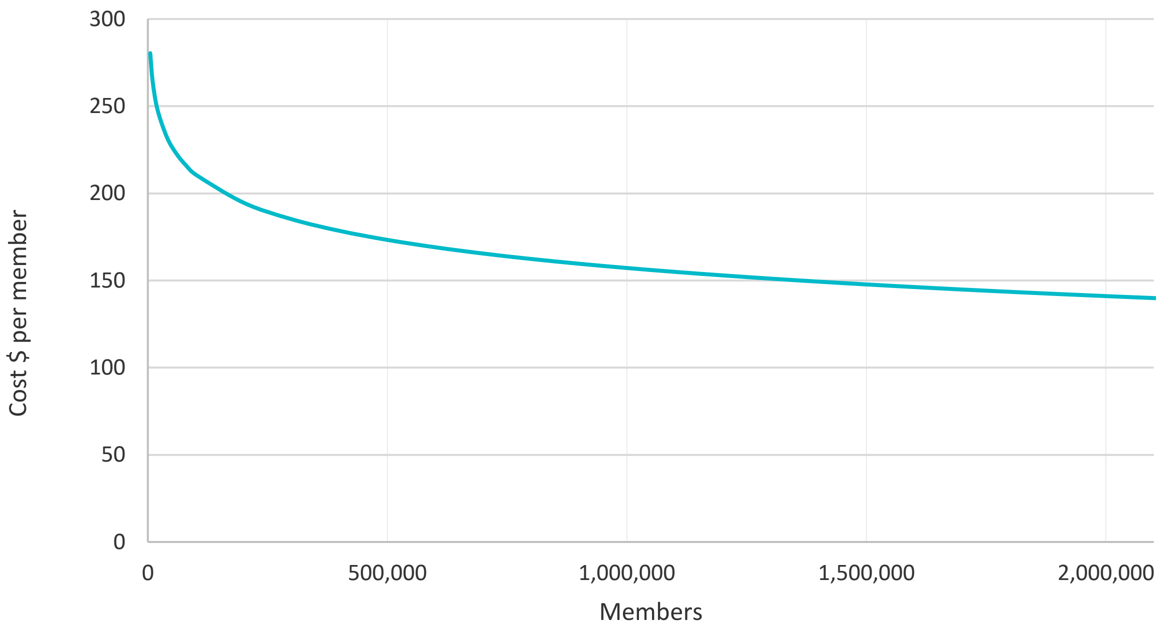
6.2 Benefits and costs of scale

While market concentration can cause issues, there are major benefits that come with increased scale. Having scale provides funds with regular positive cashflows, allows for investment in illiquid assets and reduces expenses and costs for the fund as a proportion of member balances.

In 2017, approximately 36% of APRA regulated superannuation funds experienced negative cashflows. In a system dominated by the top 10 *best in show* funds, it is likely that most of the remaining funds would have negative cashflows. Positive cashflows allow funds to pay benefits and expenses from regular cashflows rather than having to liquidate assets (at potentially reduced prices). The ability to do this creates opportunities to invest in illiquid assets such as unlisted property and infrastructure, which carry an illiquidity premium and are less correlated to the state of the stock markets.

Increased scale also allows funds to spread the same fixed costs over more members, leading to economies of scale and reduced fees. Graph 3 demonstrates that as funds approach approximately 2 million members, average fund operating expenses could reduce to $140 per member, the PC demonstrated similar results in Section 7.2 of its draft report. If the *best in show* approach were adopted, it is likely that the funds on the top ten list would exhibit increased scale as a result of receiving a greater share of new default Superannuation Guarantee contributions, and therefore experience a reduction in costs.

Graph 3. Fund Operating Expenses per Member



Source: Rice Warner Expense Benchmarking Survey 2017

We also note that scale does not come without some costs. As funds get larger, the benefits of scale taper off as the fixed costs are already sufficiently diluted such that the marginal impact on members is close to zero (as seen in Graph 3). From this point, there is potential for diseconomies of scale from:

- Large mandates reducing the flexibility of the fund to invest strategically and change asset allocations quickly
- Increased bureaucracy within the funds and additional layers of management
- More difficulty in understanding and effectively communicating and marketing to a membership that come from a single industry group (though we note increased resources may allow for more tailoring to diverse groups).

