FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

31 October 2016

Superannuation Productivity Commission

Locked Bag 2, Collins St East

Melbourne VIC 8003

Email: super@pc.gov.au

Re. Inquiry into alternative default models

Dear Sir/Madam,

The Financial Planning Association of Australia (FPA) welcomes the opportunity to provide feedback on the Commission's inquiry into alternative default models for the superannuation system. While we support enhancing competition in the system, we would encourage the Commission to focus on default models that accommodate the different patterns of preferences of each firm's employees.

If you have any queries or comments, please do not hesitate to contact me at policy@fpa.com.au or on 02 9220 4500.

Yours sincerely

Dimitri Diamantes
Policy Manager
Financial Planning Association of Australia[1]

[1] The Financial Planning Association (FPA) has more than 11,000 members and affiliates of whom 9,000 are practising financial planners and 5,500 CFP professionals. The FPA has taken a leadership role in the financial planning profession in Australia and globally:

- Our first "policy pillar" is to act in the public interest at all times.
- In 2009 we announced a remuneration policy banning all commissions and conflicted remuneration on investments and superannuation for our members – years ahead of FOFA.
- We have an independent conduct review panel, Chaired by Mark Vincent, dealing with investigations and complaints against our members for breaches of our professional rules.
- The first financial planning professional body in the world to have a full suite of professional regulations incorporating a set of ethical principles, practice standards and professional conduct rules that explain and underpin professional financial planning practices. This is being exported to 24 member countries and the 150,000 CFP practitioners that make up the FPSB globally.
- We have built a curriculum with 17 Australian Universities for degrees in financial planning. As at the 1st July 2013 all new members of the FPA will be required to hold, as a minimum, an approved undergraduate degree.
- CFP certification is the pre-eminent certification in financial planning globally. The educational requirements and standards to attain CFP standing are equal to other professional bodies, eg CPA Australia.
- We are recognised as a professional body by the Tax Practitioners Board

SUPERANNUATION: ALTERNATIVE DEFAULT MODELS

FPA submission to:
Productivity Commission

31 October 2016

INTRODUCTION

The high level of disengagement of members of superannuation funds means there is a potential mismatch between the attributes of default superannuation products and the would-be preferences of members.

While we are support enhancing completion in the system, we would encourage the Commission to focus on default models that accommodate the different patterns of preferences of each firm's employees.

Developing alternative allocation models

Criteria for assessing alternative models

1. How should the principles and considerations in the terms of reference be operationalised? Are the Commission's proposed criteria suitable? What trade-offs might arise between criteria and how should these be handled?

Operationalisation
Indicators of each model's likely performance against the criteria need to be identified. For example:

- members' best interests: expected risk-adjusted returns[2]; risk premium for insurance; and consumer satisfaction scores
- competition: number and severity of barriers to entry and exit; and measures of market concentration
- integrity: number (and degree of danger) of opportunities for gaming
- stability: measures of diversity (as to, e.g., risk philosophy, outsourced providers and corporate governance)[3]
- system-wide costs: estimate of costs (at an aggregate and stakeholder level) of each model

Suitability
We support the Commission's criteria.

Trade-offs
There will eventually be a trade-off between minimising system-wide costs and all other criteria. A model would need to be developed that seeks to optimise the trade-off. We also note that, eventually, there will be a trade-off between returns (net of fees) on invested contributions, and non-financial measures of product quality. Again, we need to optimise the trade-off.

2. What regulatory impediments to optimal competition might be relevant?

Regulatory impediments include:

- default funds being prescribed in industrial awards and agreements
- employers acting in their own interests rather than those of their employees (e.g., gaining benefits from bundling default superannuation with business and personal financial services)

Designing the models

3. Is this framework suitable for designing alternative models? What other steps might be necessary?

We believe the following steps, which have been identified by the Commission, are suitable:

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[2] For one measure, risk-adjusted value added (RAVA), see Liu, K.Y., Australian Superannuation: Operational Structure, Investment Performance and Trustee Governance (2013) https://ses.library.usyd.edu.au/bitstream/2123/9264/1/Liu_K_THesis_2013.pdf (accessed 25 October 2016) pp 193-4
[3] See Donald S. *et al*, 'The implications of complexity for systemic risk in the superannuation system', *CLMR Research Paper Series Working Paper No. 13-3* http://www.australiancentre.com.au/sites/default/files/D1P7%20Complexity%20in%20the%20Superannuation%20System.pdf (access 26 October 2016)

- identifying which employees the model would cover
- specifying a competitive process to determine which products are eligible to be used as defaults
- specifying how employees would be allocated to eligible default products

4. What lessons arise from models used in other countries and sectors? How applicable are these to Australia's superannuation system?

