

**PRODUCTIVITY COMMISSION – DRAFT REPORT - HOW TO ASSESS
SUPERANNUATION COMPETITIVENESS AND EFFICIENCY**

SUBMISSION

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The Association of Superannuation Funds of Australia

TABLE OF CONTENTS

EXECUTIVE SUMMARY.....	3
INTRODUCTION	5
THE EFFECTS OF REGULATORY COSTS ON EFFICIENCY	11
CRITERIA - COMPETITION.....	14
C1. Is there sufficient member engagement to exert competitive pressure?	14
C2. Are members and member intermediaries able to make informed decisions?	17
C3. Is there low market segmentation along member engagement lines?	19
C4. Do active members and member intermediaries have sufficient countervailing power?	21
C5. Are principal-agent problems being minimised?	23
C6. Is there rivalry among incumbent providers?	25
C7. Is the market contestable?	28
C8. Are there material anticompetitive effects of vertical and horizontal integration?	32
C9. Do funds compete on costs?	34
C10. Are economies of scale utilised and benefits passed through to members?	36
C11. Do funds compete on relevant non-price dimensions?	39
C12. Is there innovation and quality improvement in the system?	41
C13. Are outcomes improving at the system level?	45
CRITERIA - EFFICIENCY.....	47
E1. Are long term net investment returns being maximised taking account of service features to members?	47
E2. Are fund costs, and fees charged, being minimised taking account of service features to members?	52
E3. Do all types of funds have opportunities to invest efficiently in upstream capital markets? ...	55
E4. Is the system effectively managing tax for members, including in transition?	58
E5. Are member preference and needs being met by minimising unpaid contributions and lost accounts?	60
E6. Are member preferences and needs being met by funds collecting relevant information to ensure product offerings are suitable for their diverse member bases?	63
E7. Are member preferences and needs being met by the system providing high-quality information and financial advice to members to help them make decisions?	65
E8. Are member preferences and needs being met by the system providing products and information to help members optimally consume their retirement incomes?	67
E9. Are members' balances being allocated in line with their risk preferences and needs?	70
E10. Is the system using behavioural finance to design products?	72
E11. Are the trustees acting in the best interests of members?	74
E12. Are there material systemic risks in the superannuation system?	75
E13. Do funds offer insurance products that meet members' needs?	78
E14. Are the costs of insurance being minimised given the type and level of cover?	89

EXECUTIVE SUMMARY

ASFA considers that the Productivity Commission's proposed framework requires significant refinement in order for the Commission to draw meaningful conclusions about system efficiency and competitiveness.

- In ASFA's view there are too many criteria and indicators, some of which are not well specified.
- For some criteria, meaningful assessment would require significant, and as yet unspecified, supporting qualitative analysis.
- For many of the indicators the data identified is not available. ASFA is concerned that the data requirements would increase the data reporting burden for the industry.
- A significant gap in the framework, which is relevant to several criteria, is the effect of regulation on efficiency and competition.

Objectives

- ASFA considers that the framework should have an overarching objective for the system:
 - *To provide an adequate income to ensure all Australians achieve a comfortable standard of living in retirement, supplementing or substituting the Age Pension*
- The Commission's proposed objectives are subsidiary objectives that relate to, and would support, this overarching objective.
- The proposed subsidiary objectives require refinement – in particular the insurance objective should incorporate the broader social and economic benefits of insurance.

Competition

- There should be only one criterion that assesses member behaviour – in the current framework member behaviour is addressed in (at least) the first four competition criteria.
 - In ASFA's view the significant focus on member engagement in isolation would not assist assessment of system competitiveness.
 - Reliance on the proposed indicators is likely to lead to misleading conclusions about the nature and extent of member engagement and its role and effect on competition and efficiency, so indicators should focus on when members take action in regard to an option available to them (bearing in mind that inaction does not necessarily connote disengagement).
- Market rivalry and contestability (*Competition Criteria 6 and 7 respectively*) are appropriate criteria, but the Commission's perspective should be broader.
 - Indicators should capture rivalry and contestability in all stages of the supply chain, as well as insourcing and outsourcing.
 - Indicators should be supplemented by analysis of the regulatory constraints on competition.

- The role and effects of innovation (*Competition Criteria 12* and elsewhere) should be more prevalent in the framework.
 - In general, the proposed indicators are focused on product innovation and do not contemplate improvements and innovation in services and in the modes of delivery of products and services.
 - A broader perspective would better capture innovation as source of competition, and the value and benefit of innovations to members.

Efficiency

- Net investment returns (gross returns less all fees, costs and taxes) should be the key criterion against which to assess member benefits and system efficiency.
 - Returns should be risk-adjusted, unless the measurement period is suitably long, and should be measured and benchmarked on a 'like for like' basis.
 - Potential benchmarks have specific strengths and weaknesses, so ASFA supports the use of two complementary benchmarks.
 - Indicators need to take account of the quantity and quality of member services – which is explicit in the criterion, but not captured by the indicators.
- The treatment of systemic risk (*Efficiency Criteria 12*) requires significant refinement.
 - This is a broad and complex issue. The proposed indicators need a range of supporting qualitative indicators and analysis to be useful.
- ASFA considers that, in assessing efficiency, the Commission needs to quantify the effects of regulation.

Costs

- The treatment of costs (which is the focus of three separate criteria) should be rationalised, and costs should be considered in the context of value and benefits to members.
 - At the very least, the criteria that relate to cost and non-price competition (*Competition Criteria 9 and 11*) should be combined so that assessment of competition looks at non-price dimensions in combination with cost.
 - Many of the proposed indicators are unlikely to be informative, particularly with respect to non-price competition.
 - Margins are a better indicator of competition than costs alone.

Insurance

- For both criterion and all of the indicators there needs to be greater focus on benefits, relative to costs, including the broader social and economic benefits of insurance.
 - The majority of life and disability insurance coverage for Australians would not be in place if not for automatic cover under group default arrangements.
 - The framework should acknowledge the role of trustees in ensuring that insurance in superannuation meets members' needs and that defaults generally provide flexibility for members to tailor their cover.
 - The framework should assess the reasonableness of costs given the type and level of insurance cover, and take into consideration the benefits and value of insurance to members.

INTRODUCTION

KEY POINTS

- ASFA supports the balanced scorecard approach adopted by the Commission.
- There is scope for significant refinement of the 27 criteria and 115 associated indicators that the Commission has proposed. All criteria and indicators need to directly measure efficiency and competition.
- There are a range of drivers of competition and ASFA is concerned that the Commission is focusing too heavily on member engagement and not sufficiently focusing on non-price competition.
- ASFA supports using net investment returns (returns net of all fees, costs and taxes) to measure efficiency and using both a margin over inflation (CPI +X) and a reference portfolio as a benchmark.
- Assessment of insurance is broader than costs and should be about receiving appropriate protection at a reasonable cost.

A competitive, efficient and dynamic superannuation system is crucial to fund the Australian economy and ensure people retire with dignity. The system must provide a framework to deliver an adequate income to ensure all Australians achieve a comfortable standard of living in retirement, supplementing or substituting the Age Pension. ASFA notes the objectives identified by the Productivity Commission and considers that it is crucial that these relate to the primary objective of the system (when it is legislated).¹ Ultimately, the industry and the Government should be measured on meeting this objective.

Balanced scorecard approach

As ASFA mentioned in its submission to the Commission's Issues Paper, it is a challenging task to measure the efficiency and competitiveness of the superannuation system. ASFA supports the 'balanced scorecard' approach proposed by the Commission as a framework as there is no single measure to assess the efficiency and competition of the system. A balanced scorecard needs to be focused on direct measures of efficiency and competition to be effective. As such, our preliminary analysis is that there is scope for **significant** refinement of the 27 criteria and 115 associated indicators (89 of which are unique) that the Commission has proposed for the assessment process.

Criteria, indicators and data

ASFA has a number of broad concerns with the Commission's framework. Unless refined, the framework – in its current form – would make it difficult for the Commission to draw meaningful conclusions about the efficiency and competitiveness of the system. ASFA looks forward to working constructively with the Commission over the next few months to assist in refining and finalising the assessment criteria and indicators.

Firstly, there are too many criteria and indicators – some of which are not well specified. As noted above, the framework needs to be refocused on key measures of efficiency and competition. The Commission's framework has a large number of ambiguous/indirect indicators. This means that information from any (potentially) key indicators would be diluted.

¹ The Government and FSI proposed objective is "To provide income in retirement to substitute or supplement the Age Pension".

For some criteria, the Commission seems to be assessing only what it can measure and not accounting adequately for context. *Efficiency Criterion 12* is a case in point, where the Commission proposes to assess systemic risk in wholesale provider markets with measures of market concentration. Systemic risk is a very complex issue, requiring in-depth assessment of a range of factors (see our discussion on *Efficiency Criterion 12*).

One of the factors to bear in mind is that superannuation largely is a pooled system (apart from self-managed superannuation funds (SMSFs)). Trust law imposes a fiduciary duty on trustees to act in the best interest of members - as a whole - when developing its products and services. While superannuation products are able to be tailored by the member according to their preferences and needs - for example being able to choose between investment options or dial up or dial down insurance - when designing default products the trustee must take account of their entire membership.

Further, there is little detail in the Draft Report on how the Commission would combine the information from the indicators to make an overall assessment of efficiency and competitiveness. In the current framework, it is clear that some indicators would be more important than others, but how much more important is likely to be a matter of significant judgement.

ASFA also has concerns about the volume and nature of the proposed data requirements.

For many of the proposed indicators, the data that the Commission has identified is not available, or is not of sufficient scope or quality for the intended purpose (the Commission has identified some of these data gaps in its Draft Report, but not all).

As such, ASFA is concerned that the Commission's proposed framework will increase the data reporting burden for the industry – which already is subject to extensive data reporting and compliance requirements. ASFA considers that the Commission's assessment process must minimise the burden on the industry, and thus ultimately on members and consumers. The Commission's assessment should be based on existing data, as much as it is possible to do so, and ensure that the data is used and interpreted in its correct context.

A further concern is the Commission's relatively heavy reliance on surveys (Table 1). While surveys can be a valuable tool, they have their limitations. The Commission discusses some of these shortcomings in its Draft Report.² Survey results can be affected significantly by survey design – a poorly-designed survey can lead to ambiguous or even misleading conclusions.

² Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, page 199. ('Draft Report')

Table 1: Frequency of data type for indicators

	Regulator data	Industry data	Surveys	Case studies	Reviews by others
COMPETITION	19	16	32	8	7
EFFICIENCY	26	23	26	8	3
TOTAL	45	39	58	16	10

Competition

Competition within the superannuation system is complex and the nature of competition throughout the superannuation value chain varies markedly.

ASFA is broadly supportive of the assessment criteria proposed by the Commission that analyse the characteristics of a competitive market, though ASFA has some concerns.

The Draft Report identifies costs and fees as important aspects of efficiency and competition in the system, however, it fails to adequately acknowledge the importance of non-price competition (through products and services including advice, call centres, web-sites and seminars).

In addition, ASFA has concerns about the degree of emphasis on strong member engagement as a driver of competition in the system. There are a number of factors outside the control of the system that affect levels of engagement such as age and financial literacy, and MySuper was developed in recognition that there will always be a group of members who are relatively disengaged. Further, member engagement is only one component of the many factors relevant to competitive pressures.

Efficiency

ASFA supports using net investment returns (returns net of all fees, costs and taxes) as the key measure of member benefit. Returns should be risk-adjusted, unless the measurement period is suitably long, and should be measured and benchmarked on a 'like for like' basis. Potential benchmarks have specific strengths and weaknesses, so ASFA supports the use of two benchmarks:

- Margin over inflation (CPI +X%)
- Set of reference portfolio benchmarks

Insurance

ASFA has concerns about the Commission's views on insurance. Insurance in superannuation is crucial as it addresses some of the effects of underinsurance in our economy and provides protection against the financial hardships that can be caused by disability or premature death. Generally, insurance in superannuation is at a lower cost than insurance held outside superannuation, and it is much easier for people to obtain cover as policies are provided on a 'group' basis rather than being individually underwritten.

For most Australians the insurance they have in their superannuation is the only life insurance they hold. Insurance needs to be considered more broadly than just on cost and considered through the lens of ensuring that members receive appropriate protection for a reasonable cost. The purpose of insurance in superannuation is, in effect, to cover the ‘future service’ period between the event (disablement or death) and retirement age, to put the member (or beneficiaries) back in the approximate position they would have been but for the occurrence of the event.

The full benefits of life insurance within superannuation, for individuals and the government, need to be considered. KPMG has estimated that the total level of underinsurance with respect to premature death in Australia is \$800 billion.³ Underinsurance in relation to death, total & permanent disablement, and income protection costs the government over \$1 billion per annum in additional social security payments.⁴ This figure would be much higher without insurance in superannuation given the majority of cover across all of these insurance types is held through superannuation.⁵ Thus, there are material positive external benefits for the Government and the economy from life insurance being provided within superannuation.

Impact of regulation

One of the significant gaps in the assessment criteria is regulatory costs. Any assessment of competition or efficiency by the Commission should include the capital cost of effecting change to comply with new regulatory obligations, the levies paid to APRA (some of which is forwarded to ASIC, the ATO and Department of Human Services) and ongoing compliance with legislative obligations, including as the requirements change from time to time.

A recent example is the requirement from 1 July 2016 that superannuation funds can no longer self-insure. Instead they must obtain cover from a third-party life insurance company, or establish such an entity themselves. This has meant that funds that have been cost-effectively self-insuring, for many decades in some cases, have had to re-design their insurance offerings at additional cost.

The costs of regulation are discussed in more detail in the next section.

Objective of superannuation

ASFA considers that there should be a formalisation of an objective for superannuation and, while the objectives proposed by the Financial System Inquiry (FSI) are a sound starting point for an assessment of efficiency and competition, a more holistic objective needs to be developed. Superannuation ultimately is about delivering income which affords a comfortable standard of living in retirement.

In this context, we consider that the objective of the system should be:

“To provide an adequate income to ensure all Australians achieve a comfortable standard of living in retirement, supplementing or substituting the Age Pension.”

³ KPMG 2013, *Underinsurance: Death Protection Gap in Australia*.

⁴ Rice Warner 2015, *Under Insurance in Australia*.

⁵ Rice Warner 2014, *Insurance Administration Expenses*.

We consider that the proposed objectives identified by Commission are subsidiary objectives that relate to, and support, the primary objective of the system (when it is legislated).⁶ The industry (to the extent the outcome is within their control) and the Government should be measured on meeting both the primary and subsidiary objectives.

As noted in the Commission's Draft Report (in Figure 2 – The Commission's approach to assessment),⁷ the Commission's formulation of potential assessment criteria and indicators has been undertaken with reference to their proposed system level objectives. Therefore, to the extent these secondary objectives do not accurately reflect the purpose of the system, the criteria and indicators that follow will not adequately assess whether the overall objective of the system is being met.

With this in mind, we consider that the following enhancements can be made to the proposed secondary objectives in the Draft Report.

1. The superannuation system **optimises** net returns on contributions and balances over the long term.
2. The superannuation system meets member preferences and needs, in relation to information, products and risk management, over the member's lifetime.

ASFA considers that the first two objectives should be considered together. Superannuation is more than just maximising returns (hence the term 'optimises') and is about meeting the diverse needs of members as well (providing value and benefits to members). For example, although a fund can have high returns, the failure to provide advice services can affect members adversely, particularly their ability to make informed decisions about what to do with their superannuation as they age and approach retirement. 'Optimises' net returns also recognises that expected returns must be contextualised by the level of risk taken.

3. The superannuation system provides insurance that **delivers valuable protection to the community and** meets members' needs at **reasonable** cost.

ASFA believes that the existing definition proposed by the Commission does not reflect the broader policy role that insurance in superannuation now fulfils in the community. The provision of group insurance is a crucial part of the system supporting Australians who suffer a health-related misfortune, resulting in absence from the workforce, which affects their ability to contribute to superannuation. The superannuation system enables members to manage the financial risks associated with ill-health death during their working life whilst also supporting substantially improved retirement outcomes for claimants.

In terms of social and economic benefits, these arrangements alleviate systemic underinsurance and the potentially devastating economic implications for individuals and their families who face disability or premature death. Lack of, or insufficient, insurance cover also adds to the call on the public purse through increased social security benefits. It is crucial that the system provides the right level of cover at a reasonable cost.

⁶ The Government and FSI proposed objective is "To provide income in retirement to substitute or supplement the Age Pension".

⁷ Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, page 79.

4. The superannuation system complements a stable financial system and does not impede long term improvements in efficiency.

ASFA is supportive of this subsidiary objective. One factor which would contribute to this would be if the government and regulators were to endeavour to ensure that the regulatory framework and requirements were not changed as frequently as they have been in recent times.

5. Competition in the superannuation system that drives innovation and produces the **best outcomes and benefits for members.**

We believe that it is important to reflect a concept of the value received by members. Competition should drive innovation which produces the best outcomes and benefits for members. Efficiency is just one measure of member outcomes – but the most efficient outcome may not necessarily be the best outcome.

THE EFFECTS OF REGULATORY COSTS ON EFFICIENCY

KEY POINTS

- Compliance costs have increased 265 per cent⁸ since 2010 and these costs ultimately affect members through higher fees.
- The Productivity Commission should incorporate regulatory costs in their assessment of the efficiency of the system.
- Cost should include the capital cost of new regulation, levies paid to APRA and ASIC (and indirectly to the ATO and the Department of Human Services), and ongoing compliance with legislation.
- Regulatory barriers to exit can constrain competition (and efficiency) and the existing taxation impediments should be addressed through legislative change.
- Regulatory barriers to allowing greater consolidation of member accounts can be addressed through changes to the *Superannuation (Unclaimed Money and Lost Members) Act 1999*.

Compliance costs

Superannuation is compulsory and a key part of the financial system, therefore regulation is important. However, excessive regulation - and unduly frequent changes in the regulatory framework and requirements – adversely affects efficiency, productivity and innovation. In the case of superannuation, fund members ultimately face higher costs due to excessive regulation.

The pace and volume of regulatory change has been dramatic over the last seven years and shows no sign of slowing down. There have been 14 major reviews and inquiries into financial services since 2009. Independent research by Tria Partners, commissioned by the Financial Services Council, indicates that the past five years of reform have cost \$2.75 billion in total across the industry or \$105 per superannuation account.⁹ There were eleven measures alone in this year's Federal Budget that affect superannuation. Since 2010 overall annual compliance costs have increased by 265 per cent (per member basis).¹⁰

It is essential that the Commission quantify and assesses these regulatory costs in any analysis of efficiency. Assessment of efficiency should include analysis of the cost of regulation by looking at the scope and cost of recent reforms, the costs of compliance with prudential and consumer protection regulatory requirements and the effect of levies (such as the APRA levy – including the substantial SuperStream component - and the proposed ASIC levy).

To the extent that the Commission uses a survey as a tool to assess costs, questions should focus on the cost to the superannuation industry of the regulatory reforms (both incurred and budgeted/expected costs) in Table 2 (note that this list is not exhaustive).

⁸ On an annual per member basis (Rice Warner data).

⁹ Sally Loane 2016, 'Achieving the most for financial services and consumers within 100 days of Government', speech to the FSC Leaders Summit, 20 July.

¹⁰ On an annual per member basis (Rice Warner data).

Table 2: List of regulatory reforms

Future of Financial Advice
MySuper
APRA reporting and its continuing refinements
SuperStream
Single Touch Payroll 2017
Other Stronger Super changes (such as product dashboards and portfolio holdings)
Disclosure requirements, for example ASIC Regulatory Guide RG97
Life Insurance Framework
Adviser standards
AML/CTF reporting
Compliance with APRA prudential standards
Tax changes 2016-17

Regulatory barriers to exit (funds)

Regulation also affects the ability of the superannuation market to operate efficiently and effectively. As identified in our submission to the Commission's Issues Paper, barriers to exit are a constraint on competition and efficiency and ASFA considers that further action is needed to identify and remove barriers to exit (some examples are included).

Consolidation activity has slowed in recent years. Reasons for the drop-off in consolidation activity include:

- increasing difficulty in meeting the regulatory requirement to ensure that members receive 'equivalent rights' (on a 'bundled' basis) in their new fund as they did in their old fund
- the absence of enduring Capital Gains Tax (CGT) relief, as well as other tax issues
- the risk of inheriting liabilities from the 'transferring-out' fund
- in certain circumstances consolidations may trigger the re-pricing of group risk policies, which could substantially affect members.