6.3 Incentives for funds to change strategy and investments in asset classes

The PC report[9] states that funds should be assessed for the *best in show* shortlist on the following criteria:

- The match between the product's long-term investment return target and risk profile for the types of members who typically default.
- The expected ability of the fund to deliver on the product's return target, given its history and risk profile.
- Fees and costs, given the product's stated long-term investment return target and risk profile.
- The fund's governance practices, including mechanisms to deal with conflicts of interest.
- Compliance with the *Insurance in Superannuation Voluntary Code* (chapter 8) (that is, it would not be enough to simply be a signatory to the Code). The merits of a product's insurance offering would

[9] PC Draft Report – page 435

not be a selection criterion, but funds should justify why the insurance offering was demonstrably in members' best interests.

- The administrative efficiency of the fund.

The PC also recommends that the panel consider a fund's intra-fund advice offering and track record on innovation. To allow flexibility, the panel would be able to consider any of the above factors they consider relevant, however the **key focus should be on the likelihood of a fund producing high net returns for members**.

Given the emphasis placed on net returns, the *best in show* model could have a range of impacts on the investment strategies of funds depending on whether funds are:

- likely to make the shortlist
- on the cusp of making the shortlist
- would not be considered likely to make the shortlist.

For those funds that are either likely to make the shortlist or on the cusp of making the shortlist, the emphasis placed on net return outcomes could see a homogenisation of investment strategies. Funds that can achieve benchmark returns at a cost advantage may be more likely to join the top 10 list without taking additional risk. Specifically, the illiquidity risks and increased leverage associated with unlisted assets could see funds shift to listed assets. As unlisted assets often attract higher fees, the best in show model may discourage investment in unlisted assets or other higher-cost alternatives as funds try to attain competitive fee structures.

A reduction in investment in Australian infrastructure assets (if sufficiently large) could have a negative impact on the broader Australian economy and productivity. A reduction in investment in unlisted assets could also harm venture capital investment.

For those funds who do make the shortlist, the cash flows provided by default member flows may give them a sustained advantage as they have cash flow certainty (for a period of time) which may enable higher allocations to unlisted assets and illiquidity premiums, the length of time in between tenders will influence this decision.

For those funds unlikely to make the shortlist (unless short-term net returns improve), the emphasis placed on net returns could incentivise funds to implement increasingly risky investment strategies to achieve higher net returns to get on the list. This is due to the risks vs. rewards of the strategy, if the risky investment strategy is successful they may make the list at the next tender. If the strategy is unsuccessful they will not suffer much detriment relative to the current position off the list. Of course, even if the strategy pays off now it may experience large negative returns in the future.

These strategies may prove unsuitable for members. The criteria for the short list should include consideration of whether the long-term investment return target and risk profile is appropriate for members who default. However, further clarification on the relative weighting of the above criteria would be needed to judge the likelihood of these types of funds changing their investment strategy.

6.4 Consequences of funds falling off the list

There will likely be negative consequences for those funds who fall off the *best in show* list in the future. Funds that fall off the list may lose the inflow of default members and could see many current members transfer out of their fund (to another fund on the *best in show* list). Though this behavioural impact is likely, there is substantial uncertainty in estimating it. A fund that falls off the list will therefore experience continued outflow of member benefit payments to retirees and those leaving the fund.

We understand the PC has undertaken modelling with APRA to assess the potential impact on the market[10]. Many funds will experience negative cashflow and will need to make the strategic decision to exit the industry.

The PC has assumed that only 'Up to 10%' of MySuper members who are not starting a new job will switch to a shortlisted product[11]. However, this ignores the fact that although the experience of the market may average less than 10% individual funds may experience higher levels of exit.

This continued outflow of assets and reduction in inflow of new default members could result in some funds being forced to sell assets to fund member benefit payments. In the extreme case, if a large fund is forced into asset sales this could impact the market, particularly for Australian unlisted assets.

If returns continue to decline, funds may see further loss of membership. This could create a downward spiral of lower returns and members leaving the fund.

If the negative costs associated with removing a fund from the *best in show* list deters the expert panel from removing funds, then the intended disciplines of the PC's proposed model would erode over time, while the risks would remain.