Chile

Noting the following observations from Chant West[4], we are concerned about the merits of introducing a tender system:

> [We do not] see any merit in the suggestion of a tender process. The initial idea for this came from the Grattan Institute, and grew mainly from their observation of the tender system used in Chile. Grattan claimed that Chile's default fees are less than one-third of MySuper fees, but it based that claim on analysis that compared 'apples with oranges'. It only included administration fees for the Chilean funds, but included both administration and investment fees for the Australian MySuper products.
>
> We would argue that not only did Grattan draw conclusions about fees based on inappropriate data, its tender suggestion ignores the fact that Chile has a very different market structure to Australia.
>
> When Chile introduced its tender system in 2010 there were only five pension funds – four very large funds and one small fund. Fees were generally considered to be high because of the lack of competition. The Government introduced the tender system with the objective of increasing competition and reducing administration fees.
>
> Five years on, Chile still has only six pension funds and there are serious doubts as to whether the pricing of the current default fund is sustainable. The Chilean model, therefore, has not increased competition in any meaningful way and it has resulted in a short-term reduction in fees that is likely to be reversed. We do not believe this is a model that Australia should seek to emulate.
>
> Contrast the Chilean market with Australia where, at June 2014, there were 116 MySuper products competing for default superannuation. Of these, 16 had assets over $10 billion and 29 had assets over $5 billion. Clearly, there are enough funds with sufficient scale to generate vigorous price competition. This was not the case in Chile.
>
> From our like-with-like comparison, which is included in the Financial Services Council's second round submission to the [Financial Systems] Inquiry, it is clear that Australia's MySuper fees compare more than favourably with Chile's default fees.
>
> Using OECD methodology, the average non-profit MySuper administration fee is 19 bps compared with 20 bps for the current Chilean default fund. The average non-profit MySuper investment fee is 63 bps compared with 27 bps for the current Chilean default fund. There are valid reasons for the difference in investment fees. Essentially, investment fees in Chile are

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[4] Chant West, *Financial System Inquiry Final Report Response to Superannuation Recommendation* (10 March 2015) http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Financial%20System%20Inquiry%20Final%20Report/Submissions/PDF/Chant_West.ashx (accessed 26 October 2016) p 9

much lower because over 55% of assets are managed in-house at very low cost, the vast majority of which are Chilean government bonds.

The conclusion we draw is that Australia already has strong price-based competition, and to superimpose a Chile-style tender process would be neither appropriate nor necessary.

New Zealand

We are concerned about a process that prescribes a narrow list of default funds at the national level. While many employers don't have expertise in assessing superannuation, they know their employee base better than government. Further, it is possible for employers to access such expertise.

Sweden

We are concerned about the efficiency of a government-run scheme. While the fact that most employees in Sweden choose the default scheme shows the fund's value, we question whether overall economic efficiency wouldn't be improved if investors could choose where their capital is invested (rather than having that decision dictated through government policy and the taxation system).

While having a single default scheme might achieve economies of scale and the risk of that scheme dominating the market might be best dealt with by government, it is at least possible that optimal scale can be achieved by private providers. Optimal scale might be achieved through removing anti-competitive arrangements that allow sub-scale funds to continue.

Similarly, any benefits of a not-for-profit operating model can be achieved through a regulatory environment that doesn't create disproportionate barriers for such providers to participate in the market.

United Kingdom

We are again concerned, for the reasons already discussed, about governments providing superannuation other than to its employees.

Step 1: Identifying employees

5. Which employees should be covered by the new default allocation model? Should any employee groups be exempt?

Ideally, no employees should be exempt. However, there are difficulties where the number of eligible default funds is small. For example, defined benefit funds with highly tailored plan designs, legal and funding arrangements and legacy issues are unlikely to be accommodated by new providers. This outcome may not be in the interests of existing members.

