kinetic
superannuation

Productivity Commission: Superannuation - Alternative Default Models

Submission by Kinetic Superannuation Ltd

Introduction

The current environment for allocating default fund members is in need of change. The present reliance on employer-nominated default funds is both:

- outdated: being based on industrial relations settlements for historical, rather than market, reasons; and

- ineffective: being unable to realise the full benefits of scale in the superannuation system.

As identified by recent inquiries, the Australian superannuation industry lacks a strong consumer-driven competition that is particularly pronounced in the default fund market.[1] This contributes to perceptions of inertia and complacency in the default fund system.

Kinetic Super favours a market-based model of a competitive tender process operating by the allocation of a single account retained for each new job undertaken by the employee, unless opting out by individual member choice. The fairness of the system can be maintained by the prohibition on price discrimination between existing and new MySuper members among other protections under existing superannuation law. The stability of the system can be maintained by the orderly management of cash flow impacts supported by transition rules regulating changes in default fund status and closer regulatory monitoring.

We take this opportunity to observe that much of the discussion in other submissions pointing to the possible abuses of a competitive tendering process, such as collusive practices or discriminatory pricing, takes place in an assumed open market without reference to the wider regulatory environment in which superannuation funds operate and the comprehensive governance and risk management frameworks in which directors and managers make decisions and plan strategy. It is important to consider the Issues Paper within the broader context of the regulated superannuation industry in which the competitive tender process is intended to operate in a manner complementary to the MySuper regime.

The fundamental merit of a market-based tender process lies in its potential to stimulate competition in the default fund market and to extend the benefits of scale without imposing lower returns. Its application to existing default members has the potential to cause a beneficial flow-on effect to the member choice market. We view the Issues Paper as a significant contribution to confronting the lack of competitiveness and efficiency in default funds in the Australian superannuation industry.

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[1] Productivity Commission, *Superannuation: Alternative Default Models Issues Paper* (2016) 1, quoting D Murray, K Davis et al, *Financial System Inquiry: Final Report* (2014) 101.

The assessment criteria

We consider that the five criteria proposed by the Commission are suitable because of their resonance to the superannuation regulatory regime and their response to the systemic challenges facing the superannuation industry. It is appropriate to explain our interpretation of the criteria as a recurring theme in our support of a market-based model by tender allocation:

1. ***Members' best interests***: as the bedrock of a fund trustee's administration and strategic direction, this should guide the modelling and implementation of the default model in maximising long-term net returns and allocating members to appropriate retirement products.

2. ***Competition***: competition between funds drives cost reductions and facilitates innovation, encourages new entrants to the market and leads to long-term efficiency.

3. ***Integrity***: the model must be transparent and credible and ensure the default funds remain accountable for the outcomes delivered to members.

4. ***Stability***: the model should not detract from the stability of the superannuation system and should manage cash flow impacts within prudential regulation.

5. ***System-wide costs***: the total costs to members, employers and funds, including compliance costs and funds transfer, should be contained by the avoidance of complexity and undue repetition.

These criteria assist in ensuring that the model designed to stimulate traditional market forces has no disruptive or counterproductive consequences when applied to a non-traditional highly regulated superannuation market. These five criteria explain the focus and emphasis on reduction of fees to prevent erosion of retirement incomes and enhance national superannuation savings.

The market tender model

A market-based tender is accepted throughout the commercial world, including the public sector, as a model for encouraging competition and achieving the optimum result for the purchaser. Significantly a tender process is endorsed by the superannuation regulator as the most suitable method for demonstrating regard to the best interests of the members by transparent testing of the market when engaging material outsourced service providers.[2] In responding to the Issues Paper the tender model should be approached with a recognition of the widespread acceptance and practical adaptability of market-based tendering.

As acknowledged by the Commission, market models are generally more efficient than administrative allocation models and have the advantage of revealing the relative performance of products.[3] Not only does a tender promote visible competitive bidding but its regularity of recurrence can facilitate cost reduction and innovation as funds benchmark themselves against successful bidders.[4] The successful fund's continuing accountability to default members is enforceable under the existing regulatory regime comprising the range of statutory and fiduciary duties that bind all fund trustees.

We consider that a centralised single tender should be applied to all new default fund members, subject to limited exemptions for defined benefit or corporate funds.[5] A segmented allocation administered according to member profile would create inflexibility and complexity. The superannuation market is sufficiently

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[2] APRA, Prudential Standard SPS 231, *Outsourcing*, 4, [19(b)].
[3] Productivity Commission, above n 1, 15.
[4] Ibid.
[5] Ibid 10.

adaptable to mould itself to changing demographics and member profiles.[6] This is borne out in the market's experience and development since the introduction of compulsory superannuation.

