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1 September 2017

To whom it may concern

Productivity Commission Issues Paper: Superannuation: Assessing Competitiveness and Efficiency

We are committed to positively contributing to the superannuation industry by supporting initiatives such as the important work you are doing to strengthen this industry and the future prosperity of our country more broadly as a result.

As one of Australia's leading professional services firms, we believe we are well placed to share our perspectives on superannuation. Our firm's national superannuation practice has deep experience in the superannuation industry and across the financial services sector more broadly.

Our contribution in response to the issues paper is mostly general in nature and high level at this stage as we note you are seeking specific evidence or information, which in many cases will need to come from industry associations and/or superannuation funds themselves.

However, we remain committed to being involved however best we can add value and would for instance be happy to provide comment on an ongoing basis, provide pilot testing for surveys and participate in industry roundtables.

Policy impediments

What are the material policy or regulatory impediments to the competitiveness and efficiency of the superannuation system? Please relate your comments to the relevant assessment criteria (in the Commission's assessment framework) and provide evidence of how and to what extent those policy impediments affect performance as measured by the related indicators.

Regulatory change

There has been significant regulatory change in this industry over the past 25 years starting with the significant increases in taxation in 1983, introduction of Superannuation Guarantee (SG) in 1992, the SIS Act (Superannuation Industry (Supervision) Act 1993), further major changes in taxation in 2007 and again in 2017, the Stronger Super reforms from 2012, which included the Super Stream package of reforms, increasing regulatory requirements such as the introduction of MySuper licenses and new prudential standards, and throughout the entire time, regular and constant changes in preservation and contribution rules.

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Many of these changes were positive changes for the industry such as the introduction of APRA prudential standards to improve fund governance and the Super Stream reforms to improve the back office functions, efficiency and quality of data. However, many changes were the result of constant tinkering with taxation, SG levels and contribution caps and rules in order to meet budget or other political objectives, all of which were possible as there was no overarching framework and objectives for superannuation. For example, there were 96 superannuation tax changes announced under the previous Labour Government of which approximately 75 were noted to be rescinded following the change in government.

Constant change of direction especially on SG rates, taxations and contribution caps causes material costs for superannuation industry in changing PDS's and communications materials more broadly, updating web sites, education and advice materials as well as systems.

In our view, the constant negative press about superannuation changes negates the many very positive aspects of the superannuation industry, which on the whole has been well governed and delivered sound returns. The public battle between retail and industry sectors also does not help public confidence in the industry as a whole. In our view negative press is a major contributing factor to why the public are unengaged, reluctant to contribute and often a negative sentiment expressed in fund member satisfaction surveys reflects this press rather than any specific fund related issue.

We agree that the recent Government established objective for superannuation is a step in the right direction. However, we need a more comprehensive framework for policy formulation on all issues relating to the sustainable financing of our ageing population so that all such decisions can be made in an appropriate manner and that they balance all facets of ageing such as retirement income, Age Pension and aged care along with short-term and long-term budgetary constraints.

Constant short term policy and regulatory changes adversely impact your system level objectives as follows:

- Significant and unnecessary cost for the industry and consumers to bear (Objective #1)
- Lack of confidence, trust and engagement by members in the system (Objective #2 and #5)

Regulatory barriers

There are a number of regulatory barriers, which impact both the provision of appropriate product and the operating efficiency of superannuation funds and the system.

- **New retirement income products:** SIS Act amendments allowing new retirement products which provide greater longevity protection, such as deferred and variable annuities, came into effect 1 July 2017. However, there is still no progress on clarifying the Age Pension means testing treatment of these same products nor is there any imperative from the Department of Social Services to provide clarification.
  Given around 70% of retirees receive the Age Pension for a substantive part of their retirement incomes, and this is not expected to materially reduce over the next 40 years, clarification and certainty as to the means testing treatment of these new products is critical for both the supply and take up of these new products.

- **Legacy products:** There are difficulties in rationalising legacy products due to conflicting regulator priorities (ATO/APRA/ASIC) and a lack of a mechanism for changing existing products. This creates a drag on wealth management businesses in Australia due to the higher maintenance costs of maintaining sub-scale products and outdated administration systems. In addition, there are potential impediments to innovation as companies will be reluctant to launch new products that could be on the books for many years if not successful. The introduction of a mechanism for rationalising legacy financial services products (subject to a no disadvantage test) will generate significant benefits for the economy, consumers and the financial services sector.
- **CGT rollover relief:** Given that the current number of MySuper funds (115) is considered unsustainable and APRA is introducing enhanced obligations on Trustees to consider the future sustainability of their funds, permanent rollover relief should be granted.
- **Counterparty failure:** Products with long-term (30 to 40 year) payment guarantees to retirees issued by life companies are regulated by APRA and are subject to very strong capital and risk management requirements. However, there is still a potential risk that insurers may not be able to fulfil their obligations over the long term for example, due to systemic and global longevity improvements. Consumer concerns about counterparty risk may pose constraints for future development of lifetime annuity markets and products. To facilitate the take up of these longevity products by reducing counterparty risk, encourage long-term investments (such as infrastructure) and promote innovation in the longevity insurance market, consideration could be given to the introduction of an industry scheme, or other forms of support, to provide financial assistance to consumers that suffer loss through counterparty failure. Any such guarantees need to be costed and paid for by the consumers to minimise cross-subsidisation between product consumers and the taxpayer and may need to be limited to specific products or amounts so as not to impede product development of low or nonguaranteed products. There are examples overseas of similar arrangements in both the US and UK.