Our preferred model of an employer choosing their employees' default fund (and re-considering their decision on a regular basis or when relevant circumstances – e.g. a substantial change in the demographic make-up of the employee base happens) would overcome these difficulties. This is because the appropriateness of the fund would be assessed based on the circumstances of the particular employee base rather than on an abstract rule.

6. Should there be any flow-on effects for existing default members from any new default allocation model?

Again, there are practical challenges raised by the more centralised models. For example, it might be desirable for existing default funds to be upgraded to at least the level of the government-prescribed default funds if the latter are assessed as being more favourable. However, existing funds are likely to downgrade product quality in the areas they can (i.e. where existing attributes are better than the benchmark and members don't have rights to those attributes).

Our preferred model of an employer choosing their employees' default fund (and re-considering their decision on a regular basis or when relevant circumstances) would allow these difficulties to be overcome. This is because default members could be allocated based on a fund's overall merits rather than an inflexible rule.

Step 2: Specifying a competitive process to determine default products

7. What key services (or features) should be provided by default superannuation products? Should they all have to be MySuper products?

We think the users of the default superannuation system (employees, employers and super funds) need to be asked this question. We suspect they would want investments, insurance and advice. By advice we also include bespoke advice that is charged to the trustee and allocated to the member's account. Funds indirectly provide bespoke advice and such advice shouldn't be overlooked in the assessment merely because of this indirectness or because provision of the advice is member-directed (just as investments, which will undoubtedly be assessed, are member-directed).

We believe that all funds should be eligible to be default superannuation products. While the simplicity and comparability of MySuper products might increase the competitiveness of this sector, there is no reason to think other funds will necessarily be uncompetitive.

8. What are the advantages and disadvantages of allocating insurance through a separate competitive process? What should be the key features of this default insurance product?

We think the users of the default superannuation system (employees, employers and super funds) need to be asked. In general terms, they would want a reasonable balance between scope of cover, individual need and foregone investment opportunity (including due to taxes and fees required to fund research costs).

9. What other considerations are relevant to specifying a competitive process?

Other factors that need to be considered include:

- alignment of preferences of the particular subset of employees with the default product chosen
- alignment of the employer with the interests of their employees
- the desired policy outcomes and their economic and political feasibility

Step 3: Allocating employees to eligible default products

10. Within a particular allocative model, should employees be segmented into groups for the purposes of allocating them to default products? If so, how should they be segmented? What are the benefits and costs of this approach?

We support segmentation of employees for the purposes of allocating them to default products. This is because segmentation is more likely to align the would-be preferences of employees with the product chosen.

The characteristics on which segmentation is based shouldn't be decided in advance of consumer testing. The aim of testing should be to observe what product and options a representative sample of fully informed employees would choose if required to choose, and to identify cohorts that cluster around the same preferences.

However, we suspect that employees would be segmented along age marital status, number and age of children and income lines (and, in connection with insurance, occupation lines too). It is possible there are other characteristics that explain preferences.

As already mentioned, the benefit of this approach is the increase in alignment of employee preferences with the product chosen. The cost is that of extra research to identify relevant characteristics.

An alternative approach is to assess employees on an employer-by-employer basis, to decide what procedures should apply for determining how employees who don't make an active choice should be allocated to a superannuation product. While this approach might not be as rigorous as the development of a mathematical allocation model that is based on employees nationally, a local assessment would be more accommodating of the peculiarities of the particular group of employees.

We would encourage the Commission to assess both approaches. However, in the meantime, we would support segmentation down to the level of the particular group of employees. In other words, we would support being open to the possibility that each particular group of employees is unique in a material way, and that a well-designed plan can cater to such differences.

11. Who should decide on which employees are allocated to which products, where multiple default products are chosen by the new allocative model?

We strongly favour the employer (advised by a financial planner, where appropriate) to make this decision, as the employer knows their employees better than others. This is because, as already mentioned, a local assessment would be more accommodating of the peculiarities of the particular group of employees.