The last two largely are business risks and ultimately matters for trustees to identify and manage. However, concerns remain over the lack of clarity on equivalent rights and the CGT and other tax implications of mergers. In relation to equivalent rights, ASFA is pleased to hear that APRA will be providing further guidance clarifying equivalent rights in successor fund transfers. Equivalent rights should not mean that a product or offering does not change; it means that the effect on the membership of a fund or product as a whole is positive (that is, there is no overall disadvantage). With respect to the tax issues, ongoing CGT relief for funds in a merger is essential as the resulting tax liability provides an unnecessary cost and barrier to exit.

Regulatory barriers to efficiency (individuals)

While there are valid reasons for some members to hold more than one superannuation account (for example insurance), and there has been a significant reduction in the number of accounts over the last decade (from 2.5 to 1.9 accounts per person), there is still scope for further efficiencies in the reduction of accounts.

While the ATO is active in identifying and contacting account owners and encouraging them to consolidate these lost accounts with their other superannuation accounts, it would appear from discussions with the ATO that only a small percentage of these account holders follow through with the necessary action to enable the ATO Commissioner to consolidate these amounts.

Given changes to superannuation reporting requirements, that enhanced the Commissioner's information about superannuation accounts, ASFA considers that section 24G of the *Superannuation (Unclaimed Money and Lost Members) Act 1999* should be amended to empower the Commissioner to pay unclaimed money to a complying superannuation plan where the Commissioner is satisfied as to the identity of the lost member account owner and that the person holds an account in the proposed destination fund. This would improve efficiency in the superannuation system and members' retirement balances.

CRITERIA - COMPETITION

C1. Is there sufficient member engagement to exert competitive pressure?

KEY POINTS

- Greater member engagement is desirable, but competitive pressures can be driven by other factors.
- MySuper was created on the basis that there always would be a level of member dis-engagement in a major segment of the superannuation market.
- A number of the proposed indicators will not accurately measure competitive pressure.

General comments

ASFA supports analysing the characteristics of a competitive market, however ASFA has concerns about the emphasis on strong member engagement as a driver of competition in the system. There are a number of factors outside the control of the system that impact on levels of engagement such as age, financial literacy and general interest in personal finances. Further, member engagement should not be looked at in isolation, as there are other factors which contribute to competition, including the role of employers, member associations and advisers in the selection process for products and funds. Indeed, it can be argued that strong member engagement is not essential for competition.

The Draft Report seems to adopt a perfect competition model, assuming all firms sell a similar product, firms are price takers, have small market share, buyers have complete information and the industry is characterised by freedom of entry and exit. While the superannuation system has a number of these elements, financial products are complex and consumers are not always well informed, highly engaged or make decisions in their own interest.¹¹ However, strong competition can still occur if there is a range of active suppliers of products, and clear and comparable information is available.

Acknowledging the challenges of member disengagement: MySuper

Member disengagement remains an ongoing challenge for superannuation. However, the superannuation system is not unique in facing this challenge – disengagement occurs in other markets such as energy and telecommunications as well. While there has been considerable progress in terms of addressing member engagement over recent years, ASFA considers that there is still more work to be done.

There have been a number of initiatives over recent years to address concerns around engagement – including MySuper. This is about providing a safety net product for disengaged members; requiring trustees to proactively operate in members' best interests in this regard and having APRA ensure each product meets requirements. MySuper was created on the basis that it was unrealistic to expect that all superannuation fund members will be highly engaged with their superannuation. Even engaged members may not have the skills to be able to make decisions about their superannuation and may not be able to afford advice. Providing employees with good default arrangements is a strength of the system not a weakness.

¹¹ This submission also outlines examples of regulatory barriers to perfect competition and what can be done to address these.

Stronger Super: The need to evaluate its success

In addition, Stronger Super policy initiatives such as the requirement for funds to fully disclose fees and costs, portfolio holdings disclosure, systemic transparency disclosure and product dashboard (which provides information on performance) are designed to aid demand-side competition. Information that is available for consumers that is simple, easy to understand and transparent can aid interest in superannuation and ultimately member engagement. Day-to-day consumers are facing information overload as they operate in an increasingly complex world, with ever-changing regulation, and it is crucial that the system provides information that encourages the best possible decisions to be made (rather than the perfect decision). ASFA considers that the Stronger Super changes should be reviewed in terms of their effectiveness once fully implemented (and if needed, revised).

Measurement of action

ASFA considers that there should be only one assessment criterion that looks at member behaviour and that it should focus on when members have taken action in regard to an option that is available to them. ASFA considers that members who make additional contributions, whether salary sacrifice (concessional) or after-tax (non-concessional) - either regularly or one-off, are demonstrating significant financial engagement. Of course, where members are paying off HECS/HELP debts, saving for a deposit, financing a mortgage and/or bringing up children, making additional contributions to superannuation generally is not a financial priority. Other measures of activity include whether members change their insurance, update their contact details, nominate a beneficiary or switch investment options. It is important to note that inactivity, in and of itself, does not necessarily connote disengagement - it may mean that the member is happy with their current circumstances.

ASFA does not consider the significant focus on member engagement in the Draft Report will assist the assessment of the competitiveness of the system. In addition, ASFA considers that reliance on the proposed indicators is likely to lead to misleading conclusions about the nature and extent of member engagement and its role and effect on competition.

In summary, ASFA does acknowledge the disengaged nature of many Australian superannuants. However, recent initiatives such as MySuper, enhanced obligations placed on trustees to act proactively in member's best interests and greater transparency of fees and returns should assist competition and efficiency.

Concerns about indicators

Indicator 1 - Member account monitoring activity

ASFA considers that any conclusions using member account monitoring as an indicator of member engagement can be misleading. Member activity is driven by a range of factors and member activity, in and of itself, is not necessarily a good thing if it is motivated by some detrimental development. For instance, generally there is an increase in fund member call centre inquiries when detrimental changes are made to the taxation of superannuation or when investment markets drop.

Indicator 2 - Member awareness of key features of their superannuation, and

Indicator 7 - Information collection by funds on key member characteristics

ASFA considers that information collection by funds on key member characteristics is a crucial part of ensuring trustees operate in members' best interests and there is merit in understanding member awareness of key features of their superannuation, including insurance. ASFA is interested in working with the Commission on these indicators to ensure there is not undue burden on funds and the information received is meaningful.

Indicator 3 - Active member ratio

It is unclear what the 'active member ratio' is and what it might show. ASFA welcomes further guidance from the Commission.

Indicator 4 - Switching rate between and within default and choice funds and between institutional funds and SMSFs, and

Indicator 5 - Default rates for funds, investment and retirement income products, and insurance

Switching rates can indicate a competitive market, but need to be treated with caution if used to conclude whether a member is engaged. Advisers and promoters can play very important roles. With regard to indicator 5, such financial products might be purchased by an engaged fund member, but equally they can be sold to someone who is not very engaged with their superannuation and may have varying degrees of financial literacy.

In this context, and again as the Draft Report notes, any measures of engagement should also recognise the potential ambiguity in interpreting the passive behaviour of members. High levels of default and low levels of switching could be an indicator of disengagement or, alternatively, of making an active choice to adopt, and being satisfied with, the default.

Indicator 6 - Duplicate accumulation accounts and insurance policies

There are valid reasons for members to hold more than one superannuation account (for example insurance) and there has been a significant reduction in the number of accounts over the last decade (from around 2.5 to 1.9 accounts per person). The majority of people now have only one account. However there is still scope for further efficiencies in the reduction of accounts and ASFA considers policy change is required in this regard (see earlier discussion in the section on *the effects of regulatory costs on efficiency*). This is needed before any conclusions can be drawn on duplicate accumulation accounts.

C2. Are members and member intermediaries able to make informed decisions?

KEY POINTS

- This section of the Draft Report does not take into account the role of MySuper design, the authorisation of MySuper products and the roles of financial advisers and ratings agencies in making informed decisions.
- Most of the indicators proposed do not relate to the decisions being made by members and member intermediaries.

General comments

The Draft Report notes, but does not act upon, the argument that members should be divided into three segments — passive members, active members relying on advice, and informed and independent members — and that the issues and policy solutions may differ across the segments. Instead the thrust of the analysis in the Draft Report seems to be that a core group of individual members of funds need to be engaged in order to drive competitive behaviours and overall outcomes. The only method canvassed in the Draft Report for group or third-party involvement in competitive processes is employers negotiating corporate fee discounts.

Such an approach to conceptualising competition in the superannuation system fails to capture the way effective competition actually works within the system (in particular, it ignores the role of MySuper design, the authorisation of MySuper products and the roles of financial advisers and ratings agencies).

Concerns about indicators

Given the above concerns, most of the indicators proposed are not related to the decisions being made by members and member intermediaries.

Indicator 1 - Availability, cost and quality of information on fees and investment risks at product level

ASFA is supportive of indicator 1. That members and intermediaries require readily available, low cost and quality information is recognised by the extensive regulatory requirements on funds to disclose information on fees, returns and investment risks at the product level on a standardised basis.

Indicator 2 - Financial literacy and numeracy compared to an 'adequate' standard

There are benefits for the community achieving a higher level of financial literacy and numeracy – it can provide benefits in terms of competition and outcomes across a range of financial products, not just superannuation, and most particularly to people's financial decision-making. However, most fund members reaching a designated level of financial literacy is not necessary to make quality decisions regarding choice of fund.

Some members may be in a position to make an informed choice but many members, including even some of those who may be in a position to make a choice, might wish to delegate the selection of their fund/product to another informed party. Further, the same individual during a lifetime can exhibit disengagement, limited interest, casual monitoring of their account, through to full engagement and decision making (which can result in decisions to remain in the one fund, to move to one or more other funds – or consolidate to one fund, or to set up an SMSF). Financial literacy and engagement for the majority of people is a function of career progression, age and financial balance, leading to financial competence.

Indicator 3 - Use of advisers by members and/or member intermediaries, and

Indicator 4 - Capacity and willingness of employers to select a default fund

For indicators 3 and 4, the concept of member intermediaries extends beyond personal agents and advisers, such as financial planners and employers negotiating group arrangements. For many individuals the use of an adviser is appropriate, but for some individuals making use of a paid adviser is not necessarily a better outcome. The monetary and other costs and benefits from the provision of individual financial advice need to be taken into account. We note that a number of members are taking advantage of low cost intra-fund advice, or taking advantage of fund-provided information and calculators may be complementary measures of assistance provided to members.

It may be difficult to determine adequately the capacity and willingness of employers to select a default fund. The Commission proposes to use information from ‘reviews by others’. Presumably this would be a survey-based review, given the large number of employers in the Australian economy. It may be difficult to translate findings on employer attitudes and literacy into an assessment of the consequences for default fund selection.

C3. Is there low market segmentation along member engagement lines?

KEY POINTS

- Segmentation along member engagement lines in superannuation enhances, rather than detracts, from competition and contributes to the achievement of better outcomes in the provision of superannuation.
- MySuper is an example of member segmentation, and MySuper products receive some of the highest net returns (on average).
- It would be more meaningful to examine the dispersion of fees and returns within specific categories or superannuation products rather than between default and choice products.

General comments

The Draft Report appears to assume that low market segmentation along member engagement lines is a good thing in terms of driving competition. The report argues that where segmentation is not possible and the engaged group is sufficiently large, the passive members may be able to free ride on the actions, and the implicit threat of switching, from active members.¹²

An alternative, and more viable, approach is to put in place arrangements which intentionally segment members who are not actively engaged. This is the basic rationale of MySuper. Members who are in MySuper products benefit directly from being in relatively simple and low cost products where they do not have to pay for features they do not need or want.

It is important that there is effective competition in regard to each market segment and that appropriate regulatory and design arrangements are in place for both MySuper and other superannuation products. Competition does not necessarily rely on actions by engaged and active members, though ASFA agrees that actions by such members can play a role in competitive pressures. The Rainmaker Superannuation Fee Review indicates that, across all segments, the Total Expense Ratio (TER) has been trending down since 2007. Workplace superannuation, and MySuper accounts more specifically, have enjoyed the largest reduction in the TER and have by far the lowest fees of APRA-regulated funds. Over a two-year period after it became mandatory for 'default' contributions to be made to a MySuper product (1 January 2014), the 'MySuper effect' has seen a 30 basis point reduction in the TER.¹³

¹² Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, page 79.

¹³ Rainmaker 2015, *Superannuation Industry Revenue Report 2015*.

Concerns about indicators

Indicator 1 - Fund expenditure on member retention relative to overall marketing expenditure

This indicator presumably is intended to be a proxy for the extent to which a fund segments its members and focuses on member retention, rather than competing at the margin for new members. However, the indicator suggested is a very indirect measure of market segmentation and, accordingly, it will be difficult to interpret. It also is very difficult to distinguish activity which leads to member retention from activity aimed at attracting new members. Much, if not most, marketing activity is aimed at both. There also may be difficulties in obtaining such data at a detailed level as it is likely to be regarded as commercial in confidence.

Indicator 2 - Fee dispersion (between default and choice products, comparable products within a fund, and within products)

The more important issue is the extent of fee dispersion within specific categories of superannuation products rather than between default and choice products. It also would be important when evaluating fee dispersion within products to make allowance for differences in the level of services that might be provided to different fund members. It does not indicate a lack of competitive pressure, rather it is evidence of competition at work.

C4. Do active members and member intermediaries have sufficient countervailing power?

KEY POINTS

- There is considerable overlap between this criterion and the first three competition criteria.
- While the ability of individuals to set up an SMSF contributes to competitive pressures, the proposed indicators place too much emphasis on the share of, and changes in, members and assets in SMSFs.

General comments

This criterion should be combined with *Competition Criterion 1* for a broader view of engagement that covers the range of entities in the system.

There is considerable overlap between this criterion and the first three criteria proposed in the Draft Report. The comments made by ASFA in regard to those criteria also apply to this criterion. Both active members and member intermediaries have important and effective roles in exerting competitive pressures.

Concerns about indicators

It is not clear to ASFA how the proposed indicators would enable conclusions to be drawn about competitive forces in superannuation.

Indicator 1 - Fund and product switching costs (administrative, search and learning costs)

Switching costs are generally very low or zero and are linked to brokerage costs for buying or selling underlying assets and a small administration fee for effecting the switch. There are some legacy products with high exit fees, but these particular products generally are no longer offered to new members and form a small and declining proportion of superannuation assets.

Indicator 2 - Size of the SMSF sector (funds and members) relative to institutional sector, and

Indicator 3 - Switching rate from institutional funds to SMSFs

ASFA questions the emphasis on the size of the SMSF sector, and switching rates to and from APRA-regulated funds (indicators 2 and 3). While the presence of SMSFs helps to demonstrate that the superannuation system is competitive, looking at SMSFs and switching in isolation does not provide a comprehensive picture of competition.

SMSFs cater to only a relatively small proportion of overall fund members, especially given that their substantial fixed operating costs, and the legal and operational obligations imposed on SMSF trustees, mean that they are really only viable with respect to relatively large account balances where the members are prepared to assume responsibility for operating the SMSF.

Surveys consistently have shown that a key reason for establishing an SMSF relates to having greater control over investment decisions, including the timing of acquisitions and disposals. Tax and estate planning also can be important reasons for establishing an SMSF, as can be a desire to place a property or building, used in business activities by one or more fund members, within superannuation. For the great bulk of fund members these factors are not significant issues.

The size of the SMSF sector is also influenced by factors not related to competition, such as the size of concessional and non-concessional contribution caps. Lower caps tend to impact more on SMSF members given that SMSF members tend to be wealthier on average. Tighter regulatory settings and associated enforcement regarding the provision of advice by accountants and other promoters in regard to the establishment of SMSFs also may have constrained the marketing of SMSFs in recent years. It is also worth acknowledging that the SMSF sector's share of system assets and members has declined slightly over the last few years.

Indicator 4 - Changes in market shares of funds

Changes in the market shares of APRA-regulated funds are also influenced by a broad range of factors, such as the demography of the members of each fund, the effect of fund mergers and employers' decisions with respect to corporate funds and sub-plans.

Indicator 5 - Corporate fee discounts

This indicator could be useful, assuming that the Commission is referring to the outcome of tender processes and the occurrence and quantum of discounts. However, meaningful data may be difficult to obtain given that it could be regarded as commercial in confidence by the parties to such arrangements.

C5. Are principal-agent problems being minimised?

KEY POINTS

- Superannuation providers, as trustees, are under a fiduciary duty to act in the best interests of members, which has been codified in legislation and prudential standards.
- Fund governance, including the capability/capacity of trustees and their management of conflicts of interest and duty, is regulated, monitored and enforced by APRA, as the prudential regulator.

General comments

Principal-agent relationships are a key part of the superannuation system ranging from the trustee/member, trustee/investment manager, adviser/member through to the employer/member. It is crucial that the regulatory framework considers, monitors and manages these relationships. Any assessment of principal-agent relationships needs to be considered in the context of this existing regulatory framework.

Best interests of members

One of the fundamental principal-agent relationships is the relationship between the trustee and the member. Trustees have an over-arching obligation to act in the best interests of all members, to treat all members of the same class equally and for the treatment of members of different classes to be fair. While there can be conflicts between differing member interests these generally are managed well. As noted in the Draft Report, for-profit superannuation funds are required to act in the best interests of members, even when doing so may conflict with shareholder interests – an appropriate outcome in a trust environment. It is important to note that – in contrast to what is stated in the Draft Report – while trustees outsource many of their functions to service providers, they cannot outsource their responsibility for the performance of these functions. This is a fundamental tenet of trust law.

Regulating governance

Trustees, and to some extent service providers, are regulated to promote adequate governance arrangements. The two core principles to good governance are:

- effective management of conflicts of interest between parties
- capacity/capability of trustees (in terms of skills, capabilities and expertise) to act in the best interests of members.

Both these principles are legislated, primarily through the APRA Superannuation Prudential Standards, with monitoring and enforcement undertaken by APRA.

Concerns about indicators

It is appropriate that any evidence that trustees are not operating in members' best interests be identified. However it is not clear that any of the proposed indicators, apart from contraventions of regulator governance standards by trustees, employers, service providers and financial providers, would support this assessment.

Indicator 1 - Existing ratings of system-wide quality of governance

Indicator 2 - Accurate disclosure of trustee directors' and investment committee members' qualifications and relevant skills/experience, remuneration structures, and potential conflicts of interest due to related-party dealings and competing duties

Indicator 4 - Level of skills and standard of performance for trustee boards and investment committees, including review processes

ASFA considers that 'good' governance (through conflicts management and ensuring trustees have the right skills and experience) is an important component of minimising principal-agent issues and would support an indicator that identifies, in an aggregate sense, any action taken by APRA for poor governance. With respect to indicator 4, APRA, as a prudential supervisor, generally employs a relatively discrete, behind the scenes, approach to much of its prudential monitoring and supervision, working directly with the trustee. Accordingly, there may be little publically available data.

Indicators 1, 2 and 4 (while valid measures of governance in themselves) would not support the proposed criteria or overall analysis of competition and efficiency.

Indicator 3 - Contraventions of regulator governance standards by trustees, employers, service providers and financial advisers, and

Indicator 5 - Member satisfaction and trust

Indicators 3 (if based on APRA data on contraventions) and 5 may have a role in assisting an examination of principal-agent issues.

C6. Is there rivalry among incumbent providers?

KEY POINTS

- Rivalry is a relevant criterion against which to assess competition in the system, but the Commission's perspective on rivalry should be broader.
- Innovation can be a consequence of rivalry. For funds, this entails producing products, services and modes of delivering those products and services that best meet members' preferences.
- Quantitative measures of market concentration should be accompanied by qualitative assessment of innovation in the system.

General comments

ASFA agrees with the Commission that rivalry among incumbent providers in a market is a crucial aspect of competition. However, ASFA considers that the Commission's perspective on rivalry should be broadened to consider the competitive dynamics associated with innovation.

Rivalry incentivises providers (in all stages of the superannuation supply chain) to innovate, to improve the quality of their products and services, to tailor their products and services so they better meet customers' preferences, and to provide value to customers.

For the superannuation system, rivalry among incumbents is evident in all stages of the supply chain. This includes at the wholesale level, where service providers compete to supply their services to superannuation funds, and at the retail level (that is, at the fund-member and fund-employer interfaces).

For wholesale services that can be insourced,¹⁴ rivalry encompasses providers operating in the outsourced market and in-house provision of the service (insourcing is addressed in greater detail in *Competition Criterion 7*). Funds' decisions on insourcing and outsourcing are a source of flux in the structure of the broader superannuation system – with respect to the composition of the different stages of the supply chain and the degree of horizontal integration, and the degree of vertical integration in organisations that span stages of the supply chain. Vertical integration is addressed in greater detail in *Competition Criterion 8*.