6.5 Impact on tailoring

The proposed criteria for inclusion on the shortlist places a clear emphasis on the net returns and fees of funds which will likely be at the expense of some member services or tailored product offerings provided by funds.

More weight could be given to member services and tailored offerings, particularly for large employers which can build workforce retention strategies around offering additional benefits such as tailored insurance products and contributions above the statutory SG rate. An example is a large employer which provides tailored insurance arrangements for its employees (within a fund) or creates a tailored lifecycle product based on factors in addition to age.

The emphasis placed on net returns (likely at the expense of tailoring of product design) will result in a lack of innovation in the superannuation industry which (whilst difficult to quantify or measure) could result in poorer outcomes for members in the long run.

6.6 Short-term disruption

If legislated, the *best in show* model currently proposed by the PC will drive significant rationalisation of funds over the coming decade. Whilst rationalisation of funds could improve member outcomes (see Section 6.2), the rate of rationalisation under the PC proposal will cause significant disruption to the industry and may result in sub-optimal outcomes for the superannuation market. It is also possible that many members will continue to remain unengaged and will fail to monitor the first fund they join.

[10] PC Draft Report – page 445

[11] PC Draft Report – Technical Supplement 7

7. Further issues for consideration

7.1 Review of the shortlist and size

Under the PC's proposed default model, the *best in show* shortlist would be reviewed by the expert panel every four years. The frequency of the review of the shortlist will have an impact on the stability of the strategies of superannuation funds seeking inclusion on the shortlist.

For those not on the shortlist, a key strategic decision will be whether to align their fund's strategy with the other funds on the shortlist, with the aim of joining the shortlist in four years' time (see Section 6.3). An alternative approach would be to shift their strategic focus towards competing for choice customers.

The frequency of review and size of the *best in show* list will influence fund decisions and the cost of not being included on the shortlist.

- We believe a longer shortlist would likely result in greater competition for the *best in show.*
  - The PC argue a longer list reduces competitive tension as the reward of making the list would be divided between more players[12] - however, we believe this ignores the probability that the fund achieves the default status which is an important input into decision making.
  - For the initial tender, funds will experience a gain in market share vs. losing all their current market share for default business. Consequently, participation in the initial tender is likely to be high regardless of whether the shortlist length is increased.
  - For subsequent tenders, funds will need to evaluate the feasibility of achieving *best in show* status versus strategic alternatives e.g. aligning strategy to the choice market, seeking merger partners, or running a declining book of business.
  - The longer the shortlist, the greater the probability of a resurgence for funds outside the list and although the share of new entrants would be across more players, the expected number of participants in the tender would likely be higher.
  - Consequently, this may also result in more funds focusing their strategies on default rather than choice.
  - A longer shortlist may also mean:
    - less disruption to and consolidation of existing funds
    - a reduction in gaming by funds to get on the shortlist
    - less impact on funds of subjectivity in the selection process.
- A longer period between reviews may:
  - Force funds not on the short list to focus on choice customers and tailoring member benefits as the review period may extend beyond their strategic forward planning.
  - Resulting in, fewer funds competing for the shortlist, entrenching the position of incumbents.
  - Consequently, there could be a reduction in tender participation as funds that miss out on the *best in show* list may prefer to align their strategy to the Choice market.
  - This could also result in stability of fund strategies which could ultimately drive better outcomes for existing members for example, it allows more certainty of investment strategy for funds, perhaps allowing increased allocation to unlisted investments.

[12] PC Draft Report – page 435

- Though there would be increased pressure for funds participating in the tender to get their product and submission right and an increased the impact on funds of s in the selection process.

As such, there is a balance between ensuring adequate competition for positions on the *best in show* list and avoiding the preservation of powerful incumbents versus the continuity of fund strategies and focus on delivering the best outcomes for members. The PC does acknowledge that a shorter list may result in funds not applying for the tender but go on to conclude a longer list will reduce the competitiveness of the process. Our expectation is that the choice of ten funds is subjective, and a slightly longer list would give more stability to the system, align funds to the default market and may even result in more competition than a list of ten.

The proposed default model does not adequately detail what will happen if funds on the *best in show* list were to merge during the four year period. If these funds were to merge, the list of 10 products may effectively be reduced and these merged funds would receive an ever-larger share of default members. A longer period between reviews would likely exacerbate this issue as ongoing fund mergers are likely to continue over the next decade. This occurred in New Zealand when AMP acquired AXA in the first seven year period, and received one third of the sequentially allocated members as a result.