Regulatory barriers adversely impact your system level objectives as follows:

- Significant and unnecessary cost for the industry and consumers to bear (Objective #1)
- Lack of provision of suitable products (Objective #2).

Benchmarking

On the system-level benchmarking:

In the context of the approach set out in the stage 1 Study to compare long-term net investment returns to a set of passive, liquid reference portfolios, which reference portfolios would most meaningfully inform the analysis? What is the best way to ensure that equivalent taxes are netted out of returns to a reference portfolio? What fee levels should be applied to the reference portfolio? What are the most appropriate listed asset class benchmarks to use to calculate the returns to these reference portfolios?

On asset-class level benchmarking:

In the context of the approach set out in the stage 1 Study to benchmark long-term net investment returns at the asset class level, and given the available data, what is the best way to estimate long-term net returns at the asset-class level for the system, and why? Which listed benchmarks should be used for each asset class? How can the Commission best assess the investment performance of unlisted investments?

In regards to asset-class benchmarking:

- We agree it is appropriate to measure long term net investment returns at asset class level across the industry compared to an agreed set of standard indices.
  - This will provide a measure of efficiency for the industry as a whole by answering questions such as does the industry provide net of fees returns across the major asset classes in excess of the relevant market indices after allowing for the relevant indexed investment costs
  - In theory, you might expect that the sum of all performance in an asset class would match the index but in practice this may not be the case
  - We do not see this as attempting to convert all active investors to index investors, as there are benefits of active investment, but we see this as providing a check on the overall efficiency of the industry, which may encourage greater accountability at fund level to ensure active management provides value rather than simply satisfying a philosophical belief.
- For unlisted asset classes like property, infrastructure and private equity, there are both listed and unlisted indices which could be used.

In regards to the use of indexed (passive) reference portfolios:

- We agree with the use of indexed reference portfolios as a measure of the lowest cost option for executing “an investment strategy”
- However, when assessing investment efficiency across an industry, it may be difficult to define a set of appropriate reference portfolios
- Also, the result of any assessment against a reference portfolio will simply be the aggregate of the assessment of individual asset class returns
- So in practice, an assessment of asset class returns will provide some information on the efficiency of investments across the industry, especially in relation to the value added overall from active management and fees. The value added from an assessment against reference portfolios for the industry as a whole is less clear.

In regards to costs and taxes:

- An estimate of costs by asset class of indexed management could be obtained from the large indexed fund managers
- The estimate of tax is more difficult as some funds only calculate tax at investment option level but some funds may be able to provide an estimate of tax per asset class.

Alternative default arrangements

Which of the four models identified in the stage 2 Inquiry is likely to generate the greatest transition issues and costs, and why?

For the alternative models presented by the Commission, what would be the key transition issues and risks for:

- *members*
- *funds*
- *employers*
- *Government?*

In our view the multi-criteria tender and fee-based auction models with sequential allocation of default members would create the greatest transition issues and costs for the following reasons:

- These models could result in a relatively few products gaining considerable credibility in the eyes of the public over any other superannuation funds, resulting in potentially significant outflows from other funds, less competition and higher barriers to entry for other superannuation funds
- These models would make it more difficult for specific niche superannuation funds highly targeted to specific industries to survive and this may adversely impact members in these industries for example, where specific insurance covers have been obtained which would not be matched or transferrable to the selected default funds
- We would also expect participating funds to dedicate significant resources to the tendering process which at some stage is likely to increase costs to members
- This may also significantly increase the responsibility for the Government should one of these carefully selected funds fail or deliver sub-optimal investment returns.

Alternative Default Allocation Models:

How could the process for constituting the body for selecting default products be designed to deliver accountability (and thus not be judicial in nature) while mitigating the risks of politicisation and bias?

In practice this will be difficult if the Government has a say in the members of any such body.