A single default fund is preferred to a panel of successful funds in order to maximise competition. The New Zealand experience of multiple default providers is distinctive from Australia since its tender process was implemented as part of its preparation of a national savings scheme.[7] The competitive focus on a single successful fund stands in contrast to a panel of multiple providers that contains resemblances to the current system which the Commission's inquiry seeks to challenge.

Criticisms of the tender model

Concerns have been expressed in various submissions that funds would place a distorted emphasis on pricing and resort to low risk-low return investments.[8] Furthermore, according to these criticisms, funds would confine themselves to satisfying the tender criteria and not producing innovative service models or maintaining appropriate controls.[9]

If this is correct it means that the fund's directors and management would have knowingly adopted a strategy in contravention of its statutory covenants of best interests and balanced investment as well as the fund's investment governance and risk management frameworks. This critique does not consider the regulatory environment within which the bidding fund operates. The fund's reckless abandonment of quality and compliance controls and service standards, in addition to its investment and best interests covenants, or even its adoption of pricing manipulation or bidder collusion, amounts to a repudiation of a fund's governance framework and invites exposure of its directors and managers to legal liability. In practical terms the short term degrading of a fund's administration and supporting risk frameworks would be counter-productive by jeopardising its bidding prospects on renewal of the term.

Moreover, academic studies that conclude that firms have strong incentives to capture market share and then set high non-transparent fees to harvest profits by exploiting their current locked-in customers have been formulated in a macro-economic environment without reference to the Australian superannuation system.[10] According to this view, a tender process would abruptly transform a complying risk-conscious fund into a speculative enterprise that downgrades the best interests of its members. Rather, it is more likely that bidding funds would apply a considered risk-based assessment and judgment when formulating its tender response as it would in the normal course of its trustee decision-making.

The same considerations apply to manipulation or gaming. While these risks assume that a fund's management would consciously engage in unlawful conduct, the typical controls in a public authority tender, such as a probity panel and tendering rules, would apply to the tender model administered by the regulator. The tender model is applied with the usual risk controls in procurement processes.

Other criticisms are that funds would tender by 'loss leading' in an attempt to grow market share and adjusting their fees upward later. Overlapping with the above criticisms, a fund adopting this strategy embarks at its peril on a high risk strategy of discriminating against age-based categories of members and preferring the expansionary interests of the business over the interests of the members, an outcome that, again, exposes directors and management to contraventions of their statutory and fiduciary obligations. Rather a tender model can encourage positive commercial behaviour after winning a bid. The commercial

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[6] See, eg, the multiple UK Retirement Date Funds: Productivity Commission, above n 1, 12.
[7] Mercer, Submission No 15, attachment 2.
[8] ASFA, Submission No 24, 3.
[9] Ibid 13.
[10] P Klemperer, 'Competition When Consumers Have Switching Costs: An Overview with Applications to Industrial Organization, Macroeconomics and International Trade' (1995) 62 *Review of Economic Studies* 515, 539, quoted in *Centre for Market Design, University of Melbourne*, Submission No 18, 2.

imperative of a successful bidder retaining its default status on renewal would influence consistency and long-term planning in its post-bid behaviour.

The tender metrics

The metrics on which funds compete for the winning bid should be based on fees because of the competitive imperative to reduce fees in order to maximise retirement savings. In the interests of simplicity and comparability the fee metrics will correspond to the standardised fee disclosure regime.[11] The bidding funds' fee disclosure takes place against the background of increasing transparency imposed by regulation, particularly in indirect costs.

However the metrics should not be based exclusively on fees. Investment returns and investment strategy should be included in the metrics to the limited extent of a relevant factor to which the selection panel may have regard under existing regulatory reporting supplemented by a benchmark assessment. The benchmarking should include:

(a) the performance of My Super funds in the net average return to members for a minimum of 5 years as ranked by third party actuarial firms; and
(b) net average returns reported by the bidding funds compared to CPI over the same period.

Investment history and strategy should be subordinated to fees as they contain no guarantee of future reliability. Undue emphasis on investment performance will encourage a fund to concentrate on short term performance rather than long term outcomes for its members.