The PC has provided little rationale for the selection of a four year review period and number of default funds being set to ten. Further assessment of what would make a suitable review period, shortlist size and associated risks should be conducted before any implementation of the *best in show* model.

Our research demonstrates that the number of funds in the superannuation market will continue to decline over the coming decade. The PC should provide further justification to demonstrate why the competitive forces from a list of 10 default funds would provide materially better member outcomes relative to increasing MySuper authorisation benchmarks. Combined with fund mergers this will reduce the number of MySuper products, perhaps halving the current level of 65 public offer, non-employer specific MySuper products.

7.2 Ranking funds against multiple criteria

As discussed, under the proposed *best in show* model, panel members can consider any of the proposed criteria, with a strong emphasis to be placed on the likelihood of funds achieving strong net returns.

In setting criteria for comparing funds, we would refrain from relying on past performance as the key determinant for selecting the shortlist, though we note it may be useful for eliminating the bottom non-performing products from the process. ASIC forces funds to provide disclaimers that past performance is not an indicator of future performance. Further, differences in investment strategies between funds are not necessarily directly comparable, particularly when comparing MySuper products (which have existed for a relatively short period of time) with those products that existed in a pre-MySuper environment. We consider the overall investment structure including governance, processes and quality of personnel to be more important, though we note that it is far more difficult to measure.

We also note that the PC's analysis is focused on returns achieved by funds relative to a benchmark portfolio tailored to their asset allocation. Similar analysis would not be suitable for selecting funds to be in the *best in show* list as asset allocation has been shown to be the biggest driver of net returns rather than security selection[13].

[13] For example, see Houben, S. (2013). Asset Allocation vs. Security Selection: Their Relative Importance.

Outside the clear indication that net returns should be weighted relatively highly, the PC give limited indication as to how the other factors should be weighted by the panel members. The report states that the relative weightings attached to each criterion should be published to inform funds' application for shortlisting. Publishing these weightings prior to the application process will ensure a transparent process. However, some indication as to what the PC's view is on the relative weightings would be desirable in the policy development process.

Additional clarity around the relative weighting of the more qualitative criteria (for example Board composition, the strength of governance practices and specific member services) and how these would be assessed would be beneficial prior to any possible implementation of this proposal.

We note from our own experience in running tenders for employer superannuation business that extending the criteria can lead to an increased level of subjectivity in the application of scores and weights. Thus, the independence of the selection committee becomes increasingly important relative to a simple evaluative approach based on net returns only. Further to this, the expertise of the panel becomes important given the knowledge requires to assess adequately some of the more subjective elements of the tender.

Furthermore, the Government is currently implementing its proposed *Retirement Income Covenant* (which will require funds to develop a *Retirement Income Strategy* for members and offer *Comprehensive Income Products for Retirement (CIPRs)).* Further information on how a funds *Retirement Income Strategy* and CIPR offering would be considered as part of this criteria should be provided prior to considering the implementation of the proposed *best in show* default model.

7.3 Selection of members for the expert panel

The PC report states that members appointed to the panel should be free of conflicts of interest and be perceived as independent by the public.

Given the historically strong views held by many stakeholders in different sectors of the superannuation industry, we believe that it will prove difficult to find members that have the appropriate skillset to discharge their duties as an expert panellist and still ensure that no member of the panel has any actual or perceived conflict of interest, or previous affiliations with any of the competing providers. This has been evident with the difficulties in forming the Fair Work Commission Expert Panel.

For example, should a retired CIO of a superannuation fund be appointed to the panel it is likely they would have the appropriate skillset and be perceived as being conflict free. However, the experience of the expert during their historical positions in the industry may result in the perception of bias in their views of certain sectors of the market. For example, Bernie Fraser's appointment to lead a review into industry fund governance was viewed by many in industry as conflicted despite his distinguished career which included holding office as Governor of the Reserve Bank of Australia (RBA).

Since release of the report the PC has suggested that members of the panel could be selected by the ATO Commissioner, RBA Governor or similar. Though these departments do have a degree of independence from Government we do note that the appointments are made by the Treasurer, consequently it is still possible that there will be perceived conflicts of interest. Further, should the RBA need to select other members of the panel from outside of the organisation, they will face the same issue in finding members who are not conflicted.