Some options for an allocation model

12. What other types of model, in addition to the three identified here, should the Commission consider in this inquiry?

Employers are in the best position to decide default fund arrangements, based on the employer's knowledge of their employee base. However, employer and employee preferences may not be aligned.

The default fund should provide investment options and ancillary services (such as life, TPD and IP insurance) that are appropriate for the demographics of the member base; and insurance premiums and risk-adjusted expected returns within acceptable limits of the relevant benchmarks. We encourage the Commission to consider what arrangements are needed to ensure that, when choosing a default fund, each employer acts in the interests of their employees who don't actively choose their superannuation fund.

Arrangements should enhance demand-side pressures on providers (potentially pushing some out of the market), but not unduly restrict the number of eligible providers. Further, arrangements should be sufficiently flexible to allow employers/financial planners to align the fees, performance and non-financial attributes of the fund with the particular group of employees.

As discussed above, all products in the market should be eligible to be a default fund. With proper demand-side pressure from employers, and the removal of anti-competitive arrangements such as default funds being dictated by awards, there would no longer a persuasive reason to restrict the range of eligible default funds.

Metrics that employers should consider in choosing a fund include:

- Long-term returns (net of fees) compared to an appropriate benchmark
- Risk premium for insurance for each cohort for each type of cover
- Scope of insurance for each cohort for each type of cover
- Number of ancillary benefits
- Member satisfaction ratings

Each fund should be assessed relative to the market.

Administrative model

How would eligible products be determined?

13. What are the advantages and disadvantages of using some form of administrative filter to determine which products are eligible to be used as defaults?

- **What metrics should be used and how prescriptively should they be specified? Should the metrics be quantitative, qualitative or a mixture?**
- **Should there be a cap and/or floor on the number of qualifying products?**
- **How frequently should the process be run?**
- **Who should administer the selection and subsequent monitoring of products?**
- **What might be the role of MySuper in the long term under this approach?**

The advantage of using an administrative filter is that it reduces the cost of selecting defaults because funds that seem obviously inappropriate don't have to be rigorously assessed. The disadvantage is that, without interpretation, there is a risk that temporary characteristics of funds may make them ineligible to be a default fund (at least until the next assessment).

Metrics for determining funds to be ineligible should be quantitative and qualitative, be non-prescriptive and include:

- Long-term returns (net of fees) compared to an appropriate benchmark
- Indicators of future returns, such as investment management capability, investment fees and investment style
- Risk premium for insurance for each cohort for each type of cover
- Scope of insurance for each cohort for each type of cover
- Number of ancillary benefits
- Member satisfaction ratings

We believe that the metrics should not be specified prescriptively. This would provide flexibility to interpret the metrics based on the peculiarities of the group of employees, rather than merely the national-level demographic model. Because of the need for flexibility, we would not support setting a cap on the number of eligible funds.

The process should be run frequently (say yearly) to avoid the risk of performing funds becoming underperforming but remaining eligible for an extended period.

While we would strongly prefer self-administration (i.e. the employer or financial planner applies the filter), we would be comfortable if APRA administered the selection and subsequent monitoring of products. However, in the latter case, the selection and monitoring would need to be guidelines, so as to allow employers and financial planners flexibility to go outside the list where appropriate.

MySuper might become less important as funds would be assessed on performance and structure rather than simplicity and comparability – especially if other measures to enhance competition and efficiency, such as removing the ability for default funds to be dictated by industrial awards and agreements, are implemented.

14. What would be the likely effects of an administrative filter on competition between successful funds and in the superannuation system more broadly? What would be the implications for product innovation and system stability?

If the filter can be applied flexibly (as discussed above) and the interests of each particular group of employees is reflected in the choice of their default fund, an administrative filter might encourage competition on product attributes and levels that employees value. This flexibility will also allow product innovation that a highly specific and prescriptive administrative model would not, and allow diversity to flourish. For example, rather than encouraging a low-cost passive investment approach across superannuation products - which may lead to unnecessary system-wide risk, at least in the short and medium term – a flexible approach would allow a diversity of investment approaches.

How would employees be allocated to products?

15. What are the relative merits of using a single filter that covers the entire system versus a more segmented approach? What are the key practical considerations and challenges in implementing each approach?