Evidently the tender panel would be concerned that the members' interests be protected against dependence on unduly conservative investment strategies. This risk can be controlled by the review of each fund's investment strategy, including its asset allocation ranges, when accessing each bidder's regulatory reporting returns and investment governance frameworks.[12]

It is unnecessary to add a layer of complexity by including metrics such as service levels and administration systems.[13] These matters can be addressed as a tender pre-condition that the bidder submit to and implement a regulatory audit before being eligible to bid enforceable within the existing regulatory framework, rather than restating existing compliance obligations.

The bedrock principle of members' best interests cannot be viewed as an isolated metric or criteria. Rather the members' interest is woven throughout the superannuation regulatory superstructure and on a subordinate level, the tender conditions binding the funds.

The metrics should be formulated in a purposive approach: to stimulate competitive fees in order to maximise savings. The metrics should not be over-elaborated in the well-intentioned concern to restate consumer protections. Rather the modelling should operate with confidence in the existing regulatory regime, rather than react reflexively by imposing comprehensive compliance prescriptions as a policy of caution.

MySuper pre-conditions

As a condition of eligibility, rather than as an additional metric, only MySuper products should be considered for tender because of their essential character as default, as opposed to choice, products. MySuper was specifically designed for members who are not actively engaged under member choice but

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[11] The lack of comparability between default and choice products (see Australian Super*,* Submission No 19, 4) can be remedied by regulation or tendering rules.
[12] A new market entrant is likely to be the product of a merger of existing funds or a variant of a previous fund where prior statistics can be accessed.
[13] ASFA, above n 8, 3.

need the protection of a system that promotes efficiency and cost-effective savings[14] and MySuper exists as the only eligible default fund under the current system.

Administration of the tender process

The tender process can be appropriately administered by the regulator, or its delegates, by reason of its scrutiny of fund reporting. Concerns about the continuing accountability of the fund to its members are best addressed by closer regulatory monitoring during the term of the default allocation which includes broad powers of regulatory intervention in the interests of the members empowered by current legislation.

Frequency of tenders

The frequency of the tender process is an important consideration in achieving a design that minimises cost and complexity. As pointed out by the Commission[15] a process that is run too frequently makes participation less attractive by insufficient rewards for the best performance. On the other hand, a process that is too infrequent magnifies the costs of a poor selection and discourages broader market participation.

We consider that a 2 year term, as operating in Chile, is too frequent since insufficient time is allowed for the bidder to settle in to its performance as trustee. Rather, a term of 5 years is suitable because it encourages responsible long term planning and enables sufficient time to test the bidder's performance throughout the term. Importantly a term of this length recognises, in the interests of members, that superannuation is a long term investment that must be judged accordingly. A term of this length should not discourage other competitors since these funds are accustomed to a similar term for outsourced administrators and service providers.[16]

As noted by the regulator, a regularly recurring term could adversely influence investment decisions; for example, the successful fund may be disinclined to adopt a reasonable allocation to higher cost, relatively illiquid investments over the long term, such as infrastructure. In the regulator's view, the default allocation model should not undermine trustees' obligations to achieve adequate retirement outcomes for members over the long term.[17]

This observation points to the need for heightened regulatory scrutiny throughout the term of the allocation. The exercise of closer regulatory supervision can detect warning signs of inappropriate investment decisions to the disadvantage of members while the prospect of regulatory intervention can deter trustees from opting towards self-serving, short-term outcomes.

Annual tournaments

It has been submitted that in addition to the 5 year market tender allocation to a group of authorised default funds, the Government runs an annual performance tournament among the authorised default funds based on a metric of a risk-adjusted after-fee rate of return with the result that the highest performing funds are rewarded by a greater allocation of new employees. This proposal would cause undue complexity and uncertainty. The system could however be usefully adapted to encourage active exercise of individual member choice to enhance greater competition.[18]

System stability

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[14] Jeremy Cooper (chair), *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System*: *Final Report* (2010) 5.
[15] Productivity Commission, above n 1, 16.
[16] The New Zealand system of a 7 year term should be understood in the background of nine default providers: see Mercer, above n 7, attachment 2.
[17] APRA, Submission No 33, 3.
[18] *Centre for Market Design,* above n 10, 4–5.

The recurrence of a tender process presents challenges in the uncertain impact of cash flows in the superannuation system. It is acknowledged that the stability of the superannuation system depends significantly on the soundness and stability of the individual funds within the system.[19] However, the design of staged transition timeframes can support the orderly management of cash flow impacts in proportion to their magnitude.[20]

The negative impact on the remaining funds in the market that follows the award of the tender is difficult to estimate. Although larger funds may be better placed to withstand the loss of default fund status, the pressure on smaller funds to merge is likely to increase. Nevertheless it is uncertain whether these consequences will confirm an existing trend in the industry towards fund consolidation by hastening a contemplated merger or whether these consequences will produce a distortion of the market.