CFA Digest, 43(2), 93-95.

Note asset allocation refers to the choice of which asset class to invest in e.g. stocks, bonds, cash, property, alternatives, whereas security selection refers to the choice of individual securities within that asset class e.g. choice of CBA vs. NAB for stocks.

7.4 New entrants

The short list may discourage new entrants from establishing products for the default market.

- the tender will restrict the time at which funds can enter the default market (*best in show*) which will discourage new entrants if they need to wait years to attempt entry by which time they may lose the first mover advantage for the new innovation or opportunity they have identified to bring to market
- the list will require the establishment of a track record though the PC has made reference to the panel using past performance in similar products or offshore markets for new entrants[14]. It is likely that any selection committee would prefer domestic experience and have difficulties making comparisons due to differences in fees, tax and regulations in different jurisdictions
- consequently, a risk averse committee is unlikely to ever feasibly appoint a new entrant to the *best in show* list.

A new entrant may bring a new product, with a good record in another jurisdiction and some innovative features. Currently, a new entrant that overcomes regulatory hurdles can win business from employers or even by enrolling their own domestic employees if they are a large international player with a domestic presence e.g. Google. In our view, it is unlikely under the *best in show* model that the committee would select such a fund to be in the top ten even if the product can demonstrate value. The decision process is likely to err on the side of caution and appoint incumbent players. As such, new entrants are likely to be locked out of the default market under a *best in show* model.

[14] PC Draft Report – page 435

8. Comparison to other default superannuation models

The PC paper includes an assessment of a *National Default model*, in addition to the four options originally proposed in their previous report from stage 2 of their inquiry into the superannuation system. Our assessment of this *National Default Model* is included. A brief discussion of alternative default models currently in place in Chile and New Zealand are also included. We note that international comparisons of pensions systems are difficult to perform due to many unique aspects of the Australian system for example low levels of defined benefits, inclusion of insurance benefits in superannuation and choice of fund and investments.

8.1 National default fund

Since the inception of the compulsory superannuation system in the early 1990s there have been several proposals and recommendations for all default contributions to be allocated to a single government-owned entity. The former Federal Treasurer Peter Costello has recently advocated for a model where the default funds be managed by the Future Fund. It is argued by some that this single fund would have the following significant advantages over the current structure of the superannuation market:

- Lower fees and costs, driven by large economies of scale.
- A simpler system that is easier for unengaged employees to interact with.
- Avoidance of account proliferation when employees switch job.

The PC argues throughout its report (Page 23 – Overview) that there is a point where restricting the number of funds in the superannuation market will result in diseconomies of scale, with the reduction in competition driving higher fees and poor member outcomes. It is difficult to pinpoint the exact number of funds where this reduction in competition will have a negative effect on member outcomes. However, it is reasonable to conclude that the diseconomies of scale would be a factor under a system with a single national default fund. We therefore strongly agree with the PC's assessment that a single national default fund would reduce competition and lead to poor member outcomes. If given the dichotomy of a National Default Fund or *best in show* model, our preference would be for the *best in show* as there will still be some form of competition for superannuation business and the associated benefits that come with competition (e.g. product innovation).

Rice Warner's research has shown a that superannuation fund's operating expenses do reduce significantly with scale. However, as funds get larger (at around $20 billion in assets), many of these scale benefits are used to provide members with improved services rather than reductions in fees (see Section 6.2). Were a *best in show* model implemented, it is likely all default funds on the list would have this scale or reach it within a short period of time.

Given the issues associated with a single *National Default Fund* Model, the PC has examined the merits (and issues with) a model where a *National Default Fund* is allowed to compete with private providers in the market. The PC however does not believe a *National Default Fund* model with this structure is appropriate for Australia as:

- The implicit Government guarantee of such a system could pose significant fiscal risks for the Government's budget.
- It would not drive competition for default members and therefore would ultimately not improve member outcomes.

