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20 July 2018

Attention: Ms Karen Chester, Deputy Chair
Superannuation
Productivity Commission
Locked Bag 2, Collins Street East
Melbourne VIC 3000

PC'S DRAFT REPORT *SUPERANNUATION: ASSESSING EFFICIENCY AND COMPETITIVENESS*

Dear Ms Chester,

The Australian Industry Group (Ai Group) welcomes the opportunity to comment on the Commission's Draft Report *Superannuation: Assessing Efficiency and Competitiveness.*

Ai Group is a leading Australian business association. Together with our partner organisations we represent the interests of more than 60,000 businesses employing and making superannuation contributions on behalf of more than 1 million staff. Our members are small, medium and large businesses in sectors including manufacturing, construction, engineering, transport & logistics, labour hire, mining services, the defence industry, civil airlines and ICT.

Ai Group is also a shareholder in the trustee of AustralianSuper a leading Australian superannuation fund. Former Ai Group Office Bearers and senior managers and members of Ai Group's current senior management team are among the Ai Group- nominated members of the Board of AustralianSuper and its Committees.

Ai Group firmly supports the objective of improving retirement incomes for superannuation fund members and we commend the very rigorous work the Productivity Commission has undertaken in assessing performance and in highlighting the very significant differences for members' retirement incomes associated with the performance of their funds.

We agree with the Commission's identification of unintended multiple accounts and entrenched fund underperformance as two structural flaws in present arrangements which, if addressed, could be expected to substantially boost members' retirement incomes.

We support most of the recommendations of the Draft Report (DR5 through to DR22) and believe that, if adopted and subject to minor qualifications, they will help improve fund governance; lift average performance levels; assist in improving member outcomes; and enhance the regulation of institutional superannuation funds.

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Where we differ from the Commission, we believe our suggestions take considerably more advantage of the existing strengths in Australia's superannuation industry than the approach proposed by the Commission. They also avoid potential damage to member outcomes and competition in the industry inherent in some Draft Recommendations. Further, they avoid the adverse impacts the Commission's approach would have on high-performing, smaller default funds.

Fundamental to our proposals is our reading of the evidence contained in the Draft Report about the characteristics of high-performing funds.

While not true of all funds, among the higher performing funds there is a clear concentration of not-for-profit default funds. Conversely, average fund performance is pulled down by underperforming funds which, while drawn from all sectors, are clearly dominated by so-called "choice" products and in the for-profit retail sector. An additional concentration of underperformance is evident among smaller Self-Managed Super Funds.

We also note that larger institutional funds tend to be higher-performing although several large retail funds underperform and there are clear instances of smaller, niche funds also performing very strongly. There is an important group of high-performing small and medium-sized funds that have an industry-specific focus. Typically with these funds it is product and service offerings that are tailored to the workforce in a particular industry although the particularities can also extend to funds' asset allocation.

We are very wary of an approach to improving outcomes for members that focusses on a particular sector or particular sectors of the industry rather than concentrating more directly on performance. Accordingly, we suggest a greater and more direct emphasis on fund performance than proposed by the Commission. In particular, we propose a firmer approach to MySuper Authorisation (see below on DR4) than proposed in the Draft Report.

We put the case that a better way to achieve the stated objectives of the PC's Draft Report is to build on existing strengths of the superannuation industry by using the insights of the Draft Report to strengthen of the roles of APRA and the Fair Work Commission in Australia's superannuation system.

Yours sincerely,

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Ai Group's Detailed Comments on the Draft Report

Subject to very minor qualifications in a handful of cases we support most of the Commission's Draft Recommendations (DR5 through to DR22). More detail on these is contained in the Attachment.

Our major comments are in relation to Draft Recommendations 1 through to 4. These comments are aimed at improving on some of the directions proposed in the Draft Report; they set out our leading concerns with some of the Draft Recommendations; and our suggestions about avoiding them.

DR1 Defaulting only once for new workforce entrants

Ai Group fully supports the objective of removing unintentional accounts and the proposal for an efficient and effective online service to enable opening, closing and consolidating accounts; to facilitate the carryover of existing accounts; and to collect information about member choices. We suggest this information would be of value to members and funds and should be widely available. Further, we agree there should be universal participation by employees and employers.