A single filter is easier to understand and cheaper to operate. However, a more segmented approach allows a more nuanced alignment between the attributes of the default fund and the preferences of different cohorts of employees. A segmented approach is more in keeping with our preferred approach of aligning members' would-be preferences and their default fund.

16. In what ways could employees be allocated to eligible products in an administrative model? What are the advantages and disadvantages of each approach? What costs and responsibilities would fall on employees, employers, regulators and superannuation funds under each approach?

We strongly advocate the employer (and financial planner, where appropriate) allocating employees to funds based on the preferences of the employee base and taking into account any guidance from the regulators as to funds that should be eligible/ineligible. The alternative of centralised allocation has the potential to be inefficient and discourage innovation.

As a public good, we believe that comparison of funds and resulting guidelines is best funded collectively. It may be appropriate for superannuation funds to cover the cost through say a levy, and share the cost with consumers through the normal market mechanisms.

Under our preferred option (i.e. where employers allocate employees to a default fund), the costs (including of any financial planners) would fall on the employer. However, the burden would be shared between employer and employees as per the normal market mechanisms.

17. What should happen to default members in products that lose their approval under the filter?

As discussed, we don't think government should restrict which complying funds are eligible to be default funds. Rather, funds should be suggested as eligible or ineligible. Under our preferred model, if an employer chooses a new default fund for existing default members, successor fund transfer rules apply.

However, if the regulator applies the filter in a prescriptive way, we would suggest that the employer should be consulted (and perhaps their consent should obtained) before moving existing employees to the new fund. This would provide a safeguard against the possibility that the new approved list does not align with the peculiarities of the particular group of employees.

Market-based models

How would eligible products be determined?

18. What would be the likely effects of a tender on competition between successful funds and in the superannuation system more broadly? What would be the implications for product innovation and system stability? What would be the likely effects on long-term member outcomes?

While a tender system might increase competition on certain fund attributes, such as fees, we are concerned that such a system (especially one that operates nationally) might discourage innovation as funds would be incentivised to conform to the assessor's (rather than employees') expected preferences. Such a system might also increase systemic risk, as pressure on funds to reduce fees is likely to lead to a low-cost, passive investments even if other styles of investment may be appropriate (e.g. in the short and medium term).

19. What metric(s) would be most appropriate to include in a tender, and why?

- **How should the bids be assessed against the metric(s)?**
- **Where there are multiple metrics, how should trade-offs among them be assessed?**

As discussed earlier, the metrics should be based on consumer testing. However, we suspect that the following metrics for determining funds would have explanatory power:

- Long-term returns (net of fees) compared to an appropriate benchmark
- Indicators of future returns, such as investment management capability, investment fees and investment style
- Risk premium for insurance for each cohort for each type of cover
- Scope of insurance for each cohort for each type of cover
- Number of ancillary benefits
- Member satisfaction ratings

The Commission should develop a model to predict the consumer utility of combinations of performance as assessed against each of the metrics. This model should be based on data based on tests of a representative sample of consumers. Ideally, the model would account for different utility functions for different cohorts. Bids should be ranked based on the overall score of the fund.

20. What scope might there be for funds to manipulate a tender process, and how can this be minimised? How might trials or experiments help in refining the design?

Funds might collude; temporarily improve indicators around the time of an assessment; or distort returns by writing-off capital. Collusion can be managed by regulation and comparing bids for excessive similarity (i.e. substantial similarity across multiple dimensions). Temporary improvements could be assessed based on the fund's history or whether the product features on which the indicators are based give rise revokable benefits or rights to members. Long-term historical returns must be assessed, so as to incorporate losses from capital write-offs for a period that reflects the continuing risk of losses under current management.

21. How frequently should a tender process be run? Who should administer the selection and subsequent monitoring of products?

We would suggest that the tender process should be run annually and be run by APRA.

How would employees be allocated to products?

22. What are the relative merits of using a single tender that covers the entire system versus a more segmented approach? What are the key practical considerations and challenges in implementing each approach?

The benefit of a more segmented approach is the increase in alignment of employee preferences with the product chosen. While we are concerned about requiring a tender process for all default funds, if such an approach was prescribed a high level of segmentation, down to the particular employer's employee base, should be considered. The key challenge is to identify relevant characteristics; this is also going to increase the cost of the process.