Some suggestions to help mitigate this risk are as follows:

- Could the body be part of an existing independent group such as the Productivity Commission?
- Could the Australian Government Actuary be tasked with providing this group with the technical, evidenced based analysis required to inform their decision making
- Holding this group publicly accountable for their decisions would also help mitigate this risk. The results of the decision making process should be made public following the selection and we see no commercial reasons why a summary of the assessment against all key criteria could not be made public.

The first timer default mechanism:

How could the mechanism be designed to mitigate against the risks of entrenching member disengagement and the risk of members remaining in inferior products?

We agree with the previous proposal that new employees should be defaulted once only in their lifetime on commencing work and from then on they should exercise choice whenever appropriate.

We believe this approach will greatly reduce the number of unintended multiple accounts over time and encourage member engagement. We do not see that it will increase the likelihood of members remaining in inferior products compared to the current arrangements.

One of the greatest reasons why members may remain in inferior products is the difficulty of choosing between 115 MySuper funds. The rationalisation of the number of funds will be the single greatest change that may help members engage more productively in the future.

The proposed centralised clearing house:

What would be the cost to set up this platform within the ATO? What is the scope to utilise existing infrastructure within the ATO in establishing this platform? What is the evidence that a single government provider would not have the capability to operate the service, or that such a provider would fail to keep pace with technological change?

What would be the expected ongoing costs of service provision? Specifically, what is the scope to reduce costs over current arrangements due to economies of scale?

How many operators are currently in the market for the provision of clearing-house services? To what extent do existing arrangements facilitate new entry and promote the exit of inefficient providers, and what is the evidence on recent entry and exit?

What international experiences can be drawn on to provide insights into the merits of a centralised clearing house in the Australian system?

We are aware that a number of industry groups have noted the significant costs spent on Super Stream to date and the risks and capability of moving this to one provider being the ATO. We have similar concerns.

Merger transparency:

Would elevating the level of disclosure that prospective merger parties are required to provide to APRA (such as following a memorandum of understanding between the parties) create material risks of discouraging merger activity?

Would a requirement for trustees' to disclose merger discussions that had proceeded past a specific point to its members retrospectively (such as in annual reports) strike the balance between transparency and incentives for trustees to enter into preliminary discussions prior to (and during) the due diligence phase? What should this specific point be? How else could the mechanism be modified to strike such a balance?

We agree with the underlying objective here, which is to achieve more mergers in order to more quickly address the issue of any non-performing, unsustainable superannuation funds.

We do agree that disclosure of merger discussions following a memorandum of understanding between the parties is appropriate to both APRA and members in the Annual Report.

However, we note that this requirement may not encourage more mergers to occur. If trustees are forced to disclose the nature of merger proposals before they are ready, there is a risk they would be deterred from undertaking any form of "formal" discussions that would need to be reported.

Prior to any consideration of a formal merger, there should always be a significant amount of informal discussions and internal due diligence behind the scenes in order to assess a range of potential merge candidates. This preliminary informal work is required to better understand the potential strategic, cultural and operational fit and therefore whether the significant costs and time involved in undertaking a detailed due diligence are worth incurring.

We would not like to discourage this work as when done well, it leads to more sustainable and cost efficient mergers.

When management and/or boards are reluctant to merge because of personal conflicts, there will always be reasons found to support not taking action regardless of any attempts to legislate "the right behaviours".

We are struggling to see a solution to this issue other than key regulators, such as APRA, playing a more significant and important role in encouraging mergers through:

- Greater accountability and transparency of non-performing unsustainable superannuation funds
- Greater guidance on the management of key conflicts in relation to mergers
- Greater disclosure where planned mergers do not proceed.

We note that APRA has recently announced a number of measures which will require funds to more carefully and objectively assess whether they are achieving appropriate member outcomes. In principle, we see this as a positive development.

Insurance in super

Finally, the only other comments we wish to make are in relation to insurance.

- We understand the key concerns regarding insurance in superannuation namely, the impact of default covers on retirement incomes, the appropriateness of default covers and the potential impediments to account and fund consolidation.
- However, we also recognise that the provision of group life insurance covers through superannuation has provided significant benefits for many members in the form of lower premiums and reduced or no underwriting requirements. This has resulted in a broader level of coverage, which has been a positive overall but unlikely to be the case if insurance were removed from superannuation.

We believe it should be possible to confirm and validate the key concerns and the extent of the problems and then work through solutions to address these concerns as we see far greater potential issues associated with removing insurance from superannuation.

Conclusion

In conclusion, we continue to encourage your work as we believe it will ultimately improve the efficiency of the system and the outcomes for members.

We would welcome the opportunity to participate in any further way that would be helpful to you. Please contact me or Catherine Nance

Kind regards

Craig Cummins Partner National Superannuation Leader PwC Australia	Catherine Nance Partner PwC Australia