However, we think the once-only approach proposed in DR1 will add to the current risk that disengaged people will have their default account with funds that perform poorly. We think that better outcomes can be generated for members by avoiding this risk with once-only defaults.

Further, given workforce dynamics and the very strong expectation that employees will shift from industry to industry over the course of their time in the workforce, we believe there are real risks that the approach proposed in DR1 will:

- Reduce outcomes for many members;
- Tilt the playing field against high-performing, niche default funds; and,
- Reduce an important source of competitive tension and innovation in the industry.

Currently, many disengaged people are defaulted into high-performing industry-specific funds that have particular benefits tailored to the nature of their industry and its workforce.

Under DR1 *only new workforce entrants* to an industry would be defaulted into the more advantageous industry-specific fund. Other disengaged industry entrants would remain in an initial default fund that was sub-optimal for their changed circumstances. Thus, the proposal would see many people defaulted into funds - or remaining in default funds - that were less than optimal for their changed circumstances.

This, in turn, would reduce the ability of default funds to focus on offering industry-specific advantages, thus reducing the scale and often the viability of otherwise superior funds.

Yet, high-performing niche funds provide important competitive tensions to the workings of the overall market and they are often leaders "from the edge" - nimble and innovative.

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A far superior approach that preserved this source of service, specialisation and competition, would be to identify any high-performing funds that offered industry-specific advantages and to default disengaged members into these funds while facilitating, encouraging and nudging the rollover of existing accounts into the new fund. This would be greatly assisted by initiatives put forward in the May Federal Government Budget and by DR8 of the Draft Report.

A further measure that could assist with unwanted multiple accounts would be to require funds that currently do not permit accounts to be rolled over into another fund to allow this to occur. Some Commonwealth Government funds fall into this category with members often trapped with unwanted accounts that incur fees and deliver sub-optimal returns.

If combined with other measures (see in particular our comments on DR4 below), our proposal would have the very clear advantage of substantially addressing the risk of members being in poor-performing default funds. At any point in time there would be an advantageous selection bias in favour of the current crop of default funds that would be absent under the Commission's existing DR1.

DR2 Best in show shortlist

Apart from the association with the particularities of DR3 in which there would be only one shortlist of 10 products across the entire economy and on which we comment below, Ai Group supports most of the details in DR2 noting that they could apply to any of several approaches to default-product selection.

- We agree with the advantages of a shortlist of default products.
- We agree that shortlists should be comprised only of high-performing products.
- We agree there should be clear and comparable information presented on each product on the shortlist.
- We agree that members should not be prevented from choosing a product (or a fund) that is not on the shortlist (including a SMSF).
- We agree with the proposal for sequential allocation to one of the products on the shortlist in the event of an absence of choice.
- We support the creation of an online service that includes the shortlist(s) and accompanying information.

In addition to these points we also suggest that:

I. Shortlists be made available to all new employees and not just disengaged new workforce entrants; and
II. In creating the shortlist of products, high-performing products that are suitable for the industry the employee is entering should be considered for inclusion.

Both these additional suggestions flow from our comments above in relation to DR1.

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DR3 Independent expert panel for 'best in show' selection

We do not support this recommendation. In short, we think it would reduce competition and industry dynamism not only among default funds but across the broader industry.

The restriction to up to 10 default products across the entire disengaged workforce would reduce competition, variety and the viability of many otherwise high-performing funds.

Amongst these broader market structure impacts, the proposal would see a reduction in the scale and viability of many niche default funds and would ultimately see this source of value-add denied to disengaged members.

Figure 4 of the Draft Report, reproduced below, shows that, in addition to the ten best performing default products included in the sample, there are a further 22 products that returned above the BP2 benchmark. A further 10 performed above the BP-0.25 benchmark.

The Commission's proposal for up to ten default products for the entire economy to be chosen once every four years carries the clear risk of undermining the viability of a significant number of higher-performing default products. This would also undermine the extent of competition not just among default products but across the broader industry.

