21 August 2017

Superannuation

Productivity Commission

Locked Bag 2, Collins St East

Melbourne VIC 8003

Re. **Superannuation: Assessing Competitiveness and Efficiency**

To Whom It May Concern,

We welcome the opportunity to respond to the Commission's issues paper of July 2017 on assessing the competitiveness and efficiency of the superannuation system. We have provided brief answers to some of the questions you have raised in the paper, below.

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

We are concerned as to whether the allocation of default funds in modern awards limits the liquidity benefit other funds could achieve in their net performance compared to a more competitive market. It would be appropriate to assesses existing arrangements against criteria such as E1 for this purpose.

We recommend that the Commission compare funds included in modern awards, with other default funds to determine the liquidity characteristics of each group and the net liquidity benefit of being included in a modern award.

How do the existing default arrangements mitigate the paramount risk of any default system — a member defaulting to a (long-term) underperforming default product? What is the evidence of long-term underperforming default product providers exiting the default market?

We would expect that, except where the relationship between employee and superannuation product is not independent, moving to a new employer would help mitigate the risk of a member defaulting to a product that underperforms into the long-term. We are not aware of evidence about underperforming funds exiting the default market.

How do the existing default arrangements create incentives for funds to maximise long-term net returns and allocate members to products that meet their needs? How could the existing arrangements be improved to achieve this goal?

We would expect that the incentive to maximise long-term returns is created by the threat that some employees will be dissatisfied because the reported returns and ancillary benefits for their fund are less than those for their peers who aren't with the same fund, creating a risk of contagion of dissatisfaction amongst employees of the same employer.

In selecting default products on behalf of their employees, employers face administrative costs. Employers may also face the cost of professional advice.

Existing arrangements could be improved by providing employers with guidance on which funds are appropriate as default funds. The list could be produced by government or an independent commercial provider that is subject to regulatory oversight.

The list of funds should be compiled based on relevant performance indicators, such as long-term net returns. There is an argument that a tender process could be used to select funds for the list.

We are generally against the notion of excluding consideration of any member benefit outright. This is largely because default members may become engaged in relation to their superannuation.

A better approach is for a low weight to be assigned to some features (such as the ability to invest in direct assets), which current default members might reasonably be expected to rarely (if ever) value. If the weight reasonable assigned to a feature were extremely low, we'd be open to excluding consideration of the feature.

By contrast, the degree of choice as to how benefits may be accessed (e.g. as a lump sum or selection from a wide variety of types of income stream) from a fund should be given a high weight as default members are likely to become engaged when they can access their superannuation. It might be reasonable to assume that, at retirement, members who have been default members will value having access to a flexible retirement solution (e.g. access to flexible combinations of longevity products and account-based income streams, and a broad range of investment options) more than a narrow range of options to access their benefits,

While members can generally always move to another fund, there are transaction costs and potentially tax implications. Further, the system may need to be more liquid than it would otherwise need to be. Therefore, we regard an assessment that reduces the need for moving to another fund down the track as preferable.

What is the evidence that existing default arrangements encourage open participation (contestability) and rivalry between funds for the default market (competition for the market)? What is the evidence that there is competitive pressure that drives innovation, cost reductions and more efficient long-term outcomes for members? How could the existing arrangements be improved to achieve this goal?

Qualitative indicators that existing arrangements are not open include that superannuation funds have been prescribed as default funds in modern awards despite potential conflicts in the decision process.

Existing arrangements could be improved by opening up modern awards to competition from funds not currently included in the modern awards. Given the disengagement of members and, in turn, the dampened incentive for employers to provide optimal superannuation for their employees, guidance in the form of a list of default funds approved by government or an independent commercial provider (as discussed above) may be appropriate. Publicising these lists may nudge employees and their advocates to identify default funds that may be sub-standard.

How do the existing default arrangements promote accountability and integrity in the selection and delivery of default superannuation products? How could the existing arrangements be improved to achieve this goal?.

The existing default arrangements promote accountability through requiring a default fund to be a public offer fund or for its trustees (or board of its corporate trustee) to have equal representation of employer and member representatives. The existing default arrangements promote integrity through legislation that precludes an employer from receiving incentives for their selection of default fund.

Default arrangements could be improved through legislation imposing penalties on directors or corporate trustees who don't act in the best interests of members or who use their position to pursue their own interests at the members' expense; and requiring funds to hold annual general meetings. We understand that the Government already intends to legislate such measures.

Do the existing default arrangements create any concerns about stability in the superannuation system that could lead to significant systemic risks?

Concentration of key service providers, for example, asset consulting, auditing and custodial services, exists in the superannuation industry: see https://australiancentre.com.au/wp-content/uploads/2016/04/D1P7-Complexity-in-the-Superannuation-System.pdf, p 13. This may pose a systemic risk because of the domination of a single approach to key aspects of service delivery (e.g. approach to risk management).

Do the existing default arrangements minimise overall system-wide costs, taking into account costs on members, employers, funds and governments? How could the existing arrangements be improved to achieve this goal?

Under existing default arrangements, overall system-wide costs are not minimised as members have multiple funds because of previous employment; and members rollover benefits when they can access them (typically in retirement). These unnecessary duplication and rollover costs bump up costs for funds or members across the default sector. For example, rolling over takes time for the member and involves transaction costs.

Similarly, employers (or their advisers) are each researching funds in order to select a default fund. This duplication of research also raises costs across employers, unnecessarily.

Government and funds use resources to administer or comply with the legislation covering lost and unclaimed superannuation. Existing default arrangements contribute to the need for, and high costs associated with, the regime for lost and unclaimed super.

System-wide costs could be minimised by:

- providing centralised ratings of superannuation fund performance against relevant criteria
- assessing default funds based not only on net returns, but also on features likely to be of value to a member once they become engaged (for example, the ability to commence a superannuation income stream and the cost of such products)

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

New members of the body should be appointed by government (and confirmed by parliament) for each round of selection of default funds, with only limited grounds for removal from the position of member.

However, government should have oversight of the board without being able to direct (or substantially direct) its selection decisions.

Government appointment promotes decisiveness, while parliamentary confirmation promotes democratic legitimacy and mitigates the risk of bias. Having limited grounds for removal from position mitigates the risk of politicisation, while having government oversight promotes democratic accountability.

On the first timer default mechanism:

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

One of the criteria that should be taken into account in selecting default funds should be the extent to which the fund encourages default members to become engaged. For example, funds that faciliate advice and workplace education encourage members to develop a financial plan for their retirement.

The risk of members remaining in inferior products could be managed by considering the history of volatility of fund performance on relevant criteria, including net investment performance. Evidence of funds reducing performance after being selected as a default fund should be taken into account in assessing history.

On the proposed centralised clearing house:

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

We don't have a response to the specific questions. We merely note that the ATO already operates the Small Business Superannuation Clearing House, and offer the comment that if there is only one provider, there is a heightened risk that the provider will not keep pace with technological change.

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

A central clearing house offers efficiency benefits to employers and payroll systems because all contributions would be sent to a single location. A clearing house could also help employers meet their Superannuation Guarantee obligations.