Commentators have noted that the Future Fund has outperformed industry[15], however these comparisons are not on a 'like-for-like' basis as the Future Fund does not pay Australian income tax and is also exempt from income tax in many foreign countries due to its sovereign immunity (which would likely be at risk should the beneficiaries change to superannuants). The performance of any top funds in a *best in show* list or remaining MySuper funds were authorisation strengthened would likely have long term performance that is higher than the current industry average.

Further, the comparisons rarely consider the expense paid by Future Fund which would also likely increase with additional services required (administration and member services e.g. contact centre) and the cost of regulatory oversight.

The PC has outlined the risks associated with this model. An outline of these risks and our own assessment of the issues with this model is included.

8.1.1 Fiscal risks

The PC views the fiscal risks as the most significant risks associated with a *National Default Fund* model. In the event of poor or negative returns, political pressure could drive the government to guarantee the benefits from the fund, or even decouple returns credited to members from the underlying investment returns (as is the case for the Singapore Central Provident Fund). This is not only inequitable to members of other funds but creates a transfer of risk from members to taxpayers. The presence of this risk could also cause the fund to take a more conservative approach to its investment strategy, resulting in poor member outcomes by locking in lower investment returns.

The *best in show* model could also be perceived to have an implicit Government guarantee given the Government vetting process. But, we do not see this as being materially different to community views of the MySuper licensing regime. We expect that should a MySuper product or best in show fund fail financially, compensation for members could be funded by industry rather than Government. This option has precedent with some victims of the Trio collapse receiving compensation via a levy on APRA regulated superannuation funds.

We strongly agree with the PC's assessment of the fiscal risks associated with this *National Default Fund* model. Transferring this investment risk from the individual to the Government of the day is completely counter to the policy rational of Australia's superannuation system, which has been well established over the last two decades. The intergenerational inequity involved in the transfer of this risk is also an undesirable outcome for Australian society.

8.1.2 Agency risks

Government ownership of pension schemes creates significant agency risks. The government currently plays the role of regulator and supervisor. Under a *National Default Fund* model, the government would become the sponsor, service provider, fiduciary agent and recipient of pension fund investments. This is in addition to acting as supervisor and regulator.

Under a *best in show* model the government would only be involved in the selection process, licensing and regulation of the funds. This reduces agency risks as management of the funds would be independent of government.

We believe that regulation/supervision and provision of pension schemes should not be provided by the same entity and for this reason, do not support a *National Default Fund model.*

[15] For example: Kohler, A., 19 August 2017, "Make Future Fund the default superannuation fund", The Australian

8.1.3 Political influence on investment strategy

The PC report argues that a *National Default Fund* model could result in the government of the day having increasing control over the investment strategy of an ever larger pool of superannuation assets. We believe the significant agency problems associated with this could result in poor outcomes for members and the broader Australian economy.

The government could for example influence the fund to invest in government preferred infrastructure projects, despite not being in the best interests of members. We agree that this would be a significant risk and that (given the size of the superannuation pool and the potential lack of prioritisation of investments) these infrastructure investments could deliver poor returns for members and fail to deliver the significant productivity enhancements expected from large increases in infrastructure investments.

The alternative of the current system or *best in show* model retains the trustee's fiduciary duty to invest in the best interests of members only and avoids this political influence unless the government were to introduce new legislation which we believe the industry would lobby against.

8.1.4 Constitutional issues and competitive neutrality

The PC report also argues that a state-owned default structure could face constitutional issues, as well as creating issues of competitive neutrality. The PC argues that the perception that a state-owned fund would be seen as the most appropriate default choice would provide the fund with a competitive advantage as unengaged members could be automatically allocated to the government fund.

It is reasonable to consider that this Government owned default fund may appear to have a competitive advantage over other default funds in the market, however the political and fiscal risks associated with this *National Default Fund* model are much greater risks to providing poor member outcomes.

8.2 International comparisons

8.2.1 New Zealand (KiwiSaver) Model

The New Zealand system (KiwiSaver) work-based savings model is similar to but has a number of key differences to the PC's proposed *best in show* list of 10 model.

Under the KiwiSaver system, all new employees who are not existing members of a KiwiSaver scheme are advised of the employer chosen pension scheme. Employees are then either defaulted into the employer scheme or are able to select their own fund.

If both employer and employee fail to select a scheme, the employee is randomly allocated to a fund on the approved list of default providers and employers are required to make default contributions to this fund thereafter (unless employees choose to opt-out of the KiwiSaver scheme, which is allowed since the New Zealand system is not compulsory).