Included among the highest-performing default products identified by Figure 4 of the Draft Report are several smaller products. Most of these are supplied by smaller industry funds providing default products on an industry-specific basis. These successful niche products are not suited to the sequential allocation of members from across the whole economy as proposed in the Draft Report.

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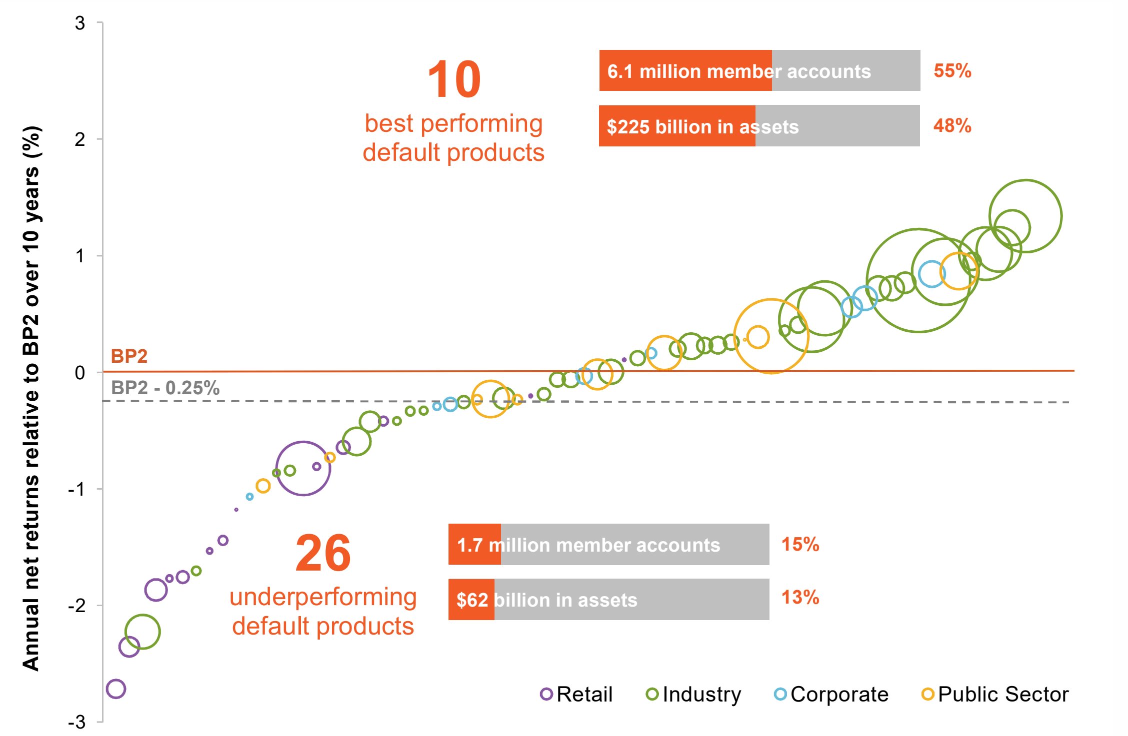
Default products: vastly different net returns, with 1.7 million default member accounts in underperforming products

Compared to MySuper average asset allocation, 2008–2017

Size of circles indicates the size of each fund's assets under management



Sources	PC analysis of SuperRatings and APRA data, and financial market index data (various providers).
Benchmark	BP2.
Coverage	66 of 108 MySuper products covering 75% of member accounts and 73% of assets in all MySuper products as at December 2017.
Survivor bias	Yes. **Selection bias** Yes.
Further results	22 MySuper products performed above BP2 but not in the top 10 (3 million member accounts and $150 billion in assets). 10 products performed between BP2 and 0.25 percentage points below BP2 (428 000 member accounts and $29 billion in assets).

Source: PC Draft Report, p.13.