In its Draft Report the Commission concentrates on the degree to which individual providers have influence over a market – or the degree of market concentration.¹⁵ ASFA agrees with the Commission's approach to assess concentration in all stages of the supply chain and to incorporate insourcing and outsourcing. That said, for wholesale services, the Commission concentrates on full-service providers and does not recognise adequately the competitive impact of niche players in the wholesale markets.

¹⁴ Not all wholesale-level services can be insourced – most notably custodial services.

¹⁵ There are two elements of market concentration – the number of providers and the degree to which individual providers are of equal size.

The Commission notes that, when looking at concentration with respect to each wholesale service, market shares would need to be assigned to both specialist providers in the outsourced market and in-house providers.¹⁶ With respect to providers in outsourced markets, the Commission should look beyond the full-service providers of particular services, and include entities that provide niche services. The Commission also should look beyond the typical upstream service provider markets, and look at such markets as IT platform provision.

Given that this approach focusses on outcomes, context would be required to interpret the indicators. As the Commission rightly notes, market concentration outcomes can be the result of competition. For example, for large and mid-sized superannuation funds insourcing investment management (and thus vertical integration) is becoming a significant strategic issue. As such, the Commission should contextualise its quantitative measures of rivalry (as per the Commission's proposed indicators) with a discussion of how the measures should be interpreted.

A broader perspective on rivalry could incorporate innovation. Innovation is central to the competitive dynamic in the superannuation system, as it is in many industries, where funds and service providers innovate as a means to distinguish themselves in their market. Funds and service providers are constantly innovating to produce better products, better services and better modes of delivering those products and services to customers. For funds in particular, this entails producing products and services that better meet members' preferences, and developing means of delivering products and services that best suit particular members (which, in the process, improves member engagement).

Examples of recent innovations by funds include:

- Superannuation fund 'applications' – these provide a 'one-stop shop' for superannuation products and services that particularly appeal to younger members. Applications can incorporate electronic retirement calculators and tools, and functions that allow electronic fund contributions and show insurance details.
- Robo-advice – whereby fund members are able to access digital advice through fund websites.

It is doubtful that a specific indicator could capture adequately the relationship between rivalry and innovation. Instead, the Commission should contextualise its quantitative measures of rivalry with a discussion of innovation within the superannuation system.

Concerns about indicators

Indicator 1 - Market concentration

In its Draft Report, the Commission has proposed that its main indicator of rivalry would be the Herfindahl Hirschman Index (HHI). ASFA notes that derived figures require careful interpretation.

The Commission rightly notes that the degree of market concentration does not, on its own, provide an adequate indication of rivalry in a market. Indeed, the Commission notes that market concentration can be an ambiguous indicator of the degree of rivalry.

¹⁶ Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, page 85.

For example, with respect to administrative services, consolidation in the outsourced market over recent years (and funds' outsourcing of administrative functions) is a consequence of significant economies of scale that make it efficient to have a small number of large service providers (note that the providers of wholesale administrative services are broader than just the full-service providers and include providers of niche administrative services).¹⁷ Nevertheless, some funds have the ability to insource administrative functions if it is cost effective to do so.¹⁸

Indicator 2 - Number of institutional funds

ASFA considers that this indicator would not add value to the Commission's framework. A market concentration measure for institutional funds (using the HHI) would incorporate the information contained in this indicator.

¹⁷ Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, page 83.

¹⁸ Examples are on page 28.

C7. Is the market contestable?

KEY POINTS

- Contestability is a relevant criterion against which to assess competition in the system, but some of the proposed indicators should be broadened to better assess contestability.
- The proposed set of indicators does not capture explicitly the effects on contestability in wholesale services markets of insourcing and outsourcing.
- There are a number of barriers to exit for funds from legislative and tax settings that are not incorporated in the indicators. Reducing these barriers would materially improve contestability and competition.

General comments

ASFA agrees that market contestability is an important driver of competition in the superannuation system and is a relevant criterion against which to assess competition in the system. However, ASFA considers that some of the Commission's proposed indicators should be broadened to better assess contestability.

In general, for a particular market, contestability refers to the threat to incumbent providers from potential new providers entering the market. Market contestability can be affected by barriers to market entry, barriers to exit and the advantages of incumbency – for example from economies of scale that benefit very large providers.

As with market rivalry (*Competition Criterion 6*), contestability incentivises providers to (among other things) better meet customers' preferences and provide value to customers.

The Commission's perspective on contestability is reflected in its indicators. Overall, the proposed set of indicators would not provide an adequate assessment of the nature and extent of contestability in the various provider markets. In particular, the indicators (in their current form) would not be able to assess the effects on contestability in wholesale services of insourcing and outsourcing. Further, the proposed indicators would not provide an adequate assessment of the barriers to entry and exit caused by legislative and tax settings.

Contestability throughout the supply chain

Within the superannuation system, there is a (wholesale level) supply chain that comprises different types of products and services that are sourced by fund trustees. These products and services include those that funds require in order to operate (such as administration, custodial, investment management and asset consulting services), and products and services that funds provide to members (such as insurance and advice). The retail level refers to the markets where funds, and other service providers, interact directly with members and employers or their agents.

Contestability within each of these provider markets arises from the threat of new providers entering the market, and at the wholesale level from the threat of funds insourcing particular functions. Funds insource functions for various reasons – to generate quality improvements, cost efficiencies and better outcomes for members.

There have been numerous examples of insourcing over recent years:

- Administration: examples include TasPlan/RBF and the ‘unbundling’ of administration services and the insourcing of parts of them – for example, Club Plus, Hostplus, First State Super and LGS Super. Indeed, eight of the ten largest superannuation funds insource some aspect of their administration services, such as call centres or the handling/monitoring of insurance claims
- Investment management: funds that now have or are developing their own investment teams include AustralianSuper, Equipsuper, First State Super, MTAA Super, QSuper, REST, Telstra Super and UniSuper
- Call Centres: First State Super and Hostplus have insourced their call centres to improve quality and focus on members’ needs
- Insurance: this year QSuper established a wholly-owned registered life company (QInsure), which provides life insurance to QSuper members.

The Commission’s indicators do not explicitly incorporate decisions made by funds around insourcing and outsourcing. For example, the Commission proposes to measure the number of market entries and exits, but this measure does not account for trends in outsourcing and insourcing with respect to each of the provider markets.

Concerns about indicators

Indicator 2 - Market impediments to funds accessing distribution channels

The Commission suggests that a potential indicator of barriers to entry is impediments to funds accessing distribution channels that are used by other funds. ASFA considers that the current situation is not necessarily inefficient, and thus not a concern with respect to competition.

The development of distribution channels is, in part, a function of competition in the broader financial services industry, where players seek to realise economies of scale and scope.

A broader point relates to the potential disruptive effects of new technologies. Current modes of product and service distribution are increasingly likely to be challenged by innovations in distribution, some of which are not yet apparent. For example, in the insurance industry, online aggregators (that allow customers to compare prices and purchase products) are disrupting the traditional channels for distributing insurance products and services. Disruptive innovations to distribution channels would be expected to make the market more contestable.

Indicator 3 - Mergers prevented by bulk transfer rules

As ASFA stated earlier in this submission and in our submission to the Commission’s Issues Paper, there are a number of regulatory barriers to exit with respect to superannuation funds. In its Draft Report the Commission acknowledged one of these – the potential constraints on mergers imposed by the bulk transfer rules. Other regulatory barriers are discussed below (ASFA addressed all of these in its submission to the Issues Paper).

Bulk transfer rules

Constraints on mergers imposed by the bulk transfer rules essentially relate to the difficulties that funds face in meeting the regulatory requirement to ensure that members receive 'equivalent rights' (on a 'bundled' basis) in the new fund to those they received in their old fund.

The Commission's proposed indicator is mergers that have been prevented by the bulk transfer rules. However, the Commission acknowledges that it would be difficult to assess whether the bulk transfer rules have prevented consolidations that otherwise would have occurred.

ASFA agrees with the Commission's observation, so considers that the Commission should attempt to assess the effect of bulk transfer rules from a qualitative perspective.

Fund level – absence of on-going CGT relief

The absence of on-going CGT rollover relief creates a significant barrier to fund mergers.

The triggering of CGT events on merger, such as the realisation of otherwise unrealised gains, and the inability to carry forward losses, can prevent a trustee from entering into a successor fund transfer arrangement.

In determining whether to merge with another fund, a trustee of a superannuation fund is under a trust law and fiduciary duty to act in the best interests of the members of the fund. As such, the threshold decision as to whether or not to merge is made taking into consideration the various benefits and costs to members of the potential merger – such as CGT.

Depending on the volatility of the market, after a downturn, a fund can carry deferred tax assets of an amount equivalent to 1.5 per cent or more of member account balances, the benefit of which would be lost if a merger were to go ahead without CGT relief. For a member with an average account balance (approximately \$70,000), this could represent a reduction in the value of their superannuation account of over \$1,000.

In such circumstances, the absence of CGT rollover relief may cause the costs to members, through the extinguishment of deferred tax assets, to outweigh the benefits of any proposed merger.

Fund level – other tax issues

There is a similar issue with respect to the loss of imputation credits, due to the deemed disposal of assets, and the potential reduction in the 'tax-free component' of some member accounts. These can act as barriers to a superannuation fund merger being agreed.

Further examination of the loss transfer rules may be warranted, especially the look through aspects, as there can be many losses captured in Pooled Superannuation Trusts held by superannuation funds. If there is a holding in an underlying fund that has deferred tax liabilities, there should be an ability to take that up a proportionate amount into the superannuation fund and transfer it across to the successor fund.

Product level – legacy products

Notwithstanding the benefits of product innovation, various legal and regulatory barriers have often seen products forced to continue where it would be more efficient to rationalise them. For an individual fund, the existence of legacy products can be a barrier to a potential merger.

Frequently these products are closed to new members (legacy products), when new products are launched for new members.

In some cases – a lifetime pension product by way of example – an inability to commute (under the regulatory provisions), combined with reversionary provisions, may see providers compelled to support such products for decades, even if they are not commercially viable.

Some legacy products also have early termination fees for members attached to them, reflecting the fact that in such products advice and other costs are recovered from the member's account over a period of time. The existence of such legacy fees may act as a disincentive for members to exit affected products.

Indicator 4 - New entries into and exits from the market

As noted in the general comments section addressing the criterion, the current number of market entries and exits does not provide an accurate indicator of contestability. If this indicator is to be used, it should be broadened to incorporate insourcing and outsourcing in the range of wholesale service markets.

Indicator 5 - Capacity and willingness of employers to select a default fund

This is addressed in our response to *Competition Criterion 2*.

Indicator 6 - Prosecutions of fund trustees for contraventions of SIS Act on inducements

We are comfortable with this indicator.

C8. Are there material anticompetitive effects of vertical and horizontal integration?

KEY POINTS

- Vertical and horizontal integration provide economies of scale and scope which can reduce costs for consumers where conflicts are managed in well-regulated markets.
- The existing regulation should be examined to evaluate whether it is ensuring these benefits are captured without conflicts.

General comments

In its broadest sense, vertical integration refers to entities that operate in multiple parts of the financial services value chain or production path. Horizontal integration is where entities increase production in the same part of the supply chain.

Vertical Integration

In terms of vertical integration, ASFA considers that ‘one size does not fit all’ when it comes to an appropriate business structure. ASFA would be concerned if there was unreasonable inflexibility or restrictions imposed on business models without careful consideration.

Changes in business models are often driven by competitive forces. A recent example is the significant change occurring in investment management services. As outlined previously, insourcing is becoming a significant strategic issue for large and mid-sized superannuation funds as funds under management grow. More funds are bringing services in-house, which increases vertical integration, but can have a positive impact on efficiency and competition. For example, Cbus is increasing its insourced investment management, expanding its investment team from 34 to 59 people with the aim of capturing the benefits of scale for members.

In looking at vertical integration, it is important that the regulatory settings are focused on ensuring trustees act in the best interests of members when providing superannuation products. A key initiative to ensure trustees are operating in the best interests of members is a comprehensive conflicts regime. Where conflicts are properly managed, integration can provide efficiency and cost benefits of economies of scale and scope, whilst minimising the effect of conflicts.

Conflicts of interest within superannuation funds are heavily regulated by APRA. In 2013, APRA introduced new standards in the superannuation industry, including Prudential Standard *SPS 521 Conflicts of Interest* (SPS 521), which took effect on 1 July 2013.

The regulatory regime to manage conflicts of interest in the system is largely working. The prudential regulator APRA is driving funds to appropriately address any competitive issues related to horizontal and vertical integration. This ongoing regulatory review process will continue.

Horizontal integration

As outlined in our submission to the Commission's Issues Paper, the Australian superannuation system has a large number of players and the market does not have the market concentration issues that are present in other domestic industries, such as petrol and supermarkets. In many ways, the superannuation industry has dual regulators (the ACCC and APRA) when it comes to competition matters.

Consolidation or horizontal integration can have a positive impact on efficiency and allow funds (and providers in wholesale service markets) to achieve scale.¹⁹

The future success of the system will see efficiencies being achieved by funds directly through scale (but not at the expense of competition) and through funds using outsourced providers (who may have scale themselves).

Concerns about indicators

While ASFA notes how the Commission proposes to assess the impact of vertical and horizontal integration, we consider that, rather than use the proposed indicators, the Commission instead should look at the operation of the existing regulatory framework in areas such as conflicts management and regulatory barriers to exit such as tax and equivalent rights.

¹⁹ Scale can also be achieved through the use of outsourced providers such as investment and administrative services.

C9. Do funds compete on costs?

KEY POINTS

- Benefit/value to members (primarily gross returns less costs) are more important than the level of costs in isolation.
- Costs depend on the breadth and complexity of the service offering, which differs markedly between the main pooled sectors (MySuper and Choice) and within those sectors.
- Margins are a better indicator of competition than costs/fees alone, and there has been a general decline in margins over time.

General comments

Any assessment of efficiency and competition should look at cost but not in isolation, superannuation is a long-term product that is about providing a benefit/value to members. Therefore we consider that this assessment criteria needs to be considered and combined with *Competition Criterion 11*, which refers to competition on relevant non-price dimensions.

ASFA considers that it is more important to focus on the concept of ‘value’ (benefit for cost) and the value proposition, including the net benefit provided to members, as opposed to focussing purely on cost – particularly with respect to the range of options and investment styles available in the choice environment. This also applies to wholesale service providers.

It is appropriate for funds to compete in terms of their capacity to deliver value for members rather than providing superannuation at the lowest possible cost. Across the system, cost does not necessarily, and generally does not, correlate with the highest net benefit. Some funds are high cost options which engaged members are able to choose to invest in if, for example, this reflects their investment preference. Members may, for example, consciously choose to invest differently inside superannuation than they do outside superannuation.

Beyond costs and net investment returns, funds compete on the basis of the quality and variety of ancillary benefits and services, such as insurance cover, access to financial planning and information, transactional capability and the reporting provided to members.

As we outlined in our submission to Commission’s Issues Paper, the key indicator as to whether funds compete on costs and non-price dimensions is the net benefit to members. In this context, the prime outcome which superannuation providers need to deliver is net investment returns (after all investment and administration fees, operational costs, indirect costs and taxes – see discussion on *Efficiency Criterion 1*).

Any assessment of fees and costs also should recognise the role of trustee governance and decision making in determining the level of fees. The fiduciary duties in place mean there is already a heavy burden on trustees to ensure that the level of fees is determined in accordance with the relevant regulations.

Concerns about indicators

ASFA has concerns with the indicators and data proposed to measure competition among funds on the basis of costs.

There are also significant issues with the required data. In particular, cost data is available only at the MySuper product level and the fund level. For choice, there is no product/option-level data, and for MySuper products the available data does not indicate whether costs are actual or merely have been apportioned (which can affect its accuracy).

Indicator 2 - Margins: wholesale (by service) and retail (by segment), and

Indicator 4 - Alignment of the structure of member fees and underlying costs

Conceptually, we support Indicators 2 and 4. Margins is a better indicator of competition than costs/fees alone, where margins are the excess of fees over fund expenses. A general decline in margins over time, all else being equal, would indicate ongoing competitive pressure.

As outlined in our submission to the Commission's Issues Paper, Rice Warner has shown, in broad terms, that APRA-regulated funds have experienced margin compression over the past decade and attributes this reduction to competition amongst funds to reduce fees, relative to competitors and increasing market share of all profit-to-member funds.

We have concerns about cross-country comparisons of investment management fees (indicator 3) as the distinguishing features of the Australian system and industry data quality make international comparisons difficult. Where comparisons are made with international systems, we note that the range of fees being compared should take into consideration all government and employer subsidies on behalf of members²⁰, and the analysis should ensure that quoted international fees include the same sets of fees that are charged – *whether reported or not* – as those charged/reported in the Australian system. We also note that, under RG97 for PDSs issued on or after 1 February 2017, fees charged in Australia will *appear* higher due to the depth of reporting of underlying indirect costs and charges (not currently reported separately).

Indicator 5 - Transparency and efficacy of fee disclosure by funds, including for distinct services

While we support fee disclosure as an important mechanism to inform members and help inform decision making, any analysis needs to be considered in the broader context of overall benefits.

²⁰ For example, the fees referenced for the Chilean system reflect investment fees only, not administration fees; and the New Zealand government pays for the ongoing account fees for KiwiSaver accounts.

C10. Are economies of scale utilised and benefits passed through to members?

KEY POINTS

- Economies of scale is a valid lens through which to assess competition in the system.
- The Commission recognises that the pass-through of economies of scale can be broader than just lower costs, but the proposed indicators cover a relatively narrow range of benefits and so should be broadened accordingly.
- Innovation, in particular, should be incorporated. Providers invest in new technologies and innovate with respect to products, services and modes of delivery that better meet customers' needs.

General comments

ASFA agrees that economies of scale is a valid area of exploration. However, AFSA considers that the Commission's proposed indicators do not adequately capture the broad range of benefits of economies of scale.

Economies of scale refer to where a provider's average cost of supplying a product or service reduces as the provider increases its output. For superannuation funds, economies of scale can be realised in a number of ways, including where funds:

- merge (also applies to service providers)
- outsource certain functions to external service providers (those service providers are better able to achieve economies of scale)
- that are part of a larger financial services group, outsource functions to specialised areas of that group.

Assessment of economies of scale in a market can be helpful to determine the degree of competition in that market. In particular, the degree of unrealised economies or the degree to which realised economies are passed through the value chain to the end consumer may reflect the degree of competition.

Innovation and additional services should be incorporated in the Commission's assessment of economies of scale. Economies of scale can be passed through the value chain not only as lower costs, but also through investing in new technologies and innovations – with respect to products, services and modes of delivering products and services that better meet customers' needs.

Economies of scope should also be incorporated. The Commission mentions economies of scope in the main body of the report, yet this is not reflected in any criteria or indicators. Realisation of economies of scope enables a larger provider to (among other things) provide a more diverse range of products and services to its members than a smaller counterpart. This represents a tangible benefit for the members of the larger fund.

Concerns about indicators

Indicator 1 - Unused scale economies

Conceptually, the degree of unrealised economies of scale is a valid indicator of competition, but it is very difficult to measure and interpret. This is particularly the case where the market in question is complex, like the superannuation system – which, in effect, comprises a number of different sub-markets.

There have been a number of studies undertaken on economies of scale in the Australian superannuation industry/system. These studies have looked at economies of scale with respect to fund type (typically retail and all-profit-to-members) and service type (typically administration and investment management).

As the Commission notes in its Draft Report, the literature is somewhat conflicting. Some studies find significant unrealised scale economies with respect to different types of funds and services, though other studies do not.

In terms of any analysis, as the Commission notes, there are significant issues with using the available cost data. APRA cost data only is available at the MySuper product level or at the fund level. A particular issue with the MySuper data is that there is no way of knowing whether the data for a particular product reflects actual costs or whether costs have been merely apportioned. For service providers, cost data is not readily available. Broader issues around the completeness and reliability of cost data are highlighted in the studies on economies of scale to which the Commission has made reference.

Indicator 2 - Effectiveness of scale test

The Commission proposes to use outcomes from the application of APRA's scale test as an indicator of whether scale economies are being realised and passed through to members. It is doubtful that this indicator would provide any meaningful insights.