The approved list of default KiwiSaver providers are selected by the Ministry of Business, Innovation and Employment via a tender process. Default funds are selected for a period of seven years. Six providers were selected for the first list of default KiwiSaver provides. The following nine providers are currently on the list of defaults:

- AMP Services (NZ) Limited
- ANZ New Zealand Investments Limited

- ASB Group Investments Limited
- Booster Investment Management Limited
- BNZ Investment Services Limited
- Fisher Funds Management Limited
- Kiwi Wealth Limited
- Mercer (NZ) Limited
- Westpac New Zealand Ltd.

Table 3 shows the funds under management of the largest KiwiSaver funds (as at the June quarter 2017). The current list of default funds are the top nine KiwiSaver funds in terms of assets under management, holding approximately 90% of the KiwiSaver funds under management. These funds are also the only KiwiSaver funds to hold at least $1 billion in assets[16].

The distribution of market share within KiwiSaver funds is heavily skewed towards a handful of these funds, with 73% of the total KiwiSaver market sitting with the five largest funds – and 42% with the two largest funds.

Table 3. KiwiSaver Funds Under Management Fund June 2017

Company	Funds Under Management June 2017 ($ million)
ANZ Investments	10,401
ASB Group Investments	7,400
BT / Westpac NZ Group	4,878
AMP NZ Group	4,648
Fisher Funds Group	3,652
Kiwi Wealth	3,174
Mercer NZ	1,663
BNZ	1,268
Booster	1,245
Milford Asset Management	875
NZX/Smartshares Group	661
Generate	458
Aon NZ	446
Others	1,508
Total Market	**42,276**

Source: Strategic Insight, Actuaries and Researchers

This example provides some evidence to support the argument that the list of funds included in the *best in show* shortlist would be the only funds able to retain sufficient scale in the medium to long-term.

[16] Strategic Insight, Actuaries and Researchers. 2017. News Flash: KiwiSaver Funds Under Management at June 2017. Accessed from: http://www.pflresearch.com/news/2017/8/14/kiwisaver-funds-under-management-at-june-2017

KiwiSaver contributions are administered by New Zealand inland revenue through the pay-as-you-earn tax system. Contributions received by Inland Revenue are then transferred to the members' KiwiSaver provider. This process ensures that members do not have multiple unnecessary KiwiSaver savings accounts.

The fundamental difference between Kiwisaver and Australian superannuation is that employees are able to completely opt out of the Kiwisaver, as New Zealand has a non-compulsory work-based savings system. Given the Australian superannuation system is compulsory, any change to arrangements for allocating members to default superannuation funds would have a much larger impact on the system and the economy (compared to an opt-out system with lower rates of take-up).

Allowing employers to select a fund for their employees also recognises that large employers may be able to secure better outcomes for their members by negotiating with KiwiSaver providers. The benefit of this flexibility does not exist in the *best in show* model proposed by the PC. Not allowing the flexibility in the system for an employer to nominate could result in poor outcomes for members in the long run.

Furthermore, the longer period between *best in show* reviews on the list increases the chances that more funds on the default list may merge (providing the merged fund with significant scale benefits). (This has occurred in Kiwisaver - see Section 7.1 for the example of AMP's acquisition of AXA).

8.2.2 Chilean Model

The Chilean system for allocating members to a default retirement savings fund utilises a biennial fee based tender to select a fund that will accept all new workers who will enter the workforce for the first time. The fund with the lowest administration fee will win the tender, provided it also extends this fee to its existing members. Although this model is simple, and in theory should result in low fees across the system, it does have its issues, namely:

- This model introduces risk to the system by reducing the number of providers and creating providers that are too big to fail.
- Providers have an incentive to reduce fees at the expense of the optimal structure of investment options and the quality of service provided to members. This results in poorer member services and investment returns. It also increases the risk of administrative errors.
- The significant downwards pressure on fees has resulted in a lack of participation in the tenders, leading to reduced competition for default members. A lack of competition has the potential to stifle innovation in the sector and result in poor member outcomes.
- Where providers have lost contracts, they have had difficulties in maintaining continuity of service to acceptable standards, and transfers of members and assets to new arrangements have been problematic.