It is likely that the trustees of these funds, acting in the best interest of their current members, would not be attracted to the dilution of the industry-specific focus inherent in the proposed acquisition of members from across the broader workforce. They would face the dilemma of choosing between:

- Putting their high-performing default products forward for consideration to be among the chosen few - in which case they would face a dilution of their industry-specific membership and industry-specific service that would undermine an existing source of value-add; and
- Foregoing the opportunity to put themselves forward to be considered as a generic default fund and denying themselves the opportunity to provide industry-specific services to new disengaged members of their industry.

In either case there is a very significant risk of a loss of member service and of product and fund viability and a detraction of competition in the market. These adverse outcomes should be avoided.

That said, Ai Group does see merit in elements of DR3.

- A list of up to ten default funds presented to employees along with the information envisaged in the Draft Report will address the excess-choice issue.

- Further, subject to slight paraphrasing, we do support these parts of the DR3:

  [That an] independent panel conduct a competitive process for listing superannuation products on [the] … shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established beforehand by the panel) and judged to deliver the best outcomes for members, with a high weighting placed on investment strategy and performance.

  The panel should have flexibility to select up to 10 products, with the exact number at the discretion of the panel based on the merit of each product and what is most tractable for members, while maintaining a competitive dynamic between funds for inclusion.

Is there a way to retain the advantages offered by these parts of DR3 while avoiding the overall reduction in competition in the broader market and the loss of industry-specific advantages that are a clear strength in the current default arrangements?

Such an approach would need to offer individual employees a choice of up to ten carefully-selected, high-performing default products including products tailored to the industry they were entering. Across the broader economy, there would be many more than ten default funds if default shortlists could vary by industry.

There is an approach that can achieve these outcomes. It also has the advantage of working within the existing institutional arrangements and would require simple amendment of existing legislation so that the Fair Work Commission (FWC) could undertake the task it has already been given in a way that was enhanced by the Productivity Commission's proposals as identified above. This would include ensuring there were no barriers to funds putting forward high-performing default products for the consideration of the FWC expert panel and that there were no barriers to funds arguing the merits of their nominated products before the FWC panel.

While they could be improved by taking from DR3, it should not be forgotten that the past arrangements, which have involved a major role for the FWC and its predecessors, have been associated with what has been shown by the Draft Report to be the relatively high-performing default sector. Both in respect of this and because it avoids tilting the playing field away from high-performing niche default funds, Ai Group submits that this alternative approach to DR3 is superior to that proposed by the Commission.

The current default fund provisions of the *Fair Work Act* have not yet been implemented including because of some initial problems with the composition of the FWC's expert panel. These problems are surmountable. The relevant provisions of the *Fair Work Act* address many of the issues of concern raised by the Productivity Commission and they have a considerable amount in common with the proposals in the Draft Report. For example, s.157F of the Act includes the following worthwhile criteria for selecting default funds:

(a) the appropriateness of the MySuper product's long-term investment return target and risk profile;
(b) the superannuation fund's expected ability to deliver on the MySuper product's long-term investment return target, given its risk profile;
(c) the appropriateness of the fees and costs associated with the MySuper product, given:
(i) its stated long-term investment return target and risk profile; and
(ii) the quality and timeliness of services provided;
(d) the net returns on contributions invested in the MySuper product;
(e) whether the superannuation fund's governance practices are consistent with meeting the best interests of members of the fund, including whether there are mechanisms in place to deal with conflict of interest;
(f) the appropriateness of any insurance offered in relation to the MySuper product;
(g) the quality of advice given to a member of the superannuation fund relating to the member's existing interest in the fund and products offered by the fund;
(h) the administrative efficiency of the superannuation fund;
(i) any other matters the FWC considers relevant.

In taking the alternative route proposed and building on demonstrated strengths of the existing default arrangements, there would be a substantial reduction in the risk inherent in the Commission's proposal of establishing a fundamentally new approach that worsened outcomes for disengaged superannuation fund members.

DR4 MySuper Authorisation

Ai Group regards this Draft Recommendation as the most important single proposal put forward in the Draft Report. We propose that it be firmed up to give it greater system-wide effectiveness in reducing the incidence of underperforming products and funds.