In what ways could employees be allocated to eligible products in a market-based model (including through single winner and multiple winner tenders)? What are the advantages and disadvantages of each approach? What costs and responsibilities would fall on employees, employers, regulators and superannuation funds under each approach?

Each cycle, new default members could be allocated to that cycle's winner, with existing default funds having to upgrade to provide equal or better benefits for existing members.

Where there are multiple winners, the employer could decide which of the winners to choose from. Existing funds would need to upgrade to provide equal or better cover to the level of the lowest-ranking winner.

This process would ensure broadly equal treatment for default members and encourage continual improvement to their benefits.

The regulator (or a regulated exchange) would administer the process to avoid misuse. The cost could be funded by super funds (through say a levy) and shared with employers/consumers through the normal market mechanism.

23. What are the merits of using the MySuper requirements as an entry threshold to the tender process? What are the potential problems with this kind of approach?

We disagree with using MySuper as a threshold test. While simplicity and comparability might increase the competitiveness of this sector, there is no reason to think other funds won't be competitive given the introduction of a tender process or other competition-enhancing measures.

Active choice by employees
Active choice with filter

24. What are the advantages and disadvantages of an active choice model? How can these costs and benefits be assessed and measured?

There are big challenges with nudging employees to make an active choice. Employees who would otherwise be default members will either: choose based on brand loyalty rather than rational self-interest.

Fund should be assessed against the following metrics:

- Long-term returns (net of fees) compared to an appropriate benchmark
- Indicators of future returns, such as investment management capability, investment fees and investment style
- Risk premium for insurance for each cohort for each type of cover
- Scope of insurance for each cohort for each type of cover
- Number of ancillary benefits
- Member satisfaction ratings

Funds should be compared against their peers, to help employees assess their fund and for the regulator to assess the demand-side pressures (of lack of them) provided by forcing employees to make an active choice.

What safeguard mechanisms might need to be put in place to deal with some of the potential pitfalls of an active choice model?

Employees might choose based purely on brand or industry affiliation. It's safe to assume that this wouldn't necessarily be in their individual interests.

We are comfortable with governments providing individuals with a basic financial education. Ideally, this would be part of the school curriculum. However, there are many adults who do not have had the benefit of such an education.

We would suggest that, until the population of people that must contribute to superannuation have had the benefit of financial literacy education, the government should provide education material (including fund comparison data) to help individuals choose their fund. This material would need to be at the fingertips of individuals when choosing their fund.

Further, we would suggest that, for more advanced financial education, employers consider engaging financial planners to provide financial education to employees. Employees might regard this as a valuable workplace benefit, especially if the education covers inspiring, broad-ranging issues of debt management and wealth creation and protection.

25. Would an active choice model benefit from a filter to ensure good quality products are chosen? What are the costs and benefits of government involvement in specifying a recommended list of products, compared to private sector provision of such information?

We strongly recommend that active choice be combined with the regulator (or a regulated private provider) publishing their ranking of funds according to the above matrix. To be valued, the assessor would have (and be seen) to be independent. Given the compulsory nature of superannuation, there is an argument for the assessor to be government and for government to fund the assessment. However, the service could also be funded by a levy on superannuation funds, the burden of which would be share as per the normal market mechanisms.

Alternatively, reputable private entities that have a deep understanding of the industry could conduct the assessment. An employer, for example, might choose to pay for such an entity to provide ranking information to that employer's employees. Competition, industry knowledge and diversity of opinion may enhance the quality and efficiency of the service. However, there is a risk that private ranking services will be captured by special interests that are different from those of employees.

26. How can behavioural finance inform the development and refinement of an active choice model? What experiments would need to be formulated and conducted to provide relevant evidence?

While it's possible that there a predictable patterns of sub-optimal choices in subsets of the population, our anecdotal experience has been good and bad decisions vary in degree and cut across all demographics. Our preferred approach is to set the conditions to allow individuals to readily access the information and professional advice they need to make god choices. A basic level of financial literacy on the part of employees, and employers and financial planners looking out for the interests of employees, provide a means to bridge the gap between actual and optimal decision-making.