The scale test is a framework to assess whether a MySuper fund/product has access to sufficient scale so that members of the MySuper fund/product are not disadvantaged in comparison to members of other MySuper funds/products.

APRA has not published formal directions on how trustees should apply the scale test. Further, APRA does not publish any information about how effective the scale test has been in prompting fund consolidation. As such ASFA has concerns about this proposed indicator.

Indicator 3 - Mergers prevented by bulk transfer rules

Discussion of this indicator is in our response to *Competition Criterion 7*.

Indicators 4 to 6 - Pass-through of scale economies to members

The issues with determining the pass-through of scale economies are more significant than those with respect to Indicator 1.

As noted earlier, providers that realise economies of scale can pass on the benefits in a variety of ways. This can include lower costs, improved quality of products and services (a function of innovation at the provider level) and an increased range of products and services.

ASFA's interpretation of the Commission's framework is that the Commission is attempting to capture these benefits in the last three indicators in this criterion, where:

- indicator 4 refers to the broad range of benefits to members
- indicator 5 refers to quality improvements in administrative services
- indicator 6 refers to investment management services – where greater scale allows for a greater degree of asset diversification.

With respect to indicator 4, if the Commission uses econometric methods to estimate the degree of pass through it is vital that the aforementioned benefit types be incorporated – that is, lower costs, improved quality and greater range. If not, the equations would be mis-specified and the results misleading. The data issues highlighted with respect to indicator 1 are also relevant with respect to this indicator.

In this regard, the benefits to members are broader than those reflected in indicators 5 and 6. These benefits include the whole gamut of member services, such as intra-fund advice, call centres, assistance to members and employers, interactive web sites (which allow members to view statements and perform some transactions), calculators, member communication materials and member seminars.

It is also worth noting that the Commission's framework is not relevant to some fund types. For some public sector and defined benefit funds (and some accumulation plans), employers pay some or all of the costs so the pass-through of scale benefits to members is less, or not, relevant.

C11. Do funds compete on relevant non-price dimensions?

KEY POINTS

- Assessment of efficiency and competition should look at non-price dimensions in combination with cost. Superannuation is a long-term product that is about providing a benefit/value to members. This criterion needs to be considered in conjunction with *Competition Criterion 9*.

General comments

Any assessment of efficiency and competition should look at non-price dimensions in combination with cost. Superannuation is a long-term product that is about providing a benefit/value to members. This criterion needs to be considered in conjunction with *Competition Criterion 9*.

As the Draft Report notes, non-price competition can lead to improved efficiency (both allocative and dynamic). A key characteristic of the Australian superannuation system is that funds compete on relevant non-price dimensions such as the quality and variety of ancillary benefits and services, including insurance cover and access to financial planning.

It is worth emphasising that significant non-price competition occurs in the MySuper space. As part of their design objectives, MySuper is about providing default superannuation products that are reasonably simple in design and easy to compare. However, there is scope for funds to tailor offerings in line with their members' needs and requirements. One example is the offering of life-stage investment asset allocations designed to meet member needs in regard to investment risk exposure at different stages in their life-cycle. Out of 116 MySuper products in total, there are 29 life-cycle products. Amongst the life-cycle products there are variations in asset allocation and age segmentation to reflect the specific demographics of those funds.

More generally, funds compete in regard to the type, level and cost of insurance provided. As set out elsewhere in this submission, insurance benefits associated with superannuation are a core part of superannuation and are highly valued by members, particularly when a member, or their dependant(s) in the event of premature death, qualifies for an insurance benefit payment. The provision of insurance that meets the needs of members can be an important consideration for employers and members alike in deciding to join, or stay with a fund.

Provision of advice is also something that fund members value. Funds compete in terms of the level and range of advice options that are provided and the pricing for each form of advice. Efficiencies in the delivery of intra-fund and limited-scope advice means that much of such advice can be provided without any explicit fee – instead the costs are covered by a small proportion of the general administration fee charged for each account. As with insurance, the provision of advice that meets the needs of members can be an important consideration in encouraging members to stay with a fund.

Concerns about indicators

Indicator 1 - Fund marketing expenditure

Funds are use marketing to protect and increase market share (i.e. marketing aimed at both member retention and attracting new members). The indicator proposed is likely to be a reasonable measure of the extent of competition. However, there also may be difficulties in obtaining such data at a detailed level as it is likely to be regarded as commercial in confidence. In relation to the comparability of insurance product information, we note that this is also proposed to be considered under *Efficiency Criterion 13* (see further comments there).

Indicator 2 - Information collection by funds on key member characteristics

Indicator 3 - Availability, cost and quality of information on fees and investment risks at product level, and

Indicator 5 - Member awareness of key features of their superannuation

In relation to indicators 2, 3 and 5, ASFA considers that these indicators – in this particular context – are indirect measures at best and are likely to provide little, if any, evidence of whether the services provided meet the preferences of members.

For indicator 2, ASFA considers that information collection by funds on key member characteristics is a crucial part of ensuring that trustees operate in members' best interests (see *Competition Criterion 1*). However, it is not clear that the indicator would be useful in this context. Specifically, indicator 2 assesses the degree to which funds collect information, which presumably is meant to be a proxy for the degree to which funds tailor their products and services, which in turn is a source of competition. Such indicators are, at best, ambiguous.

While noting the limitations of surveys, ASFA considers that it would be worth considering a survey of fund member views on the relevance and value of services provided by funds such as insurance, financial advice, investment choices and transactional and reporting capabilities rather than the information proposed to be collected under indicators 2, 3 and 5. This only would be worthwhile if the survey was well-designed.

C12. Is there innovation and quality improvement in the system?

KEY POINTS

- Innovation is more than product design; it includes innovation in services and in the delivery of products and services.
- Reductions in the numbers of products may be a function of mergers, while in other cases there may be barriers to exit.
- There are regulatory barriers to the development of new retirement income products and more tailored MySuper (default) products.

General comments

Innovation is more than product design. It relates also to innovation in services and modes of delivery of products and service – especially those enabled by digital technology.

It is worth noting that with respect to the Commission’s broader framework, the Commission underplays the importance of innovation, and does not adequately address the potential constraints on innovation.

There is a tension between price competition and innovation, as considerable resources may need to be invested in developing and effecting innovative products and services. Accordingly, an undue emphasis on price competition may have unintended deleterious effects on innovation.

Further to this, the need to comply with changing and expanding regulatory requirements can represent a considerable opportunity costs which serves to stifle innovation. Unduly onerous regulatory requirements can also act as a deterrent to developing more complex products and solutions, as the future regulatory change may affect them disproportionately.

Dynamic efficiency involves improving operational and/or allocative efficiency over time. Whereas operational and allocative efficiency assume current technological and other constraints, dynamic efficiency occurs when innovation and technological change increase the overall benefits that are achievable in a competitive and efficient system. This can mean finding better products and/or better ways of producing them, as well as improvements in distribution, which may serve to achieve enhanced member engagement. Dynamic efficiency can be achieved by maximising the options between consumption and retirement savings such as to enable members to achieve a better retirement outcome. Measures of efficiency should not just focus on saving costs and passing those savings on to members.

The indicators with respect to innovation should be expanded to include areas such as operational efficiency, online/digital capabilities (including electronic communication) and access to financial advice.

Concerns about indicators

As is the case for the criterion, ASFA is concerned that the indicators are focused solely on product innovation and do not contemplate improvements and innovation in services and the delivery of products and services. The latter in particular is enabled by changes in digital technology, which can enhance the member experience and serve to improve engagement.

Indicator 1 - Declining number of products over time (accumulation)

A declining number of products may be an indicator of efficiency as older products are closed and members moved into alternative vehicles. It is important to note, however, that there are often regulatory, and sometimes commercial, barriers to reducing the number of legacy products.

A decline in the number of products does not necessarily say anything about innovation. For example, reductions in the number of products may come about from fund mergers, while an increase in products may be indicative of innovation.

Indicator 2 - Introduction of new retirement income products and development of more tailored default products

Introduction of new retirement income products and development of more tailored default products are severely constrained by the restrictions imposed by the regulatory requirements. While the Government has committed to reform the pension standards it will be difficult to assess the effectiveness of this until sometime after the amendments have been made.

For retirement income products, the pension standards in the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) effectively confine trustees of funds (other than public sector or defined benefit funds) to being able to offer an account-based pension and/or acquire an annuity on behalf of the member.

Accordingly, trustees of superannuation funds are severely constrained in their ability to develop and offer new retirement income products, as any product other than an account-based pension or an annuity would be in breach of the SIS pension standards. In order to develop its group self-annuitisation product, Mercer had to design and create a product which is not considered to be a superannuation product under the SIS or tax legislation.

Regarding more tailored default products, the MySuper regulatory framework is highly prescriptive and only permits the provision of:

- a single diversified investment option or a life-cycle option
- a level of death and TPD insurance, on an opt out basis.

Similarly, there is extremely limited scope to tailor a MySuper product – all the trustee can do is introduce a lifecycle product (as opposed to a single diversified investment option) or re-examine the design of their insurance offering (which should be the same for all MySuper members).

Box 1: Examples of innovation

There are many examples of innovation within the superannuation industry which achieve dynamic efficiency, including in delivery, disclosure and changing to a self-service model.

Digital delivery of disclosure material

ASIC released guidance (*RG 221 - Facilitating digital financial services disclosures*) on 29 March 2016 in relation to default digital delivery of financial services disclosure, which had the effect of removing some regulatory barriers to the use of innovative Product Disclosure Statements, Financial Services Guides and Statements of Advice.

Previously, digital delivery had required specific agreement from the member – this requirement has been removed. When releasing RG 221 ASIC advised that it was “aiming to strike an appropriate balance between administering the law effectively and with minimal procedural requirements (reducing red tape) and promoting investor trust and confidence in the financial system”.

These new regulatory settings allowed more efficient, cheaper, digital disclosure and messaging, and reduced market inefficiencies, through reducing costs associated with the preparation, printing and posting of paper documents.

Digital disclosure

It is important to note, however, that the cost saving from delivery may not always translate to lower costs to members, instead, they may be used to enhance the quality of communications to members. The removal of these barriers by ASIC has provided incentives for superannuation product providers to develop more innovative disclosure which is better able to meet members’ preferences and needs. This includes interactive web-based disclosures, applications, videos, games and audio presentations, which can lead to an improved communication experience for members.

Use of digital technology enables more efficient administrative processes, and costs, in providing the services combined with a more dynamic experience, where members are communicated with in the format or medium that they prefer. This leads to better engagement and retirement outcomes. This is especially the case for superannuation funds which have a majority of young members. Engagement of younger member is particularly challenging, given that their retirement is decades away.

Innovations such as applications, where members can check their superannuation balances and transactions on their mobile devices, have proved in increasing member satisfaction and trust with superannuation. Information presented is more likely to be acted upon, which is more efficient in terms of achieving a fund’s objectives of communicating with members and achieving engagement.

Member self-servicing

The ability to join online, make contributions electronically, perform other transactions and utilise retirement calculators all contribute to applications operating as an ‘one stop shop’ for superannuation, increasing efficiencies through member self-service.

Robo-advice is another innovation offered by many superannuation funds whereby fund members are able to access digital advice through fund websites. Some funds have found that offering advice through different channels – for example face to face, telephone and online - achieves a greater engagement with members which assists them to achieve an improved retirement outcome. These innovations create back office efficiencies where the self-administration by members reduces the need for manual processes by the fund.

Cloud computing

Cloud computing allows funds, their administrators and other service providers (such as custodians and insurers) to access, process and store data more efficiently. Subject to being able to ensure that the cloud provider complies with regulatory requirements, some superannuation funds are able to utilise cheaper overseas servers.

C13. Are outcomes improving at the system level?

KEY POINTS

- Though this is a worthy question, it relates directly to the objectives of the system. In general terms, this criterion is what the Commission should conclude from considering all the evidence from the other criteria and indicators.
- This criterion should be removed.

General comments

Although this is a worthy question, it is not clear that the question of improvement in system outcomes should be addressed in a specific criterion.

Improvements in outcomes at the system level should be determined by the Commission in a general sense, from considering all its indicators and the supporting analysis (qualitative and quantitative), rather than from just the two proposed indicators.

To put it another way, the answer to the question posed in this criterion is, in effect, the degree to which the system meets the system objectives over time. In this regard, it should be noted that ASFA recommends that the Commission should broaden its system objectives (for details, see the section of this submission on *Objectives of the System*).

ASFA considers that this criterion should be removed.

Concerns about indicators

With regard to the indicators as specified, ASFA has a number of concerns.

Indicator 1 - Growing voluntary consumption of superannuation services (investment, retirement products, advice, insurance)

Growing voluntary consumption of superannuation services is an ambiguous indicator. In particular, voluntary consumption is affected by a multitude of factors that are outside the scope of the Commission's framework. Further, the effects of these external factors would be very difficult to remove, particularly as they relate to individuals' personal circumstances and financial choices.

Changes in financial market conditions and taxation settings affect the voluntary consumption of superannuation.

Voluntary contributions to superannuation fell significantly in the period immediately after the Global Financial Crisis. For instance, personal contributions to funds with more than \$50 million in assets fell from \$7,799 million in the June quarter 2008 to \$5,919 million in the June quarter 2009, and then to \$5,445 million in the June quarter 2010.²¹

²¹ APRA, *Quarterly Superannuation Performance Statistics*, June quarter 2016.

Changes in tax settings and financial market conditions affect the use of SMSFs. The largest annual growth in the number of SMSFs (13 per cent) occurred in 2007. This coincided with the introduction of the Government's Superannuation Simplification measures which, in effect, encouraged the making of large non-concessional contributions of up to \$1 million during a limited transitional period. Over the next three years, from 2007 to 2010, the growth rate for new SMSFs fell to pre-2007 levels of around 6%, most likely influenced by global economic circumstances. Contribution caps and lessened confidence in the stability of the tax treatment of superannuation would also have had an impact.²²

More recently, the proposed 2016-17 Budget measures (if enacted) likely would lead to reductions of the degree of salary sacrificing among members. On the other hand, the ability to claim a tax deduction for personal contributions may lead to an increase in contributions. The Government's announcement of the proposed measures led to an increase in members contacting funds for advice about the potential effects of the measures. Changes to the system tend to reduce consumer confidence, especially as it is a long term investment over decades. Funds observed that voluntary contributions were reduced, when compared with previous year, after the 2016-17 Budget measures were announced.

Indicator 2 - Member satisfaction and trust

In broad terms, this indicator is addressed in our response to *Competition Criterion 5*.

The Commission is correct regarding the importance of member satisfaction and trust. ASFA has no significant concerns with this indicator, but rather with its application within the criterion – that is, one of only two proposed indicators as to whether system-level outcomes are improving.

A more specific point is that it would be difficult to consistently measure member satisfaction and trust across the industry and over time. Measures of member satisfaction and trust are likely to correlate strongly to recent market performance – a factor that is external to the system. Further, levels of satisfaction and trust differ according to a member's degree of engagement, awareness and financial literacy. Because these factors differ across fund type and product type, system-wide measures are potentially misleading. This is particularly the case for measures of member satisfaction and trust over time, given that industry and product shares change (over time).

²² ATO, *Self-managed Super fund Statistical Report*, March quarter 2016.

CRITERIA - EFFICIENCY

E1. Are long term net investment returns being maximised taking account of service features to members?

KEY POINTS

- A primary indicator of efficiency should be net investment returns, which are gross returns less investment and administration fees, costs and taxes.
- Net returns should be risk-adjusted unless the measurement period is suitably long – at least 20 years.
- Net returns should be benchmarked using two complementary benchmarks.
- More broadly, net returns should be assessed with reference to the broad range of products and services that funds provide members – which are reflected in fund fees/costs, but not reflected in returns.

General comments

ASFA is broadly comfortable with the criterion. ASFA agrees with the Commission that net investment returns should be the key criterion to assess the efficiency of the superannuation system, where net returns are gross investment returns less all fees and taxes.²³ As the Commission notes, net returns on contributions and balances are the most important way in which the superannuation system contributes to adequate and sustainable retirement incomes.

One notable concern with the criterion is that none of the proposed indicators take account of the quantity and quality of member services – notwithstanding that member servicing is part of the criterion. The fees charged to members reflect the broad range of benefits provided to members.²⁴ As none of the Commission's proposed indicators for this criterion assess the quantity and quality of member servicing, measured efficiency would systematically under-estimate actual efficiency (with respect to the criterion in its current form).

In terms of the proposed indicators, ASFA has preferences about how net returns should be measured and benchmarked. These issues are discussed below.

Assessment needs to account for different product types and compare 'like with like'

ASFA's submission to the Commission's Issues Paper noted that within the superannuation system, there are distinctly different business and operational models. The four main models are:

- MySuper – where the trustee makes all of the investment and operational decisions
- Choice – where the consumer makes the investment decisions with respect to their benefit, while the trustee makes the (non-investment) operational decisions with respect to the product

²³ The Commission defines net returns as gross investment returns less all fees and taxes.

²⁴ These include: intra-fund advice; call centres; assistance to members and employers; interactive web sites (which allow members to view statements and perform some transactions); calculators; member communication materials and member seminars.

- Defined benefit – where the trustee makes investment decisions, primarily to match assets to liabilities (that is, promised benefits)
- SMSFs – where consumers actively choose to run an SMSF and make all of the investment and operational decisions.

With respect to investment strategies, a MySuper member's investment strategy is dictated by the fund trustee, whereas a choice member's investment strategy is tailored according to their specific objectives and risk appetite (as is the case for SMSFs), taking into account their investments outside superannuation.

Given this, net returns for MySuper and choice products should be measured and benchmarked separately – which ASFA also recommended in its submission to the Commission's Issues Paper.

A broader consideration is the significant heterogeneity with respect to asset allocations and risk profiles in the superannuation market, and the challenges that this presents for measuring and benchmarking net returns for groups of products.

Asset allocation and risk profiles vary considerably across the range of choice options and, to a far lesser extent, MySuper products. In the choice environment, members have a multitude of investment options from which to choose, especially with respect to platforms, wraps and investor directed portfolio service (IDPS) products.²⁵ Typically a choice member invests in multiple investment options across their fund.

Asset allocation also tends to change with age, and age profiles differ by fund and product type. On average, members of retail funds and SMSFs are older, and tend to invest in more conservative portfolios (for example, cash and fixed interest). Almost a quarter of total member benefits in retail funds are invested on behalf of members aged over 65.²⁶ Asset allocation is also a function of whether the member is in the accumulation or draw-down phase.

Given this, a guiding principle for measuring and benchmarking net returns for groups of products/options is that 'like should be compared with like' – in terms of asset allocation and risk profiles. This principle should apply to how products are grouped when measuring net returns, and the choice of benchmarks against which groups are assessed. In this respect, benchmarking the average returns of a group of 'like' products against an appropriate benchmark is **not** equivalent to benchmarking the average returns for a group of products with different profiles against an 'average' benchmark.

Concerns about indicators

Indicator 1 – Long-term (5, 10 and 20 year) net returns from the system and market segments compared to reference portfolio benchmark

ASFA considers that net returns should be risk-adjusted, unless the measurement period is suitably long – ideally 20 years.

²⁵ Investor Directed Portfolio Services: custodial, transactional and consolidated reporting services, which are often referred to as master funds/master trusts.

²⁶ Based on research from BT.

As stated in ASFA's submission to the Commission's Issues Paper, a 20-year period would be sufficiently long to account for the effects of market volatility. ASFA does not agree with the Commission that a five year period is 'long-term' with respect to investment markets. Five-year averages of historical returns would not account sufficiently for market volatility and risk.

A major challenge for the Commission in calculating long-term returns is availability of data. In particular, APRA's annual returns data for MySuper products is for 2013-14 onwards. That said, a large number of MySuper products were developed from pre-existing industry fund product offerings with longer data histories.

As noted in the previous section, there are distinctly different business and operational models within the system, and significant heterogeneity in asset allocations and risk profiles in the superannuation market. These issues provide guidance as to how the net returns indicator should be applied to groups of products (benchmarking is discussed in the next section):

- For MySuper products, the indicator should be applied to the group of products.
- For choice products, it generally would be appropriate to apply the indicator to groups of trustee offered, diversified, investment options which are considered to be a 'balanced' option ('balanced' options generally are regarded as being where the allocation to growth assets is between 60 and 80 per cent).
- If using a set of different reference portfolio benchmarks (as discussed below), it would be appropriate to apply the indicator to groups with asset allocations that are consistent with the benchmarks.