Ai Group supports a more rigorous approach to MySuper authorisation and agrees with the proposed requirements for audit-level independent verification of funds' outcomes test assessments, comparison against other products in the market and determination of whether members' best interests are being promoted at least every three years.

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We also support the proposal that funds report annually to APRA on intra-fund switching. We note however that while concentration only on member switching to higher-fee choice products will help address a particularly serious problem, it would not provide insights into the degree to which members switch into such options aiming to achieve higher returns net of the higher fees.

Greater information on switching behaviour and its consequences has the potential to add to member outcomes over time and should be widely available.

We agree that APRA should revoke MySuper authorisation for underperforming funds or for funds that do not meet their verification and reporting requirements.

In relation to the details of revocation, we see considerable merit in the Member Value Benchmark proposal developed by AustralianSuper under which:

- The performance of MySuper options would be assessed against a single, easily-understood performance benchmark; and
- The consequences of persistent underperformance would be revocation of MySuper authorisation and the automatic initiation of a prudential transition process for the relevant fund. This process should be undertaken promptly by APRA with the aim of assessing whether there is a strong case not to oversee the winding up of the fund. During this period the fund would not be eligible to receive contributions on behalf of new members.

We agree with the proposal to conduct an independent review of the effectiveness of the new authorisation arrangements every five years.

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Attachment

Ai Group Comments on Draft Recommendations 5 to 22

DR5 Regulation of Trustee Board Directors

Ai Group supports these recommendations and believes they will assist in lifting governance standards and fund performance.

We welcome that the Commission did not make a recommendation prescribing the number or proportion of independent directors, notwithstanding the view expressed in the first part of Draft Finding 9. In our view the Commission rightly preferred to concentrate on proposals aimed at ensuring boards rigorously assess whether they have the necessary skills and experience and take measures to address identified gaps.

One of the difficulties with the emphasis on proposals to mandate a proportion of independent directors is that there is a lack of clarity and lack of consistency about what it is that directors should be independent from and an associated lack of transparency about the rationales for independence. It is therefore not surprising that discussions about mandating a proportion of independent directors generates much more heat than light.

DR6 Reporting on Merger Activity.

Ai Group supports this proposal but considers it could be strengthened by also requiring funds to inform APRA when they have made or received a formal merger offer.

DR7 Capital Gains Tax Relief

Ai Group supports this recommendation.

DR8 Cleaning up Lost Accounts

Ai Group supports the objective of cleaning up lost accounts and enabling the ATO to auto-consolidate as proposed.

We note that the "Protecting Your Super" measures announced in the 2018-19 Budget would do much of the work of DR8 and in key respects are better than the DR8 (particularly in relation to larger-balance inactive accounts).

DR9 and DR10: Dashboards

Ai Group supports these recommendations and proposes that requirements for dashboards to be made available should extend beyond the ATO's online service so that dashboards were available in a wider variety of circumstances in addition to when a person changes jobs or super funds.

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DR11 Guidance for Retirees

Ai Group supports this recommendation noting that it may be more effective if funds were required to refer their members to the guidance.

DR12 Exit fees

Ai Group supports limiting exit fees and other costs of moving. As indicated in our response to DR1 above, we also support removing non-cost barriers to exit that contribute materially to the number of unintended multiple accounts.

DR13 Disclosure of Trailing Commissions

Ai Group supports this recommendation.

DRs 14, 15, 16, 17, 18 and 19 Insurance in Superannuation

Ai Group supports these recommendations.

DR20 Australian Prudential Regulation Authority

Ai Group supports the recommendation that APRA:

- Require funds to conduct formal due-diligence of their outsourcing arrangements subject to there being clear guidance from APRA on materiality and reporting.
- Report annually on progress under various initiatives to bring about fund mergers.
- Undertake an assessment of the costs of legacy products and facilitate their rationalisation.
- Embed as soon as possible consistent product-level reporting across all funds and extending to both MySuper and choice products.

DR21 Australian Securities and Investments Commission

Ai Group supports the recommendations noting that APRA may be the more suitable regulator to investigate stalled or failed merger proposals.

DR22 Superannuation Data Working Group

Ai Group supports this recommendation.