If market distortion is judged by reduced competitive incentives for smaller funds, the achievement of a competitive tension in a single default fund should count as a balancing consideration. The competitive gap left by smaller funds should not be viewed in isolation but should consider the prospect of other funds in the market faced with competitive pressure to improve the performance and efficiency of their MySuper products in the wake of an unsuccessful bid or their active members seeking to transfer to the successful bidder.[21] These considerations apply similarly to the implementation of an administrative allocation model.

Administrative model

The administrative allocation model contemplates the regulator's use of a filter to determine eligibility of default products measured by prescribed minimum standards, such as MySuper. While this process could enhance competition by improving product comparability, lowering costs and encouraging active choice, a filter would attract complicated metrics by reliance on the prescribed standards. As a result this distracts from the original purpose of encouraging competition on price.

The administrative model in awarding a panel of products does not create the same rewards as a tender process nor the same competitive pressure. Funds that lead in industry ratings could subconsciously assume they will be successfully appointed. Another negative feature of the administrative model is the uncertainty of funds qualifying between regular assessments, which are likely to be more frequent than a tender process, and the pressure to emphasise short term performance. In essence the administrative model suffers in comparison with the market-based model.

Active choice by employees

The active choice model described in the Issues Paper raises doubts as to whether it is in fact a choice. There is a conceptual difficulty in enforcing the exercise of a choice of fund. Under this proposal new employees would be required to nominate a fund on commencement of employment similar to a nominated bank account to receive salary payments whereby the fund would direct future contributions to its MySuper product unless the member opts out.

While the objectives of active choice seek to deliver increased member engagement and enhanced competition, the implementation of an enforced choice, as opposed to an engaged choice, raises questions about the quality of the employee's decision making. This has particular resonance in financial services groups where the employment relationship orientates in favour of a related fund.

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[19] APRA, above n 17, 2.
[20] See, eg, ibid 2.
[21] Ibid 4.

The Commission's discussion of a filter or market-based mechanism to narrow choices or 'nudge' members again raises questions of informed decision making and the extent to which the exercise of choice can effectively be legislated. It is a telling observation by the Commission that most countries with employer-funded superannuation retain some variant of a default option.[22]

The discussion of active choice should take account of recent improvements that assist employee engagement. In particular the single touch payroll system[23] will facilitate an accessible streamlined process for member choice on commencement of employment. These developments are consistent with the proposed aim to improve consumer decision-making by passively nudging individuals towards a decision.[24] For these reasons the active choice model is an option more suitable for advancing member engagement, rather than as a competitive process.

Insurance allocation

We share the views of other submissions[25] that healthy competition already exists in the group insurance market demonstrated by its superior comparison to the level of premiums in retail personal insurance and the advantage of automatic acceptance levels. The protection of members' best interests is reinforced in the trustees' insurance covenants and insurance strategy and framework as well as regulated minimum standards of cover.

This level of competition occurs against a backdrop of market tendering by group insurers which, arguably, supports an optimistic outlook for a market tender model implemented for default members. In these circumstances a separate competitive allocation of group insurance for default members becomes unnecessary.

Conclusion

In recent years a consistent theme that pervades the various enquiries and reports into the superannuation system is the lack of competition in price relative to scale, with adverse consequences for retirement savings.[26] To date the problem remains unresolved. It is timely to implement a solution that confronts competitive barriers and breaks the current perceptions of inertia in the default fund system.

A market-based tender is the most effective solution because of its ability to revitalise benchmarking against the winning product and its international acceptance as promoting competition. Because of its adaptability throughout commercial relationships and public sector procurement a tender can accommodate itself to the regulatory regime with minimal disruption and without causing undue cost and complexity. The model is preferable to the administrative model that does not harness competition to the extent maximised by a market bid.

We commend the market-based tender model as the best alternative model for a formal competitive process for allocating default members as directed by the Commission's terms of reference[27] and answers a long-standing need for competitive initiative in default funds.

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[22] Productivity Commission, above n 1, 17.
[23] Commencing 1 July 2017 and mandatory for employers with 20 or more employees by 1 July 2018.
[24] Productivity Commission, above n 1, Box 5, 17.
[25] See, eg, ASFA, above n 8, 17.
[26] See, eg, Murray, above n 1.
[27] Productivity Commission, above n 1, 1.