Indicator 1 benchmarks

Any benchmark of net returns has its relative strengths and weaknesses. As such, ASFA agrees with the Commission that a combination of benchmarks would be appropriate:

- Margin over inflation (CPI +X%)
- Set of reference portfolio benchmarks

Benchmark: CPI + X%

The Commission proposes a benchmark based on a margin over inflation (CPI +X%) as a secondary benchmark. ASFA recommended the CPI +X% benchmark in its submission to the Commission's Issues Paper.

A CPI +X% benchmark provides a means to assess the degree to which (like) groups of products/options contribute to members' real balances and, ultimately, to retirement incomes. Fundamentally, funds need to deliver net investment returns above inflation to ensure that members' balances increase in real terms (notwithstanding the effect of contributions and withdrawals).

The CPI +X% benchmark has the benefit of being transparent and provides an easy-to-understand, headline measure of member outcomes in terms of the purchasing power of accumulated savings. A weakness is that the degree to which net returns compare favourably/unfavourably against the benchmark is heavily influenced by market conditions – though this is less of an issue over a long period time period (such as 20 years, as ASFA recommends).

ASFA reiterates its position in its submission to the Commission's Issues Paper, that a possible relative benchmark for groups of MySuper and balanced choice options would be CPI growth plus 2.5 percentage points (over a 20-year period).

Benchmark: set of reference portfolio benchmarks

The Commission proposes a benchmark comprising a reference portfolio – for example with 70 per cent growth assets and 30 per cent income assets.

ASFA considers that a single reference portfolio is arbitrary. It only would be useful for benchmarking the performance of groups of products/options that have the same asset allocation – such as groups of choice options with the equivalent asset allocation.

Instead, benchmarking using a set of reference portfolios – reflecting some of the most frequently offered asset allocations – would provide a broader perspective.

As noted in the general comments for this criterion, asset allocations differ markedly across the superannuation system – there are many thousands of separate investment options. Each has a particular risk-return profile – from defensive asset allocations to high-growth allocations – reflecting, in large part, relative exposures to different asset classes.

If groups of products/options were benchmarked against a single arbitrary reference portfolio then those groups would pass or fail depending, in large part, on their assets allocations. As such, benchmarking against an arbitrary reference asset allocation makes little sense – except if the group has an asset allocation that is consistent with the reference portfolio. This same criticism can be extended to benchmarking the system as a whole on this basis.

The Commission could use a set of reference portfolios, each a 'vanilla' lowest-cost form of a product in each prescribed asset allocation/risk profile. In using these benchmarks, the Commission would have to take care that it is comparing like with like – that is, use the benchmark for equivalent groups of products/options.

One issue that the Commission did not address in its Draft Report is the treatment of fees and taxes in the benchmark. For the net returns indicator, the Commission would have to derive figures for historical fees and taxes. However, it is not clear how the Commission would derive an appropriate benchmark for fees.

Other benchmarks – aggregate asset allocation

The Commission proposes a benchmark comprising the aggregate asset allocation in the superannuation system.

If applied at the system level (as is suggested) this benchmark would measure only the performance of the system with respect to the particular system-wide asset allocation. Implicitly, the benchmark would measure the degree to which the system can 'beat the market' for each asset class – that is, the degree to which investment decisions within an asset class, on average for the whole system, provide superior outcomes than the relevant asset market benchmark. As the Commission notes, this would not reveal anything about whether the particular system-wide asset allocation is efficient.

For cohorts of funds, products or options, this benchmark is more problematic. The Commission would need to construct different representative portfolios for each particular cohort.

With respect to fees, there are similar issues to those discussed regarding the reference portfolio benchmark.

Indicator 3 – Dispersion of funds and products from a frontier of best-performing funds and products (based on historical long-term net returns)

ASFA sees little value in this indicator. Frontier analysis is unlikely to provide robust results, and would be both data and time intensive.

The main shortcoming of frontier analysis for its proposed purpose is the treatment of risk. As the Commission rightly notes in its Draft Report, frontier analysis only should be used if product returns have been adjusted explicitly for risk or if the analysis is undertaken for products that have identical asset allocation profiles. If not, frontier analysis would tend to produce spurious results – in particular, that products with riskier asset allocations are more efficient.

Given the range of asset allocation profiles among products, the Commission would need to undertake a number of different frontier analyses – one for each chosen asset allocation cohort. The larger the number of separate cohort analyses, the more robust the overall frontier analysis.

It is doubtful that the available data would support such an approach. With respect to APRA data, product-level data is available only for MySuper products – and this data, as a comprehensive set, only goes back to 2013 (although a large number of MySuper products were developed from pre-existing all profit for members industry funds with longer histories). For other products or options, publically-available data on current asset allocations could be obtained from Product Disclosure Statements (PDSs). However, historical data (required to build a time series) would be more difficult to obtain.

Even if the Commission were able to undertake such analysis, it is not clear that the results would be particularly illuminating. The Commission states that it would expect to see ‘a high degree of clustering near the frontier of best performing funds’. The frontier, by construction, would comprise a very small proportion of products (analysis would have to be undertaken on the basis of products, not funds), and the remainder of the products would lie within the frontier. However, there is no benchmark to determine how far in from the frontier the remainder of the products should lie.

Further, as the Commission notes in its Draft Report, frontier analysis is highly sensitive to data quality and the assumptions underpinning the analysis. This is exemplified by the contrasting conclusions from recent studies that have used frontier analysis.²⁷

²⁷ Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, page 117.

E2. Are fund costs, and fees charged, being minimised taking account of service features to members?

KEY POINTS

- This criterion is very similar to the *Competition Criterion 9* and should be combined with that criterion.
- As previously indicated in this submission, the emphasis should be on net returns and benefits, not just on costs.
- Administration costs and fees need to be considered in the context of the level and complexity of the services provided to the fund member.

General comments

This criterion is similar to *Competition Criterion 9: Do funds compete on costs* and ASFA suggests that they should be combined. We also note that the criterion does not recognise that in public sector and private sector defined benefit plans employers generally pay some or all of the costs. Employer sponsors in those situations will be receiving professional advice to ensure that costs and fees involved are being minimised, taking account of the features of the services provided to members.

Concerns about indicators

The proposed indicators are substantially similar to the indicators in *Competition Criterion 9* and have the same limitations in this context. The relevant commentary is in that section. Further, although the criterion incorporates ‘service features to members’, only one of the criterion’s indicators touches on this issue.

With respect to indicators 1 to 4, given the fundamental aim of superannuation is to deliver a net benefit, in terms of investment returns above a specified level, it is not clear how examining detailed expenses incurred at a fund level will assist. If additional investment expenses are more than compensated for by additional investment returns then a higher absolute level of investment expenses is not a concern in itself. It is more appropriate in a policy sense to focus on what is the appropriate net investment return benchmark (i.e. CPI +X/reference portfolio – see *Efficiency Criterion 1*). Implicit in setting such a benchmark is the acceptable level of expenses and fees for a given level of returns and risk.

Indicator 5 - Administrative costs and fees at system level and for market segments, and

Indicator 7 - Relationship between level of administrative fees and quality of member services

There also are issues with considering the absolute level of administrative costs (indicator 5). In particular, a fund’s level of administrative costs is a function of the level and complexity of the services provided by that fund. This issue is discussed in more detail elsewhere in this submission. Indicator 7 would be a better measure of efficiency with respect to administrative costs.

Indicator 6 - Cost savings from SuperStream

In regard to SuperStream, to date the expenses of implementing SuperStream (both direct system costs²⁸ incurred by funds and the levies paid to the ATO related to SuperStream) are likely to outweigh any reduction in transaction costs, especially given that small employers are only now being required to become SuperStream compliant. As a result, cost savings are yet to be passed on to members in terms of any significant reductions in administration costs. In this context, the supposed \$1 billion a year cost savings (a significant proportion of which would relate to employer costs) has yet to materialise.

It is too early to recognise the full realisation of benefits of the SuperStream program. While SuperStream is likely to deliver cost savings in the medium to longer term, it is important to acknowledge that after a successful implementation, the SuperStream network is still evolving and maturing. As outlined above, the substantial cost of implementing SuperStream is likely to outweigh any reduction in transaction costs in the short to medium term. There are several reasons for this as outlined below:

- the superannuation industry has incurred a levy totalling \$421.8 million across the period 2012-13 to 2017-18 to pay for the ATO's implementation of SuperStream and supporting technology. These cost are ultimately borne by superannuation members
- the SuperStream system is still being enhanced during 2016-17 to bring Government payments into the system
- as a result, the superannuation industry continues to upgrade and enhance its technology systems, incurring a large upfront capital cost while the benefits will be realised over the longer term
- the implementation of the SuperStream program has been slower than the original timetable which in turn has slowed the realisation of benefits. For instance, there were still several hundred-thousand small businesses to become SuperStream compliant as at 30 June 2016, their initial compliance date. To provide small businesses with more flexibility, the ATO has effectively deferred the SuperStream compliance date for small businesses to 28 October 2016²⁹
- The SuperStream Enabling Services (for example, SuperTICK, SuperMATCH, and the Fund Validation Services) which are provided by the ATO are also still maturing and need further investment to improve performance and availability. These services are pivotal to an efficient and effective SuperStream system.

²⁸ Such as capital cost, operational costs and maintenance costs.

²⁹ ATO 2016, *Flexibility for Small Business to Become SuperStream Compliant*, media release, 22 June 2016 (<https://www.ato.gov.au/Media-centre/Media-releases/Flexibility-for-small-business-to-become-SuperStream-compliant/>).

While it is too early to measure the full effect of the SuperStream program, it is important to outline how this could be measured. The key stakeholders in SuperStream are:

- *Members* – Members will benefit from SuperStream through receiving contributions in to their account in a timely manner. Over time, there will be a further reduction in the unnecessary generation of member accounts as well as the number of ‘lost’ accounts (currently \$11.7 billion accounts are legally considered to be ‘lost’ – about 0.6% of the total assets in superannuation).³⁰ A real benefit will also be the opportunity for Government to manage any Superannuation Guarantee (SG) obligations through better and more timely reporting of contributions, both through SuperStream as well as Single Touch Payroll (STP)³¹ – a Government initiative currently before Parliament.
- *Employers* – The ATO commissioned a report ‘*Australian Taxation Office. Superannuation Reform*’,³² in which it measured the time savings for employers using SuperStream to remit contributions into superannuation funds. While considerable benefits were achieved by employers submitting contributions through SuperStream, one would expect these benefits to increase as solutions mature and the quality of reporting data improves.
- *Funds* – It is too early to determine the SuperStream benefit realisations for funds. In addition, there is currently no consistent way to determine how any benefits would be measured in the future. ASFA is currently working with the ATO on determining an appropriate framework to measure SuperStream benefits.
- *Government* – The ATO is a significant stakeholder in the management of superannuation as the relevant regulator of the *Superannuation Guarantee (Administration) Act 1992*. SuperStream enables the ATO to better manage SG compliance through regular and electronic reporting of contributions made to superannuation funds by all employers. Linked with the impending STP initiative, and subject to the design being practical and efficient, the ATO will be able to ensure that employees receive their superannuation entitlement.

Finally, there needs to be an ongoing commitment to continuous improvement of SuperStream led by the ATO and APRA to maximise efficiency of the system, and a commitment from Government to reduce the amount regulatory change (for example, to the SuperStream regulations and standards).

³⁰ ATO 2016, *New Data Reveals Postcodes with Most Lost Super*, media release, 18 August 2016 (<https://www.ato.gov.au/Media-centre/Media-releases/New-data-reveals-postcodes-with-most-lost-super/>).

³¹ ATO 2016, *Single Touch Payroll*, media release, 31 August 2016 (<https://www.ato.gov.au/General/New-legislation/In-detail/Other-topics/Single-Touch-Payroll/>).

³² Colmar Brunton 2015, Australian Taxation Office, *Superannuation Reform: Final Report* (https://www.ato.gov.au/uploadedFiles/Content/SPR/downloads/SPR_SuperStream_Reform_Report.pdf).

E3. Do all types of funds have opportunities to invest efficiently in upstream capital markets?

KEY POINTS

- Australia's market for upstream funds management is very competitive and APRA-regulated funds can easily access all types of investments, including infrastructure and overseas equities.
- The market for asset management has developed to provide intermediaries that all superannuation funds, including SMSFs, can use to access all asset types.

General comments

The market is operating effectively to provide access to investment opportunities for all superannuation funds. The proposed indicators would not provide meaningful data and comparisons on how the market is operating.

APRA-regulated superannuation funds have ready access to upstream capital markets such as international equities, bonds and infrastructure. Australian superannuation funds are recognised by the OECD and other international bodies as world leaders in involvement in such markets.

Taking infrastructure and non-listed property as an example (as these are the asset classes viewed as most difficult to invest in due to scale), there are several ways that APRA-regulated superannuation funds can access this type of investment. These include:

- bidding for projects in a consortium with other superannuation funds and with debt providers
- investing in a third-party infrastructure company in which several superannuation funds, and potentially other investors, take a stake.

Further evidence that the market is operating to drive efficient access to these markets for APRA-regulated funds is the process of insourcing investment by some of the larger superannuation funds.

SMSFs may have difficulty accessing some upstream capital markets directly. For example, an SMSF will have difficulty investing directly in equities in other countries, unlisted property, bonds or infrastructure. However, there are many intermediaries that can provide access to these capital markets, including through exchange-listed funds.

Given the large volume of funds under management held by SMSFs (\$624 billion as at June 2016) it can be expected that the market for delivery of investment and other services to SMSFs is highly competitive. Accessing the SMSF market and delivering wider investment options to them exercises the minds of domestic and international fund managers and other service providers. Many organisations have been selling these services to SMSFs as a core strategy to drive growth and there are many players in this market.

While there may be an argument that SMSFs should be able to access these assets directly, members of SMSFs have made the choice to establish an SMSF and as such they are responsible for that choice. They must also recognise there is a price to pay for accessing these markets which is the fees paid to intermediaries.

There is also the very real issue of the type of investments members of SMSFs are interested in. Typically they prefer to invest in a similar manner to many individual investors outside of superannuation, that is, primarily in term deposits, direct shareholdings of Australian companies, residential real estate and business real property (when the member has a small business). Particular investment preferences also are affected by access to limited recourse borrowing through SMSFs.

Concerns about indicators

The proposed indicators are limited in line with the above concerns.

Indicator 1 - Asset allocation in SMSFs compared to institutional funds

Indicator 1 is ambiguous. Asset allocations in SMSFs relative to institutional funds largely reflect the aforementioned supply-side effects and particular investment preferences of the individual members, all of whom are trustees of the fund and make the investment decisions.

Indicator 2 - Retail investment management costs compared to wholesale, and

Indicator 3 - Minimum transaction values

Indicators 2 and 3 are potentially misleading with respect to restrictions on SMSFs. It can be expected that there will be differences in costs between retail and wholesale products due to scale, which also applies to minimum transaction values. It is difficult to compare a \$1 billion mandate for the wholesale management of equities for a superannuation fund with a retail product, with a similar investment mix, for a \$100k investment for an SMSF.

Data collected by the ATO and APRA on asset allocations for SMSFs and the APRA-regulated sector respectively use different nomenclature and categorisations. The government could give consideration to standardising nomenclature and categorisations, as well as to having one statistical house to collect all of the data, such as the Australian Bureau of Statistics.

Box 2: Case study - H2Ocean

As outlined in the main text, gathering funds to invest in different asset classes from APRA-regulated funds and SMSFs is the focus of many large and small fund managers in Australia. Apart from large fund managers developing strategies to sell specific asset classes, such as international equities, to SMSFs the market is delivering niche fund managers who act to dis-intermediate investment in certain asset classes.

H2Ocean is one such example. H2Ocean is currently listing as a venture capital company to invest in a portfolio of early growth stage financial technology companies. In the past it has been difficult for APRA-regulated funds to invest directly in start-ups as the upfront cost of the investigation of the investment proposal is expensive.

The cost of investigating the potential investments is too high, relative to the small size of the investment, to warrant the cost. The same is true of SMSFs, which in addition generally would lack the capacity to engage directly with private equity investment. However, this has provided an opportunity for a business to enter the market and offer this service through a pooled fund where shares can be purchased and exposure to specific assets can be achieved. As such it provides the ability for all superannuation funds to invest in an alternative asset through a vehicle that can be traded on the ASX.

This, and other funds which are seeking to provide specialised access to investments, demonstrate that the market is working to create appropriate vehicles for investment in different types of assets in the economy for both APRA regulated funds and SMSFs.

E4. Is the system effectively managing tax for members, including in transition?

KEY POINTS

- The fiduciary duty of trustees, and a well-developed market for tax advice, ensures that superannuation funds analyse the costs of taxation in order to maximise returns to members.
- While policy design is neutral across different segments of the superannuation industry, the outcomes differ between them due to the nature of fund structures.

General comments

For this assessment criterion, the Commission should focus on whether funds are maximising rates of return less tax, rather than on the relative tax strategies of SMSFs and institutional funds (which is driven by structural differences).

The tax effectiveness of investments is one of the factors that affects returns to members. Hence in acting in members' best interests, superannuation funds identify and analyse tax costs and seek to manage these, consistent with maximising net returns. In addition to internal teams, which many funds employ to manage the costs of tax, a number of private companies now provide these services as a specific consultancy service to superannuation funds. This is in addition to existing accounting firms providing this service.

Concerns about indicators

Indicator 1 - Use of tax strategies by funds for members in transition

ASFA has concerns with this indicator. Tax design has a significant influence on the tax effectiveness of transition to retirement arrangements (TTR). The proposed Budget changes (introducing a 15 per cent earnings tax on new and existing arrangements) are likely to impact on the cost-effectiveness of providing TTR arrangements (due to the need to change IT systems) and this will affect the tax strategies used by funds.

Separately, industry best practice has enabled individuals to capture the tax benefits at transition. However, the opportunities for minimising tax at the exact point of retirement for members of APRA-regulated funds (other than for some platforms/wraps/IDPS products) are not large as assets are pooled, and any unrealised capital gains associated with them are not related to individual account balances. Having said that, pooled superannuation products do endeavour to manage tax and a provision for deferred tax assets and liabilities is incorporated into the process for determining unit prices.

Indicator 2 - Average effective tax rates across market segments

This measure should be refocused on optimising tax effective rates of return across the industry rather than simply analysing average effective tax rates across market segments.

Indicator 3 - Tax advantages as a motivation for setting up an SMSF, and

Indicator 4 - Take-up rates of co-contributions and offsets

For indicators 3 and 4, the relative tax effectiveness of SMSFs to APRA-regulated funds goes to the nature of the different structures rather than the tax strategies the industry uses. It is driven by the fact that, generally, members of SMSFs have greater control, flexibility and higher account balances than the average member of an APRA-regulated fund. SMSFs also are more likely to have significant unrealised capital gains, particularly if an SMSF has residential real estate or business real property in its assets.

While the policy design in the retirement phase is consistent across structures (APRA funds and SMSFs), there is much more flexibility for SMSFs (given their different structure) and some choice products to manage their taxation obligations.

E5. Are member preference and needs being met by minimising unpaid contributions and lost accounts?

KEY POINTS

- The number of accounts per members has reduced significantly in the last decade.
- The ATO should have the ability to transfer unclaimed monies to the member's last active superannuation account.
- The \$450 per month threshold for superannuation guarantee payments should be removed.
- The ATO should be adequately resourced to enforce the superannuation guarantee obligations of employers.

General comments

The last decade has seen a significant reduction in the number of accounts per person from 2.5 to 1.9 accounts. There is scope for further efficiencies from reductions in accounts.³³

More active matching before and after roll-overs to the ATO

As discussed in the regulatory section (at the beginning of this submission), ASFA considers that more can be done to minimise unpaid contributions and lost accounts. This includes the ATO actively matching inactive and lost superannuation before balances are rolled over to the ATO along with reuniting accounts balances held by the ATO when the ATO has information indicating that the member concerned has another active account. The lost superannuation provisions require lost and inactive balances below \$6,000 to be rolled over to the ATO (from 31 December 2016).³⁴

While the ATO is active in identifying and contacting account owners and encouraging them to consolidate these lost accounts with their other superannuation accounts, it would appear from discussions with the ATO that only a small percentage of these account holders follow through with the necessary action to enable the Commissioner to consolidate these amounts. Given changes to superannuation reporting requirements, that enhanced the Commissioner's information about superannuation accounts, ASFA considers that section 24G of the *Superannuation (Unclaimed Money and Lost Members) Act 1999* should be amended to empower the Commissioner to pay unclaimed money to a complying superannuation plan where the Commissioner is satisfied as to the identity of the lost member account owner and that the person holds an account in the proposed destination fund.

These proposed initiatives would improve efficiency of the system and members' retirement balances.

³³ It does need to be acknowledged that there are good reasons why some people may have more than one account (for example insurance).

³⁴ ASFA considers that the change in the threshold from \$4,000 to \$6,000 has unintended consequences for insurance for members and should be reconsidered.

Removal of the \$450 threshold

The issue as to whether the superannuation system is meeting the needs of members with low incomes or irregular work patterns was addressed by ASFA in its submission to the Senate inquiry into the economic security for women in retirement. ASFA identified a number of factors which, among other things, contribute to lost accounts/unclaimed monies and unpaid contributions, including:

- broken working patterns
- the increasing casualisation of the workforce
- structural issues in superannuation system.

Among other things, ASFA recommended that the \$450-a-month threshold for superannuation guarantee (SG) be removed as it impacts on superannuation contributions for low income earners.

Enforcement of the Superannuation Guarantee

The non-payment of SG contributions by employers is a critical issue affecting the retirement outcomes of Australians. SG non-compliance was assessed to be a \$2.5 billion per annum problem in a 2014 Tria report, rising to \$2.6 billion per annum in the 2015 Tria report³⁵. An average 25 year old impacted by SG non-compliance for five years loses 14 per cent of their retirement income, or around \$8,000 per annum. ASFA estimates show that for a 25 year old, a one-off loss of \$4,000 in superannuation contributions could equate to a loss of over \$14,000 at retirement, in today's dollars.

SG non-compliance is clearly a serious issue and one which represents a significant risk to the retirement security of a large number of Australians. In this context, ASFA considers that dealing with SG non-compliance should be more highly prioritised within the ATO and that the relevant areas within the ATO should be more appropriately funded.

In addition, the treatment of unpaid superannuation in the case of an employer insolvency or bankruptcy is currently subject to a complex combination of legislative provisions.

In ASFA's view, there is merit in reviewing the treatment of unpaid SG entitlements in insolvency or bankruptcy, with the objective of considering how to achieve the maximum possible recovery on behalf of affected employees. ASFA estimates that it would cost around \$150 million per year to include unpaid SG in the Fair Entitlements Guarantee administered by the Australian Government, with around 55,000 individuals affected.

³⁵ Tria Investment Partners 2015, *Superannuation Guarantees Non-compliance*.

Concerns about indicators

Indicator 1 - Unpaid Superannuation Guarantee contributions, and

Indicator 2 - Delayed Superannuation Guarantee contributions

This is a function of employer compliance with their obligations under the SG legislation and industrial relations instruments. This former is monitored and enforced by the ATO. The proposed Single Touch Payroll regime would necessitate reporting by large employers to the ATO of contributions made and would work to mitigate the risk of non-compliance. In addition, compliance would be strengthened through additional funding for the ATO and legislative change to address when employers become insolvent.

Indicator 3 - Number and value of lost accounts

There are a number of issues with the definitions of 'lost' and 'unclaimed' monies under the relevant legislation, which have been amended a number of times over the years.

The definitions tend to be very conservative, 'erring on the side of caution', and so include members where there has been inactivity for a period of time or returned mail, notwithstanding that the member may still be well aware of the fund within which their superannuation is located (by way of example, women who change their names on marriage or divorce often neglect to inform their superannuation funds which, over time, can contribute to increased incidences of 'lost' members). This has a tendency to significantly overstate the number and value of lost accounts, although it would be near impossible to estimate the extent to which this is the case.

The establishment of the relatively new ATO function under myGov, which identifies all superannuation accounts held by the taxpayer, is a valuable service to members to enable them to locate and easily consolidate their superannuation accounts. As identified above, one significant enhancement which could be made to the system would be to provide the ATO with the power to be able to send amounts of unclaimed monies paid to the ATO by a fund in respect of lost members to their current, or last, active superannuation account, without the need for the member to take any action.

E6. Are member preferences and needs being met by funds collecting relevant information to ensure product offerings are suitable for their diverse member bases?

KEY POINTS

- There has been significant investment to understand members through data collection and analytics in order to develop products and services that better match members' needs.
- There are limitations in collecting and maintaining meaningful data, including (lack of) availability, privacy regulations and cost.

General comments

Over recent years, there has been significant investment by funds to understand their members through data collection and analytics. The ultimate aim is to develop products that better match members' needs.³⁶

The importance of data

Funds collect and maintain information about their members for a variety of purposes, some of which is utilised to tailor various aspects of products to suit aspects of members' needs. At a minimum, in order to be able to administer the fund and the member's accounts/benefits, funds collect identifying data about the member (such as name, address, date of birth and often gender and nominated beneficiaries) as well as capturing all of the financial and other transactions which occur with respect to the member's account/benefit. The quality of the data can be dependent upon the initial provision of data by the employer and the subsequent level of member engagement, and sometimes by the use of data matching tools to keep the data up to date.

Funds tend to capture as much data as they are able, but often it is not much more than the minimum necessary to administer the fund. Funds regularly run campaigns to capture additional contact details, such as email addresses and mobile phone numbers, as well as to encourage the nomination of beneficiaries. Funds also will attempt to derive data where possible, such as estimating salary and wages based on assumptions about the level of contributions and the prevailing superannuation guarantees rate, although this can be fraught with inaccuracies and derived estimates are, at best, proxies. Funds will tend to utilise what data they have – for example industry/employer groupings – in such areas as the provision of insurance.

In an ideal world funds would capture data with respect to the member's spouse, dependants, other assets outside superannuation, occupation and industry, and income. There are, however, considerable privacy issues with respect to obtaining this personal information other than directly from the member – if it were to be provided by an intermediary this would generally necessitate obtaining the member's consent.

Defined benefit funds and funds where the members are receiving advice (and have authorised their adviser to supply their personal information to the fund) tend to have more data but it is important to note that all data tends to age, and therefore becomes out of date rapidly.

³⁶ Type of products include lifecycle products that vary asset allocations as people age (and their risk profile changes).

Collection of data with respect to matters such as financial literacy, awareness and engagement can pose significant difficulties. Financial literacy, in particular, is notoriously difficult to assess – even after a member has had extensive face-to-face interaction with an adviser, or through the use of member surveys.

Funds can develop a limited sense of member awareness and engagement through mechanisms such as monitoring:

- Behaviour – including whether members access the website, phone the call centre; send emails/letters or advise of changes to member details
- Transactions – such as making member contributions or additional employer contributions (if identifiable as such), switching between investment options for balances and/or contributions, and increasing or decreasing the level of insurance cover.

However, preferences on investment and risk are also difficult to ascertain, unless – and sometimes even when – a member receives advice from a financial adviser associated with the fund or a survey is performed (which is unlikely to be reliable).

Limitations on obtaining meaningful data

Trustees are increasingly utilising data analytic tools with respect to the data they have in their member databases and client relationship management systems, as well as data revealed through surveys of members, to design their product and service offerings.

However maintaining detailed information about members can be expensive and, in a number of cases, it is close to impossible to collect – even at an individual level – unless the member is receiving advice from an associated financial adviser. This information, such as whether the member has a spouse or dependants, other investments or assets, other funds and additional sources of retirement income, risk preferences and income goals, is a key input into personal financial planning.

Concerns about indicators

Indicator 1 - Information collection by funds on key member characteristics

While this indicator could provide insight as to whether member preferences and needs are being met by funds with respect to product and service offerings, the indicator would have to be broadened. This indicator would have to consider not only the type of data that funds collect on their members (that is, key member characteristics), but also how funds use that data to develop products and match products to members. If not, this indicator would not be particularly helpful.

Indicator 2 - Response rates to funds' member surveys

It is not clear how this indicator would add value to the Commission's assessment, as it merely assesses the degree to which members respond to surveys, not how well this information is used to better tailor products. Funds have a very good idea of the response rates to surveys, and as a matter of normal business, adjust surveys to achieve better response rates. As the draft report identifies itself, there are limitations on surveys that should be acknowledged.

E7. Are member preferences and needs being met by the system providing high-quality information and financial advice to members to help them make decisions?

KEY POINTS

- There have been considerable improvements in member disclosure in recent years, including shorter PDSs and product dashboards.
- Regulatory complexity makes it difficult to provide easy to understand information.
- Access to intra-fund advice is a valuable resource for the majority of members.

General comments

ASFA agrees that the provision of high-quality, easy-to-understand information and education to members about products, services and risks at key stages of their lifecycle (such as the transition to retirement) is a key input to better member outcomes.

A lot of disclosure is driven by regulatory requirements and, by and large, is quite good, although more can be done to improve information to consumers. There have been considerable improvements in the quality of information provided to members in recent years, such as through shorter PDSs and product dashboards for MySuper products. In particular, while there is already considerable disclosure of fees and costs, recent changes to the regulatory regime will result in further information being provided in PDSs from 1 February 2017.

It should be noted, however, that the complexity of superannuation and the regulatory framework, as well as its interactions with the social security system, can make it difficult to provide easy to understand information to members. In order to be accurate, funds often need to resort to utilising technical language, as attempts to paraphrase may be misleading. Also, funds have to qualify most statements along the lines of 'generally' or 'normally' or 'usually', with further details provided separately. This is often coupled with addressing the challenges presented by communicating with members with sub optimal financial literacy, different first languages and across multiple generations. For some members, the ability to make optimal financial decisions is further limited by financial literacy.

A key policy challenge over the next few years will be taking a more consumer-focused perspective on disclosure so consumers have the tools to make a good decision rather than the perfect decision.

Given the above, the majority of members want access to simple, lower-cost financial advice and funds are increasingly offering advice, including through new technologies, such as 'robo-advice' that complements normal advice channels.

Concerns about indicators

Indicator 1 - Availability, cost and quality of information on fees and investment risks at product level

With respect to indicator 1, the main barriers to the provision of transparent and high-quality information to members is the complexity of the superannuation, taxation and social security systems and the regulatory framework with respect to disclosure materials. It is for this reason that access to advice is so important, as it is this which often ‘unlocks’ superannuation for members and assists them to make more informed decisions.

Indicator 2 - Members acting on intra-fund financial advice

Indicators that assess whether members act on intra-fund financial advice provided by their fund may need to incorporate the nature of the advice received, as some advice may not result in a ‘call to action’ (for example, a discussion on investment risk may result in the member concluding that they are comfortable with their current, default, balanced investment option). A better measure may be members’ access to intra-fund advice.

Indicator 3 - Member account monitoring activity

Indicators which focus on member behaviours and actions, such as member account monitoring activity, may be a proxy for member awareness and engagement. However, contact with funds can be an ambiguous measure as members contact funds for a variety of reasons — including as a result of changes in policy settings or coverage of financial matters in the media (so this would not measure satisfaction but awareness).

Indicator 4 - Cost of funds’ member engagement activities

Indicators that focus on the financial costs incurred by funds in offering various services, such as online calculators or robo-advice, need to be determined in conjunction with an assessment of the quality of the services and the value for members.

Indicator 5 - Take up rates of co contributions and offsets

Take-up rates of co-contributions and offsets could be misleading as these are largely a function of the member’s disposable income and expenses, and many members may not be in the financial position to take advantage of such provisions — especially as they are targeted at members on lower incomes.

E8. Are member preferences and needs being met by the system providing products and information to help members optimally consume their retirement incomes?

KEY POINTS

- The pension standards are highly prescriptive and serve to restrict the types of income stream products which can be offered.
- There is strong member demand for account-based pensions for a variety of historical and cultural reasons.

General comments

The system provides products and information to help members optimally consume their retirement incomes within the constraints imposed by the regulatory regime.

The pension standards in the SIS Regulations in effect prescribe that the only forms of income streams which can be offered within superannuation must comply either with the standards applicable to life pensions/annuities or must be an account-based pension. Accordingly, these are the two types of products which can be offered with superannuation, although it should be noted that, for a variety of reasons, the member take-up rate of annuities is very low.

For this reason, in developing its group self-annuitisation product, Mercer was forced establish part of the product outside the superannuation system, notwithstanding that it would be taxed less favourably.

We agree that, from a member's perspective, the ultimate outcome of the superannuation system is the retirement income they will receive. The transition to retirement involves an assessment of a number of complex and inter-related risks – longevity risk, investment/market risk, liquidity risk and sequencing risks – as well as preferences/needs (for example, desire to leave a bequest) in making trade-offs between account-based pensions and annuities. These risks tend to have a greater effect on people in the middle 60-70 per cent of incomes and savings levels, as the bottom 20-30 per cent tend to rely on the Age Pension and the top 10-15 per cent tend to be fully funded.

Ensuring optimal consumption of retirement income largely is beyond the direct control of the superannuation system. The rate at which retirement income is consumed is a function of members' circumstances and decisions, including the quantum of the retirement benefit and household budgeting. This is an area where good personal financial advice can help members manage their various risks, preferences and needs. Account-based pensions are an example of a retirement product that allows members to consume retirement income in a manner best suited to their individual needs and risk preferences, as the member retains control over the investment and drawdown rates of the pension.

Account-based pensions have a residual capital value (the balance on the account) which can be left as a bequest and may be commuted in full or in part (liquidity), but offer less protection against longevity and market risk. Annuities, on the other hand, address longevity and market risk (which comes at a price), but depending on the circumstances may have no residual capital value and cannot always be commuted. With account-based pensions, members have control over how their superannuation is invested and the frequency and amount of their draw-downs (subject to statutory minimums).

All things being equal, an annuity will involve a trade-off of income in exchange for protection against longevity and market risk. As the superannuation system is still maturing, average account balances of retirees are still relatively small. This, coupled with prevailing low interest rates, means members tend to acquire account-based pensions.

We agree that at a system level it is challenging to define what 'optimal' consumption of retirement income looks like. The needs and preferences of individuals are highly diverse and will be influenced by a range of factors. It is these factors which determine both the initial allocation between account-based pensions and annuities (and lump sums) and, within an account-based pension, the investment mix and draw-down rates. One of the inherent features of account-based pensions is that they allow members to adjust payments over time in accordance with their preferences and needs.

Individual circumstances and preferences are an incredibly strong determinant of the availability of retirement income products. Demand is driven by a myriad of individual member decisions and – by and large – the average member prefers to acquire an account-based pension. Not only should member preferences and circumstances not be discounted, they are the driving factors – an example of market forces at work in a competitive market.

The fact that there is less choice and a higher market concentration in the annuities market largely is a function of demand at the moment. Proposed legislative changes, coupled with education as to the benefits of ensuring a minimum level of income, are likely to increase demand for these products.

Concerns about indicators

Indicator 1 - Supply of products and information

This indicator focuses on product diversity and take-up rates for different types of retirement income products. We agree that there are recognised limitations with this type of indicator and that, in particular, low levels of take up of annuities does not reflect inefficiency, but instead lack of consumer demand at present. International comparisons will struggle to account for differences not only in policy settings across countries, but for historical and cultural differences as well. We agree that evidence of product evolution and pricing at the provider level will only provide a partial insight, at best, into trends across the system. Interpretation of this indicator would need to be contextualised to take account of other factors outlined above which influence product diversity and take-up rates – in particular the lack of member demand.

Indicator 2 - How new retirement income products are evolving

This indicator – in focusing on the extent to which providers are seeking to discover the circumstances and preferences of current and prospective consumers, and subsequently using this information to better tailor products – is conceptually flawed. There are significant regulatory constraints as to what can be offered and a limitation to how much a disciplined drawdown of a retirement benefit can vary. The preferences and circumstances of members are known only to them, and potentially their financial advisers. The best way to develop retirement income products to take account of this – subject to regulatory requirements – is to permit appropriate flexibility for members. This is especially the case as members' preferences and needs are likely to vary quite considerably over the period of their retirement (which is one of the reasons members are reluctant to commit any significant amounts of capital to annuity-type products).

Indicator 3 - Drawdown rates and unclaimed superannuation

How a member chooses to draw down their retirement income will be a function of their initial account balance, and their preferences and needs.

Comparisons between actual drawdown rates and minimum drawdown rates (for account-based pensions) will largely be a function of size of account balances and assets/incomes outside superannuation. Drawdown rates will change for higher age categories as the minimum drawdown rate increases with age. Differences between male and female drawdown rates are as likely to be influenced by whether they are part of a couple or single, and whether or not they receive a part or full age pension, as they are by life expectancy. In analysing whether drawdown rates change substantially when the minimum rates are adjusted, it would be important to bear in mind that drawdown does not necessarily equate to consumption – for many members with larger amounts in superannuation at least some of their drawn down amounts may be saved (outside superannuation) as opposed to being consumed.

It should also be borne in mind that there are some conceptual and practical difficulties with the various definitions of lost and unclaimed superannuation. In some cases the member may be aware of their superannuation but have consciously decided not to draw upon it.

E9. Are members' balances being allocated in line with their risk preferences and needs?

KEY POINTS

- Given the diversity of individual preferences and circumstances it is impossible to define what optimal asset allocation looks for every member.
- While data analytics is improving understanding of members there are constraints on customisation
- Lifecycle and target date investment products have merit in default products.

General comments

At the system level it is impossible to define what optimal asset allocation looks like for every individual member, given the diversity of preferences and circumstances.

Life-cycle and target-date investment products are aimed at addressing, managing and mitigating the risk of investment volatility, where the consequences are exacerbated by a person's relatively advanced age (that is, with less time to retirement to make up losses) or by being in the drawdown phase.

Whether or not life-cycle and target-date products have merit as a default will be a function of the demographic and financial characteristics of the members of that product, which the trustee will take into consideration when determining whether to develop such a product.

It should be recognised that life-cycle and target-date products are still relatively young and are evolving. In addition to the member's age, some products are already taking into account additional factors such as account balance and estimated income.

While data analytics is helping improve understanding of members, it is impossible for a fund to be fully aware of the consumption needs of individual members – this is information known only to the members themselves. Asset allocation is the primary method for managing sequencing risk in pooled products – in account-based pension products the frequency, quantum and timing of withdrawals is within the control of the member, as it is with SMSFs.

Whether pooled products, such as MySuper, change asset allocation as members reach specified ages is a decision for the trustee, taking into consideration the demographic and financial characteristics of their membership and whether, for example, the majority of members ultimately will transition into an account-based pension in retirement. Very few default funds have taken the step of automatically defaulting members into a pension option, recognising the importance of the member's input to this decision). For members in choice products and SMSFs it is largely up to the member's and/or advisor to attempt to manage the member's sequencing risk.

Concerns about indicators

Indicator 1 - Comparisons of asset allocations for specific age cohorts across different segments of the market and for different products (such as choice and MySuper products)

This indicator could be difficult to measure. Any analysis would also have to be performed with caution, and ideally by product type, as it is the members themselves (or their advisers) who determine the asset allocation in platform/wrap/IDPS products (choice) and SMSFs. We broadly assume these members tend to have higher account balances and higher incomes and make individual decisions based on the financial circumstances of their household, including assets and investment held outside superannuation.

Indicator 2 - The introduction of new retirement income products and the development of more tailored default products.

While data analytics are improving fund's understanding of members behaviours there are constraints on mass customisation. In the retirement phase, account-based pensions are inherently flexible and allow members to customise their asset allocation and drawn downs, while annuities, as a result of regulatory constraints, are limited in the degree to which they can be customised.

In the accumulation phase, life-cycle and target-date products are relatively new, and are beginning to evolve to take account of factors in addition to the member's age, such as account balance. It is near impossible, however, for a pooled product to align asset allocation with individual member risk preferences and needs – this is done by the trustee having regard to the membership as a whole.

Indicator 3 - Member awareness of investment, sequencing and longevity risks

This indicator is mainly of relevance where the member is choosing a retirement income stream product, although it can come into play in when making decisions in choice products and SMSFs as well. To the extent the trustee is making this decision for a default product, such as MySuper, it is the trustee's awareness which is at issue.

Higher levels of member awareness of these risks does not necessarily indicate that market outcomes are more in line with member preferences – the awareness would need to be coupled with action on the part of the member when choosing a retirement income stream product (or within a choice product or SMSF). This is often with the assistance of fund advice and information, including robo-advice, or advice from a financial adviser.

E10. Is the system using behavioural finance to design products?

KEY POINTS

- Funds' use of insights from behavioural finance is a worthy issue, but it is a second-order criterion in the Commission's framework.
- Behavioural finance insights are a source of innovation for funds for designing products, services, member communications and modes to deliver products and services in ways that lean against behavioural biases and improve member outcomes.

General comments

Funds' use of behavioural finance insights is a worthy issue, but it is a second-order criterion with respect to the Commission's framework. The criterion has a single proposed indicator: *Funds' application of the lessons from behavioural finance to design products*. ASFA has no specific concerns with the indicator.

The Commission is correct when it notes that the superannuation system does address behavioural biases with respect to financial decisions. In fact, the design of the Australian compulsory superannuation system, and of MySuper, reflects principles of behavioural finance and myopic behaviour in terms of saving for retirement.

- Compulsory contributions and default products lean against the effects of myopic behaviour. In general, people appear to focus on near-term consumption to the detriment of longer-term consumption to a greater degree than conventional economic theories predict. As such, people tend to undervalue future benefits when making saving decisions.³⁷
- Similarly, insurance that is provided on a default, opt out basis counters myopic behaviour with respect to mitigating risk.
- Funds' provision of ready-made investment portfolio products aligns with the way in which people typically make complex decisions – that is, people tend to make complex decisions based on rules of thumb (heuristics).

Behavioural finance is an ongoing source of innovation among superannuation funds. Developments in behavioural finance helps funds design products, services, member communications and modes of delivering products and services in ways that 'lean against behavioural biases' and improve member outcomes. Such innovation enables funds to differentiate themselves, and their products and services, in the market. That said, behavioural finance is one of many considerations that funds take into account in this regard.

Examples where funds have used behavioural finance insights include the development of retirement incomes projections on members' statements, particularly when these are interactive or linked to retirement calculators. These tools help 'nudge' members to take more interest in their superannuation savings. Funds have observed increased contribution and rollover rates (both in and out) as a consequence of making these calculators available.

³⁷ Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, page 188.

Funds' use of behavioural finance does vary across sectors. In the SMSF sector, members/trustees remain vulnerable to the well-known biases identified by the behavioural finance literature, as they do not benefit from the oversight of others who may work to correct against these biases in decision making (compared to a fund trustee in a pooled fund).³⁸

³⁸ State Street 2014, *Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry*, December 2014.

E11. Are the trustees acting in the best interests of members?

This criterion covers the same issues as those identified in our response on *Competition Criterion 5*. All relevant issues are covered in our response to that criterion.

E12. Are there material systemic risks in the superannuation system?

KEY POINTS

- Systemic risk in the superannuation system is a broad and complex issue, and arguably should be the basis of a third lens through which to examine the system along with competition and efficiency.
- As such, the proposed indicators are not adequate to assess sufficiently the nature and extent of systemic risk in the superannuation system, and the implications for stability, efficiency and competition.
- This criterion should be revised or removed.

General comments

ASFA agrees that this is an important issue but considers that this criterion as outlined does not add value to the Commission's framework. ASFA considers that the criterion should be revised or removed.

There is a link between system stability and efficiency. Arguably, a more stable system would be able to achieve greater ongoing improvements in both operational and allocative efficiency, and better support innovation (together reflected in dynamic efficiency). However, system stability is a broad and complex issue, and arguably should be the basis of a third lens through which to examine the system (along with competition and efficiency), particularly given the complex trade-offs between efficiency, competition and stability.

Analysis necessarily would be complex. It would require assessment of the following:

- The sources of potential vulnerabilities among funds, as well as the multitude of service providers that support funds. This includes the full-service providers, but also other entities that provide niche services.
- Concentration risk with respect to financial markets – for example, a broad shift by funds to passive management of equities on the ASX (which is already highly concentrated³⁹), could lead to systematic trading strategies that inadvertently increase concentration risk.
- The nature of the linkages in the complex network of entities in the superannuation system (and the linkages to the broader financial system).
 - These linkages are the paths by which local failures may (in certain circumstances) be transmitted across the network.⁴⁰
- How disruptions would be transmitted through these linkages.
- The size and severity of particular disruptions on parts of the supply chain.
- The role of regulatory supervision and governance – in particular, how effective regulatory and governance regimes are in reducing particular systemic risks.

³⁹ Small number of relatively large-cap stocks and the two dominant sectors: banking and mining/materials.

⁴⁰ Donald, S., Bateman, H., Buckley, R., Liu, K. and Nicholls, R. 2016, 'Too connected to fail: The regulation of systemic risk within Australia's superannuation system', *Journal of Financial Regulation*, vol. 2, no. 1.

- Potential systemic risks from technology in general.
 - As technology continues to increase network speeds, broaden distribution networks and heighten levels of interconnectivity, these changes can also amplify the risks of failure across the system.
 - The pace of technology-driven market developments can challenge regulatory frameworks and make it difficult for regulators to adapt with sufficient speed.⁴¹

The proposed set of indicators is not sufficient for such analysis.

Concerns about indicators

With regard to the indicators as proposed, ASFA has a number of concerns.

Indicator 1 - Market concentration

As noted in our response to *Competition Criterion 6*, derived figures for this indicator would require careful interpretation.

While ASFA considers that HHI analysis is worthwhile in this context (given the caveats), the HHI would not be an adequate indicator of the degree to which a particular service provider market poses a systemic risk to the superannuation system, or the broader financial system.

As noted above, such analysis would require significant context. In particular, analysis would need to look at:

- the nature of the linkages between the particular service provider markets and the rest of the superannuation system (and the broader financial system)
- how a disruption would be transmitted through those linkages
- the size and severity of particular effects on other parts of the supply chain
- in the case of a failure of/disruption to a service provider, the availability of alternative providers (note that the providers of wholesale administrative services are broader than just the full-service providers and include providers of niche services).

Indicator 2 - Levels of leverage in SMSFs

The level of leverage in SMSFs is a necessary, but not sufficient, indicator of the systemic risks posed by leverage in SMSFs.

The Commission also would have to consider the prevalence of SMSFs (number of members), and assess levels of capital, including provisions for economic capital.⁴² In this regard, the Commission also could undertake stress-testing to determine whether there are systemic risks associated with leverage and asset concentration in the SMSF sector.

⁴¹ The Australian Government 2014, *Financial System Inquiry*, Final Report, page 144.

⁴² Broadly speaking, economic capital is the amount of capital that an entity needs as a buffer against the risk that it holds.

In addition, such analysis would require significant context (as for indicator 1). In particular, analysis would need to look at the nature of the linkages between SMSFs and the rest of the superannuation system (and the broader financial system) and how a disruption would be transmitted through those linkages.

E13. Do funds offer insurance products that meet members' needs?

KEY POINTS

- The objective should incorporate the broader social and economic benefits of insurance in superannuation.
- The extent to which superannuation in insurance alleviates underinsurance and social security expenditure should be included as an indicator and measured.
- The indicators should measure the value of insurance in superannuation at an aggregate and policy holder level, including consideration of:
 - * the total level of protection delivered to the community through insurance in superannuation
 - * the provision of affordable cover that may otherwise be unavailable
 - * non-financial benefits such as rehabilitation
- Trustees have duties to ensure insurance in superannuation is meeting members' needs, reinforced through the funds' Insurance Management Framework and Insurance Strategy which are developed in accordance with Superannuation Prudential Standards.
- Comparisons to retail benchmarks should be replaced with appropriate measurement of group insurance in its own right.

General Comments

Consistent with our commentary on the objective of insurance in superannuation, we believe the criterion needs to be expanded to ensure the subsequent indicators measure the broader social and economic benefits delivered through the system. Accordingly, the criterion should be expanded to be:

Criterion - Do funds offer insurance products that meet members' needs and delivers valuable protection to the community?

The superannuation system enables members to manage the financial risks associated with ill-health or premature death during their working life whilst also supporting substantially improved retirement outcomes for claimants.

Currently, superannuation insurance arrangements amount to:

- 71 per cent of total death sums insured in the community
- 88 per cent of total and permanent disability sums insured
- 59 per cent of total income protection/salary continuance/total but temporary disability benefits insured.

Despite the wide member coverage provided through superannuation funds, the level of underinsurance remains high. The median level of life cover meets about 61 per cent of the basic needs for average households – and for families with children it is a much-lower proportion of needs.⁴³

⁴³ Rice Warner 2014, *Insurance Administration Expenses*.

The impact of this underinsurance on increasing social security payments is significant. An analysis of aggregate insurance held by the working community inside and outside of superannuation estimates the cost to government of increased social security payments arising from underinsurance to be in excess of \$1 billion per annum across these insurance types, comprised of:

- \$60 million per annum for death cover
- \$840 million per annum for total and permanent disability (TPD) insurance
- \$140 million per annum for income protection insurance.⁴⁴

In addition to these social security costs, there is a significant further cost through lost economic production and resulting income tax in respect of partners ceasing work to care for the family.

Concerns about indicators and data

Indicator 1 - Duplicate insurance policies by insurance type

Obtaining the data to measure multiple insurance policies by insurance type is likely to prove difficult, as superannuation funds do not have data in relation to member's coverage outside their fund. We understand that the ATO's SuperMatch2 service does contain a Y/N insurance indicator however this does not inform of insurance by type.⁴⁵

A further constraint is that many members have made a conscious choice to pay multiple premiums for higher levels of aggregate cover where multiple policies will respond in the case of an insurable event (typically the case for death and TPD). This includes maintaining default levels of insurance cover offered by one or more providers. For the proposed indicator to be meaningful it will be important to segment these members from those who are disengaged and paying multiple premiums for excessive levels of cover. In practice, however, it is unlikely to be feasible to do this.

It is worth noting that where Income Protection coverage is provided, the cover is likely to lapse in most circumstances where the member has a duplicate policy, as cover is based on receipt of contributions rather than maintenance of an account balance.

The nature of default cover levels is such that it will not always suit all members. This emphasises the importance of the initial communication with members, when cover first commences, as a means to drive consumers to tailor their cover, including consideration of opting out.

More broadly, superannuation funds use of innovation and technology, combined with the advent of intra-fund advice, are gradually leading to increased levels of member engagement with their insurance, mitigating the potential for unintentional duplicate policies. We discuss the impact and measurability of increased engagement in further detail later in this section.

⁴⁴ Rice Warner 2014, *Insurance Administration Expenses*.

⁴⁵ For details see, https://www.ato.gov.au/super/apra-regulated-funds/in-detail/apra-resources/super-reform---a-guide-for-apra-funds/?page=4#SuperMatch_2.

In August 2016 the ATO released their most recent data with respect to the number of Australians with multiple superannuation accounts, based on member data reported by funds as at 30 June 2016. The data indicated that over 14.8 million Australians (just over 14 million in 2015) had a superannuation fund account. Approximately 43% of these people have more than one superannuation account.⁴⁶ On average people have approximately 1.9 accounts and this has decreased from 2.5 accounts over the last decade⁴⁷.

Table 3: Individuals' number of accounts

Number of accounts	Percentage of people	2015 figure
1 account	57%	55%
2 accounts	25%	26%
3 accounts	10%	11%
4 accounts	4%	4%
5 accounts	2%	2%
6 – 23 accounts	2%	2%

The ATO data is somewhat encouraging with a year on year increase in the number of single account holders noted. This trend is likely to continue, with account consolidation easier to undertake as a result of a range of recently implemented regulatory mechanisms, such as through myGov, and the provision of information on how to consolidate superannuation accounts readily available on ASIC's MoneySmart website.⁴⁸ Further significant account consolidation will also occur as 'accrued default amounts' are compulsorily transferred to MySuper accounts by 1 July 2017, as part of the Stronger Super reforms (ASFA has previously expressed concerns that insurance rights will be lost in this process). However as outlined in the effects of regulatory costs on efficiency section early in the submission, there is still scope for further efficiencies in the reduction of accounts. This could include amending legislation to empower the Commissioner to pay unclaimed money to a complying superannuation plan where the Commissioner is satisfied as to the identity of the lost member account owner and that the person holds an account in the proposed destination account.

While there is no data readily available with respect to insurance coverage by type for those with multiple accounts, industry estimates indicate that around 50% of inactive accounts in both the \$2,000 to \$4,000 and \$4,000 to \$6,000 balance ranges have insurance cover. Moving these accounts to the ATO will lead to a loss of valuable insurance cover for affected members and ASFA has publicly expressed concern with this outcome.⁴⁹

⁴⁶ ATO 2016, *Super Accounts Data Overview* (<https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Super-accounts-data-overview/>).

⁴⁷ ASFA derived, based on APRA and ATO data.

⁴⁸ For details see, <https://www.moneysmart.gov.au/superannuation-and-retirement/keeping-track-and-lost-super/consolidating-super-funds#how>.

⁴⁹ ASFA 2016, *Lost Super and Related Insurance Benefits Must be Fixed*, media release, 18 August 2016.

Clearly, these recently implemented regulatory mechanisms are driving measurably higher levels of account consolidation thus reducing unintentional duplicate insurance policies.

The risk of extinguishment of insurance rights without member consent, leaving affected members and their families without insurance cover to protect them from misfortune as a result of injury, illness or premature death, should be contrasted with the risk presented by duplicate insurance policies of paying more in premiums.

Considering the broader objective of insurance in superannuation, it is important to understand what detriment reductions in coverage have on members and the community at large. The cost of a duplicate insurance premium can only ever be the excess premium itself – in comparison there are potentially devastating consequences for individuals, families and society posed by the loss or lack of insurance cover. Both duplicate policies (over insurance) *and* loss/lack of cover (underinsurance) need to be measured for the review to be fully informed.

Recommendation

Additional indicators are included as follows:

- *Aggregate level of protection provided through group insurance arrangements in superannuation (level/value and number of members covered)*
- *Private and public costs of underinsurance arising from reduced levels of group insurance coverage*

Indicator 2 - Rates of insurance take up in choice products and SMSFs relative to default products

Funding insurance premiums within superannuation has become an important part of providing millions of Australians with cover and provides a safety net to those who otherwise would not have taken out insurance individually. Group insurance, in many cases afforded to members automatically as part of their MySuper account, provides a valuable social benefit which assists members deal with illness or injury or premature death.

It is unclear what this indicator is attempting to measure or why. On the face of it, the indicator appears to be seeking to compare unrelated, uncorrelated behaviour between two very different subsets of members (default and choice), for whom insurance offerings are designed very differently.

For example, a lower take up rate in choice products and SMSFs cannot lead to any meaningful inference in relation to the value of default group cover which is designed by trustees to protect members in circumstances where they do not make an active choice and rely on there being a default level of cover. Some members may in fact retain their default superannuation product due to the insurance cover but elect to utilise a choice platform or SMSF for investment purposes. Others may arrange insurance cover outside of superannuation. On this basis, we query the validity of this proposed indicator and recommend it not be used.

A better indicator would be one that demonstrates the behaviour of members in default insurance arrangements who take action with respect to their cover. Such action could include, for example, increasing or decreasing their level of cover, or opting out of cover altogether. In other words, the indicator should measure the effective take up rate of additional cover among those who take action to amend their default cover in some fashion.

One large fund has indicated that, on an annual basis, approximately 13 per cent of members 'opt-up' and increase their default level of cover, whilst only 2 per cent 'opt out' and cancel their cover. So for this particular group of members, when they do engage with their default insurance cover they are much more likely to take positive action to increase that cover than they are to extinguish the cover. Whilst the precise figures will of course vary from fund to fund, other ASFA members have indicated a similar experience within their funds. At a system level, this indicator would be a more suitable proxy to assist in determining whether default insurance is delivering appropriate value, meeting member needs and achieving the objective of insurance in the system.

It is also impossible to determine what proportion of default members have actively considered whether their default coverage is appropriate for them. Given the role of the trustee in considering members' best interests when designing and constructing group cover, many members may be satisfied that the default insurance offering largely meets their individual needs, at least at the level of being a safety net.

Recommendation

This indicator is replaced with:

- *Ratio of members increasing default cover to cancelling default cover.*

Indicator 3 - Member awareness of key features of their superannuation, including insurance

Comments on member awareness of key features of superannuation are included earlier in the submission. This indicator is difficult to measure for insurance. As noted above, maintenance of default coverage should not be assumed to be due to a lack of awareness, as many members elect to maintain their default settings once they become familiar with them because they are happy with the cover or cannot justify the additional expense of increasing their cover. Funds and insurers provide a variety of tools to assist members to consider their insurance arrangements, including calculators and quote tools. Measuring usage of these tools is one way to gauge whether members who do not vary their cover are engaging with their insurance.

Informing members of the appropriate levels of default cover is critical, however, given the complex nature of group insurance this alone will not always be sufficient to meet all members' needs. As such, funds and insurers have increasingly invested in technology and simplified processes to enable members to vary their cover or opt out should the default benefit design not meet their needs. The advent of intra-fund advice has assisted this process by enabling funds to provide personal advice to members in relation to their insurance within the fund.

Member awareness of life insurance has gradually improved over the past decade - largely driven by the aforementioned investment by superannuation funds and insurers and their focus on communicating key features and benefits, including insurance, to fund members. In addition, there has been increased competition between funds on the basis of insurance. Awareness of insurance can also be triggered at the time a member suffers an event and contacts their superannuation fund seeking financial support. An awareness issue remains for many members at an earlier age, where engagement with insurance and superannuation more generally is relatively low.

Increasing awareness will remain a key focus for the industry and we support an indicator that seeks to measure this. Longitudinal or time series data to decipher the trend of member engagement would be appropriate, to assess whether the efforts of industry to increase levels of engagement over time are bearing fruit. The degree of education and advice provided by fund trustees in relation to insurance in superannuation should be considered.

It is, however, commensurately important to incorporate indicators that measure the overall value of insurance cover for all members, including those who remain disengaged but nonetheless benefit from the existence of cover.

Insurance cover being provided as a default in MySuper, and some choice products, without relying on members making a conscious decision and taking action to acquire it, ensures a far higher degree of coverage than would otherwise be the case. Members who are relatively disengaged are, as a result of this disengagement, also significantly less likely to arrange life insurance individually outside superannuation and so would be at the greatest risk of being uninsured.

This indicates that the objectives of insurance in superannuation cannot be met by catering only to engaged members within the system. Recognition of this in major industry and sector reviews, and by successive Governments, is reflected in the legislative and regulatory framework that has underpinned the development of default insurance cover in superannuation in recent years.

Accordingly, we recommend that the Commission have regard to additional indicators that consider the following benefits arising through group insurance arrangements.

Providing access to cover where it otherwise may not be affordable

Group insurance is based on a pooling of lives that, in the absence of individual medical underwriting, includes a selection of both good and bad risks. This means that members who may have pre-existing medical conditions, work casually or part-time or work in high risk occupations are generally able to access insurance cover through group arrangements at an affordable price, without the imposition of restrictions and exclusions or premium loadings – or even denial of cover - if they were to be underwritten for individual cover.

(Note: A potential indicator to measure the value of this benefit is discussed in the next section of this submission dealing with costs of insurance).

Providing cover where individuals would not otherwise have cover in place

The evolution of group insurance over the past 20 years has seen up to 92 per cent of the working population afforded some type of insurance coverage that would otherwise not be in place.⁵⁰

Recent research indicates that almost half of those with life insurance in superannuation believed they would not be covered if it were not provided automatically⁵¹. Without default cover offered on an opt-out basis, a potential claims gap approaching \$2bn⁵² may be created, the benefit of which superannuation members and their families would forego at their time of need. The alternative for these individuals is to rely on social security and other welfare benefits to maintain some standard of living, creating a further drain on the Federal Budget. Provision of appropriate levels of insurance cover through superannuation is, in ASFA's view, an example of allocative efficiency.

Providing individuals support through their claim beyond simply financial benefits

The benefits delivered under group life insurance are more than just the amount of the financial benefit paid to the member or their dependants.

⁵⁰ Rice Warner 2015, *Under Insurance in Australia*.

⁵¹ AIA Insurance 2016, *Life Today Study*.

⁵² APRA, *Annual Superannuation Bulletin*, June 2015 (Table 13 aggregate claims paid \$4.2b for year ended June 2015).

Superannuation funds, together with insurers, have increasingly extended the support services offered to members through occupational rehabilitation and return to work support. In part, this has been delivered by life insurer claims assessors themselves, many of whom have allied health experience. This is a reflection of the focus on the member's ability, rather than their disability, and the desire of all parties involved - the member, the employer, the superannuation fund and the insurer - to see the member return to work in some capacity where possible.

Assisting a member to return to work in some capacity, while also giving the member a sense of purpose, also ensures they can continue to earn an income and save for their retirement, further reducing the drain on the public purse. This supports not only the objective of insurance in the system but a number of the other system objectives pertaining to retirement outcomes.

Insurers have extended their services to look at preventative measures, focusing on the health and wellness of members, to help them avoid or minimise the impact of preventable illness and injury. This includes investment in stay at work and absence management programs.⁵³ There are regulatory impediments that prevent insurers from providing targeted rehabilitation benefits to members that would assist them to return to the workplace faster. These should be addressed to improve outcomes for members.

Below are two real life examples (*names and details have been changed to maintain privacy) demonstrating how the group insurance market provides this support in practice.

Case Study – Work readiness and occupational rehabilitation within insurance in superannuation

Isabelle*, a 46 year old pharmacy assistant diagnosed with major depression and anxiety, attempted to return to work. However, she was unsuccessful due to the stressful and unpredictable nature of her workplace. A tailored work readiness program was developed by her group insurer to assist Isabelle to focus on her wellness and readiness for work. A key part of the program was maintaining a strong link with her treating psychologist and supporting Isabelle to stay engaged with the community through a tailored voluntary position at a local wildlife park.

Once Isabelle regained confidence and focus, the insurer assisted her with re-training into a better-matched occupation and then provided job seeking support to obtain a paid position in aged care. Isabelle is now working within the aged care industry.

Case Study – Occupational rehabilitation within insurance in superannuation

Jack*, a 35 year old financial planner with a long term Income Protection benefit, was diagnosed with a brain tumour and underwent surgery. He required multidisciplinary rehabilitation post-surgery due to a stroke which caused paralysis and he suffered cognitive difficulties. Five years later, as part of ongoing communication, the group insurer's rehabilitation team developed an extensive occupational rehabilitation program to provide Jack with assistance with job seeking and obtaining further education and a certificate of administration. Within two years of the rehabilitation program commencing, Jack successfully obtained work in a part-time administration role and also commenced a temporary role as an education support officer. This represents an excellent outcome in light of Jack's health condition and demonstrates that where people are provided with support and assistance by insurers, as part of their group insurance policy, a return to work is possible.

Recommendation

Additional indicators are included as follows:

- *Ratio of members using tools such as 'needs calculators' and/or 'quote tools' (for those who otherwise do not vary cover)*
- *The degree of education and advice provided by super fund trustees in relation to insurance in super*
- *The ratio of members with insurance coverage through risk pooling/group underwriting compared to choice only*
- *The value of non-financial benefits, such as return to work programs, delivered through group insurance in superannuation*

Indicator 4 - Level of unclaimed insurance

This indicator is difficult to measure.

We do not expect that there would be a significant degree of unclaimed insurance in the system as when an insurable incident occurs, insurance arrangements within superannuation are a typical areas of investigation for a claimant or their family either unilaterally or in conjunction with legal/financial advisers.

Trustees are obligated to pursue all reasonable claims and claims processes mitigate the risk of unclaimed insurance arising amongst their members. For example, one ASFA member indicated they have an early intervention program to encourage early claims notification and are also developing a strategy for employer notified claims.

Measuring changes in notification periods over time would be one way of assessing whether awareness was increasing, leading to a decreased likelihood of unclaimed insurance. ASFA members indicate that notification periods have been decreasing over time, which suggests that increased levels of members engagement and improved business processes are having the desired effect.

It should be recognised, however, that exogenous factors beyond the control of trustees and insurers impacts on notification periods. In recent times the percentage of claims with a solicitor attached early in the claims process has increased and the notification delays on these claims is substantially higher than for those notified directly.

In addition, there can also be reasonable grounds upon which members opt not to lodge claims, such as the utilisation of workers compensation and sick leave provisions contained in particular enterprise bargaining agreements. These types of activities would need to be adjusted for, so that the underlying improvement could be evidenced.

Recommendation

This indicator is replaced with:

- *Length of notification periods (longitudinal analysis with reasonable adjustments for exogenous factors)*

Indicator 5 - Ease of members opting out of insurance

There is a broader issue than the ease of members opting out of insurance, and that is the ease with which members can amend their insurance arrangements more generally. This includes opting-out but should be extended to dialling cover up or down.

In general, it is relatively simple for members to make changes to their insurance arrangements by contacting their superannuation fund. Member statements contain detail about the level of insured benefits and premiums paid. Members can call, email or write to reduce or cancel insurance. Increasing insurance usually requires an application and in many instances there is an online tool available for members to initiate this.

Furthermore, insurance strategies have evolved to consider these matters in greater depth as prudential standards have increased in recent years. Funds also have to report to APRA in relation to these matters. Despite the ease with which members can opt-out of their default insurance arrangements, as noted earlier in this section, opt-out rates are quite low.

Recommendation

This indicator is replaced with:

- *Ease of members amending insurance arrangements in superannuation.*

Indicator 6 - Time to respond to members compared to retail provider benchmarks

It is not clear to us what is intended to be measured here, or why group insurance should be assessed against retail benchmarks. Despite this, for a number of reasons outlined below, we believe the arrangements across industry would do quite well on many aspects in such a comparison. However, it would be more appropriate to seek to assess group insurance against its own reasonable benchmarks, particularly given the (necessarily) very different processes that occur in each area.

For example, claims timeframes in group insurance must consider the trustee claims review process that overlays the insurer's assessment. This is of significant value to members as there is an additional layer of scrutiny to ensure claims outcomes are in line with the terms of the policy. It would be unreasonable to measure this additional trustee review time and conclude members are worse off than in retail arrangements simply because the claims process can take additional time, as such a benchmark does not consider the important role of the trustee in protecting members' rights.

The recent advent of prudential standards for superannuation, including in relation to insurance, means that trustees must demonstrate to APRA that they have mechanisms in place to protect individual members and ensure they receive timely service from the trustee and insurer. Under Prudential Standard SPS 250 this must be measurable by the trustee. As such, trustees will negotiate appropriate service standards with insurers and these will be incorporated in contractual service level agreements.

When negotiating fund level group insurance contracts trustees can leverage wholesale bargaining power that arises when striking an arrangement for many members, rather than for an individual member. This can lead to price and service benefits that are not able to be achieved in the retail insurance market in all cases. Some of these include online self-service to vary insurance arrangements and the use of needs analysis, quotes and underwriting engines.

It is important to bear in the mind the different value propositions of group insurance as compared to retail. Often, retail policies will be initiated with the benefit of financial advice and tailored to the needs of the individual as established via a comprehensive advice process. Group insurance is designed to provide benefits to a pool of members, rather than an individual member. Different service models and insurance designs arise as a consequence and it does not make sense to compare these with each other.

Instead of comparing group arrangements to retail benchmarks, the Commission should seek to measure whether the insurance design and services that group insurance members receive are sufficient and appropriate to meet the needs of members (we note insurance design is considered within the indicators that follow, hence we have confined our recommendation for this particular indicator to the measurement of service levels). As APRA are already considering these matters and they are prescribed in prudential standards, this should form the starting point for any reasonable assessment.

Recommendation

This indicator is replaced with:

- *Service levels, including response timeframes, meet the terms of SPS 250*

Indicator 7 - Information collection by funds on key member characteristics, and

Indicator 8 - Use of member information by funds to target insurance products

The way that funds utilise information to create the best possible outcomes for members raises important issues around insurance product design and the strong framework of trustee obligations that underpin this. In this section we consider how insurance design is evolving in the market place. The more salient factor that should be measured to determine whether default cover is meeting members' needs is whether, and how, improved trustee processes to collect and use of member information are translating into better insurance product design.

There is strong evidence that funds have a focus on ensuring the insurance provided within superannuation is meeting members' needs. The trustees are under trust duties to do so, which is reinforced through the funds' Insurance Management Framework and Insurance Strategy, developed in accordance with Superannuation Prudential Standards which were issued as part of the rollout of the Stronger Super reforms, in particular SPS 250.

Trustees applying for MySuper authorisation were required to demonstrate to APRA how the demographics of the fund were taken into account in developing the default Death & TPD benefits of their MySuper product.

The market has continued to evolve as funds seek to better target their benefit design to their members needs and preferences. In recent years, more funds have undertaken consumer testing and research to inform benefit design. For example, one recent piece of consumer research and testing demonstrated that 66% of TPD claimants wanted assistance finding a job and 69% wanted assistance in retraining or up skilling.⁵⁴

⁵⁴ Sunsuper and AIA Consumer Research, June 2015.

Member demographics are increasingly being taken into consideration when developing benefit designs and ensuring the right levels of default cover are in place to meet the needs of a fund's membership, together with flexibility to increase or decrease cover as suits their needs. Some examples of benefits to members that can flow from these increasingly rigorous design processes include early intervention pre-claim, rehabilitation post-claim, and the removal of waiting periods.

It is important to note that trustees have access to limited information and utilise what they have well including data on age, gender and salary. There is other data which could further enhance benefit design that is generally not available to trustees at the time of joining, such as marital status, dependants, debt levels and superannuation entitlements in other funds. Any indicator should recognise the inherent data limitations that trustees are working with.

Indicator 9 - Comparability of insurance product information disclosed by funds

As has already been discussed in this section, trustees provide a variety of tools to assist members to consider their insurance arrangements both at the on-boarding stage and once cover is in place. There has been increased investment in technology and simplified processes to assist members by communicating key features and benefits of their insurance. Funds are also providing members with intra-fund advice in relation to their insurance arrangements.

Comparability of insurance product information is supported, however it is important to compare the full range of costs and benefits associated with insurance arrangements and this can be difficult given the variety of insurance products on the market.

One potential option is the development of an insurance dashboard, such as has been legislated to compare MySuper products, or the use of key fact sheets that highlight the main features of insurance products for consumers.

E14. Are the costs of insurance being minimised given the type and level of cover?

KEY POINTS

- The Commission should measure the ‘reasonableness’ of costs given the type and level of insurance cover available to superannuation fund members.
- Assessment of this criterion would be more thorough if a cost-benefit approach, as opposed to a costs only approach, were to be adopted.
- This criterion should also be assessed qualitatively as well as quantitatively.
- Several of the proposed comparisons that the Commission intends to make in relation to policies being held inside as opposed to outside superannuation, differences in insurance expenses incurred by funds, and variations in costs for outsourced versus related party provision of cover are unreasonable in some cases, and inconclusive for most.
- Changes to coverage and definitions, how insurance in superannuation functions, or disruption to risk pools need to be carefully considered to enable stable and sustainable outcomes.

General Comments

In line with our beliefs that the Commission should alter its current objective for insurance in superannuation by considering the ‘reasonableness’ of costs, as opposed to ‘minimising’ costs, we recommend this criterion also be revised. Instead of ‘are the costs of insurance being minimised given the type and level of cover’ we consider that – ‘are the costs of insurance reasonable given the type and level of cover’ is a more appropriate criterion.

A revised approach would facilitate a cost-benefit analysis being undertaken, as opposed to a pure costs assessment. Consideration must be given to the role that insurance in superannuation plays in addressing Australia’s underinsurance gap (allocative efficiency). This underinsurance has been estimated to be costing the government \$60 million per year for life underinsurance, \$816 million per year for TPD underinsurance and \$140 million per year for income protection underinsurance.⁵⁵

We have noted that the Commission intends to assess the indicators for this criterion on a quantitative basis only, however, we believe that consideration of some qualitative (value) aspects should occur to measure more thoroughly the benefits delivered to members, and the community at large.

Concerns about indicators

Indicator 1 - Insurance premiums inside and outside of superannuation

The Draft Report notes that life and disability insurance cover held in superannuation accounts typically has lower premiums than comparable policies held outside superannuation. In our response to the Issues Paper the significance of these differentials was highlighted.⁵⁶

⁵⁵ Rice Warner 2015, *Under Insurance in Australia*.

⁵⁶ ASFA 2016, *Superannuation Efficiency and Competitiveness – Response to Productivity Commission Issues Paper (Supplementary Submission)*, pages 8-9.

Rice Warner analysis shows that the premium for a given level of cover (\$1,000,000 of Death and TPD cover) is lower across age categories between 30 to 60 years, for both genders, inside superannuation. The difference in premiums, shown as a percentage ranged from approximately 25 per cent to 55 per cent less for females with the difference in premiums increasing with age. For males this benefit ranged from approximately 35 per cent to over 60 per cent and similarly the difference in premiums increased with age.

The Draft Report does, however, question whether prices are competitive from an individual's perspective as "considerations of personal circumstances and risk profiles" are missing.

As stated in the introduction, the nature of superannuation is that of pooling and it is the task of this review to assess 'systemic', as opposed to individual, features. In our view the Commission should be considering how the best interests of members collectively are being served.

Finally it should be noted that, within a system where there are automatic default arrangements, significant flexibility exists to tailor insurance arrangements. Trustees are able to design insurance which reflects a range of occupational, health and demographic profiles. Members generally have a right to opt out of insurance in superannuation altogether, to increase or decrease levels of cover and to seek personally underwritten protection, possibly under the advice of a financial adviser or insurance broker.

It is important to note that trustees use a number of mechanisms to keep premiums reasonable for automatic group cover in superannuation. Such cover generally is issued at modest levels for a reasonable premium. This is because fund trustees have a fiduciary duty under trust law, as well as a legal obligation under the SIS Act, to balance the primary objective of superannuation, the provision of retirement benefits, with the secondary objective of protecting members who suffer illness, injury or premature death.⁵⁷ In addition, some default insurance cover is 'unitised' meaning that, as time passes, levels of cover decreases, as opposed to premiums increasing. Conversely, for those that have 'fixed' cover, this often starts low and increases with age, with premiums being adjusted accordingly.

There are some taxation benefits for insurance cover within superannuation and the Commission has expressed a desire to gain an understanding of how much any discount for insurance being held in superannuation is explained by taxation. Insurance premiums are a tax deductible expense to a fund, keeping in mind that the maximum tax rate payable by a fund in the accumulation stage is 15%. The difference in premiums between cover held in superannuation compared to those outside cannot fully be attributed to tax benefits for several reasons, including that funds use these tax credits in different ways (for the benefit of members) with the gross premiums being disclosed. Instead, differences in premiums are more a function of:

- the mechanisms outlined above
- financial advisers' commissions largely being removed from group insurance arrangements; and
- the fact that retail policies have to be individually underwritten at considerable per unit expense, as the health status of the member has to be investigated and/or confirmed.

⁵⁷ Paragraph 52(7)(c) requires that RSE licensees can only offer or acquire insurance if the cost of the insurance does not inappropriately erode retirement incomes of beneficiaries (erosion of benefits covenant).

Indicator 2 - Insurance expenses incurred by funds

ASFA is supportive of this indicator being used to measure and assess the expenses incurred by funds in administering insurance services provided to members, separately from the premiums paid. A potential problem with this approach, however, is that a focus solely on costs gives little or no recognition of the services provided by funds and, accordingly, aspects of value are missed.

The service offerings across funds vary significantly, from product design to member and other third party support processes that become particularly relevant in the claims handling phase. In our consultations with stakeholders it has been identified that insurance administration expenses are not always separately identified by trustees and that there is a lot of crossover with other, more general, administrative expenses. Similarly, there are vast differences between what administrative functions, and hence expenses, insurers are responsible for and what functions are performed by the trustee or its administrator. This will depend on what was negotiated in the contract between the parties and, to the extent that some functions are performed by the insurer, may be included as part of the premium, as opposed to being charged for separately as an administration fee.

Indicator 3 - Erosion of member balances due to insurance premiums

This indicator in isolation is inconclusive and is an example of where some qualitative analysis would also be useful. The indicator fails to consider how insurance in superannuation supports the objectives of superannuation and should be changed to 'Extent to which the effect on member balances due to insurance premiums is reasonable'.

It cannot be disputed that insurance premium deductions from a member's account will have an effect on member balances. It is reasonable to determine quantitatively what this effect might be on the balances that members may otherwise have had at retirement. However, equal attention needs to be given to the potential benefits (insurance payouts) that might have been provided due to a premature death or disability occurring.

Many superannuation fund members (or their families) will unfortunately have to claim a death or disability benefit from their superannuation fund so a measure of how many do this, and the amounts involved, is important. Successful claims are in effect early retirement payments, with the account balance increased by an insurance amount to compensate for the individual not being able to complete a full working life and missing out on future income, as well as contributions and earnings in superannuation.

For those who do not ever make a claim and enjoy a full working life, and the corresponding lifetime contribution and earnings outcomes, recognition needs to be given to the value of the 'peace of mind' and 'risk mitigation' that these members enjoy. Like most insurance premiums paid by individuals for any purpose, a sacrifice is made to cover potentially disastrous outcomes should a risk event occur.

Life insurance as a product can be inherently difficult for consumers to both value and understand. It insures an asset which is less tangible (that is, someone's future income rather than their car or house) and deals with a topic that many find difficult to confront. We know that people would rather avoid dealing with the risk than insure against it. What we do know is that those who unfortunately do suffer an unexpected event value the cover they have in place. Recent research conducted by insurer AIA reported that 74 per cent of those with life insurance in their superannuation see its inclusion as a real positive.⁵⁸

⁵⁸ AIA Insurance 2016, *Life Today Study*.

It should be noted for this indicator, as was described above, that there is a wide variety of flexibility applying to insurance in superannuation and that individuals do maintain control over how much (if at all) their balance is affected by premiums. For the majority who have settled on default cover, by choice or otherwise, the quantum of the default cover will have been determined as result of a rigorous trustee process. Trustees are subject to duties under trust law, statutory obligations and the requirements of Superannuation Prudential Standard 250 to achieve a reasonable balance between providing insured benefits that are suited to the circumstances of a like group of members and not (unduly) eroding balances – ‘smart defaults’ so to speak. Furthermore, many trustees have arrangements in place to either cancel, or engage with members to confirm cover is still required, in certain circumstances, for example when accounts become inactive or reach a low balance threshold.

Indicator 4 - Ratio of claims to premium revenue (loss ratio) within superannuation over 5 and 10 year periods

While relevant, the loss ratio is inadequate on its own in terms of demonstrating the benefits received by fund members, and the broader economy, from having insurance provided in superannuation. As the draft report noted, longer term analysis over 5 to 10 year periods is required to overcome the interpretive limitations of this indicator, however, access to this data is problematic and potentially inconsistent. The following concerns with the loss ratio have been raised by ASFA members:

- The timing of premiums paid and claims incurred, recognising that many claims are not notified until many years after the incident, for example, a loss ratio for last year’s premiums will be very unreliable relative to one for premiums collected 5 years ago
- Assumptions made for any claims which have been incurred but not yet reported
- The accuracy of these assumptions is impacted to how well developed the claim experience is (that is, what percentage of likely claims have been notified)
- Differences between cohorts of members and between funds
- Assumptions can be varied to suit different outcomes, and as such some standardisation needs to be considered to render a comparable result.

We recommend that the commission assess claims data more specifically than via the loss ratio alone and look at the numbers of Australians that benefit from insurance held in superannuation payments, and for what amounts. APRA data indicates that for the period to 30 June 2015, more than \$4.4 billion⁵⁹ was paid to superannuation members by group insurers, many of whom would not have otherwise held insurance cover. These payments were made to approximately 70,000 people. Relative margins earned by insurers providing group insurance are comparatively low⁶⁰. In the year ending June 2016, net profit being contributed to insurers from group policies amounted to \$444 million compared to \$919 million for individually held policies. Such analysis over longer time frames would be useful.

⁵⁹ APRA, *Annual Fund Level Superannuation Statistics*, June 2015.

⁶⁰ APRA, *Quarterly Life Insurance Performance Statistics*, June quarter 2016.

Indicator 5 - Fee and premium differences from outsourcing insurance services to related versus unrelated parties

The relevance of this indicator must be questioned in light of the trust law duties and the obligations that superannuation fund trustees have under Superannuation Prudential Standard (SPS) 250 -*Insurance in Superannuation* and SPS 521 – *Conflicts of Interest*⁶¹. In its thematic review of insurance in superannuation undertaken in 2014⁶², in relation to those with related party insurers, APRA reported that ‘Better practices were observed where RSE licensees were engaging an independent adviser to benchmark the insurance arrangement on, at least, a triennial basis to ensure that it is appropriate and in members’ best interests’. It is expected that these ‘better practices’ will become more frequently used following this review by APRA.

In addition, an accurate assessment of any difference in premiums will need to consider the cost savings that a fund may have been able to obtain by in-housing its insurances services for members. It is expected this will be difficult to do, as will taking account of differences in insurance products with a wide variety of benefits and services in both the default and choice segments.

⁶¹ APRA, Superannuation Prudential Standards. For details see APRA website (<http://www.apra.gov.au/Super/PrudentialFramework/Pages/superannuation-prudential-standards.aspx>).

⁶² APRA 2015, ‘Insurance in superannuation thematic review’, APRA Insight, Issue 1 2015.