19 September 2016

Deputy Chairman
Productivity Commission
Locked Bag 2, Collins Street East
Melbourne, VIC 3003

BY EMAIL: super@pc.gov.au

Dear Ms Chester

Superannuation Efficiency and Competition

The Financial Services Council welcomes the opportunity to make a submission to the Productivity Commission's (PC) review of efficiency and competition in the superannuation industry.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and public trustees. The FSC has over 125 members who are responsible for investing more than $2.5 trillion on behalf of 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world.

The Financial Services Council (FSC) supports enhancing competition in the superannuation industry to improve the efficiency of the system and improve outcomes for consumers. The FSC welcomes the draft report of the Productivity Commission as an important step in ensuring that the framework for the superannuation system is orientated towards consumers as envisaged by the Financial System Inquiry (FSI).

The FSC is broadly supportive of the system level approach taken by the Commission in its draft report, but is of the view that the Commission should clearly enunciate the audience, and the frequency of this review.

The FSC would welcome the opportunity to meet with the Commission to discuss our submission and concerns in more detail. If you have any questions in relation to this submission please contact the FSC on 02 9299 3022.

Yours sincerely

A J Bragg

ANDREW BRAGG
Director of Policy & Global Markets

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Recommendation 1: We recommend the Fair Work Commission process be abolished to allow competition.

Recommendation 2: The assessment of the system should be prospective from 1 July 2017 align with the recommendation of the FSI and recognise the significant impact of recent regulatory reforms (e.g. MySuper, Stronger Super, FOFA) on the competitiveness and efficiency of the system over their implementation period of 2013-2017.

Recommendation 3: Comparative analysis should only occur on a like-for-like basis and exclude APRA's 'whole of fund' data that aggregates investment options, thereby failing to reflect the demographic profiles and risk appetites of different consumers.

Recommendation 4: The proposed objective for the purposes of the Commission's review be extended to incorporate the concept of adequacy.

Recommendation 5: The Commission identify the material barrier that is presented by the existing policy framework to competition and efficiency in the superannuation system.

Recommendation 6: The Commission recognise evidence that the current policy framework does not protect incumbent industry funds from 'inefficient' forms of competition and this evidence be accounted for in the proposed criteria.

Recommendation 6: The Commission ensure governance criteria measures the conflicts that arise from their related party arrangements, and the extent to which they undermine the efficiency of those trustees.

Recommendation 7: The Productivity Commission adopt a comprehensive definition of vertical integration to include superannuation entities which operate in multiple parts of the financial service industry value chain or production path, allowing the Commission to obtain the most complete and clearest picture of the operating models.

Recommendation 8: The impact to competition of default funds under modern awards be included as part of the review.

Recommendation 9: The impact of an independent board (or lack of) should be considered in determining the level of competition in the industry.

Recommendation 10: The vertical integration assessment should recognise and incorporate the benefits outlined above and the existing regulatory requirements on providers.

Recommendation 11: The proposed objective "*the superannuation system provides insurance that meets members needs at least cost" be amended to "the superannuation system provides insurance that delivers valuable protection to society and meets members needs at reasonable cost".*

Recommendation 12: The Productivity Commission should incorporate a measure in the framework that can assess the efficiency of health and wellbeing programs and the value they deliver for members in order to provide a more holistic view of the benefits of insurance as part of the superannuation system.

Recommendation 13: The Productivity Commission should consider a broader definition of insurance within superannuation that goes beyond simply the financial benefit paid to members.

Overview

The Financial Services Council (FSC) supports enhancing competition in the superannuation industry to improve the efficiency of the system and improve outcomes for consumers. The seismic barriers to competition in the superannuation industry are well known and long overdue for reform. The overlay of the Fair Work Commission into superannuation law is perhaps the best example in the economy of deeply uncompetitive public policy settings.

The mere fact that superannuation funds which obtain a "MySuper" authorisation from APRA may not take their product to market (because of the Fair Work Commission overlay) highlights the competition barrier.

The FSC is broadly supportive of the system level approach taken by the Commission in its draft report but is of the view that the Commission should clearly enunciate the audience, and the frequency of this review. The FSC is of the view that the FSI recommendation and the Terms of Reference intended for this exercise to be a once off review to inform policy development, however, the Commission appears to envisage establishing comprehensive criteria for periodic, consumer facing reviews.

This submission is intended to assist the Commission as it finalises criteria for assessing the competitiveness and efficiency of the system and contemplates its potential approach to the third stage of the review.

The FSC responds to each of the criteria proposed by the Commission in Appendix A to this submission, but also provides more detailed consideration to thematic issues, including:

- The MySuper competitive framework as envisaged by Jeremy Cooper in the 2010 *Super System Review* remains incomplete. While the MySuper product framework has been legislated, MySuper products cannot compete in the marketplace as Cooper proposed. This is solely due to the industrial barriers which remain under the Fair Work Commission process for allocating compulsory default funds.

- That the FSI envisaged the review apply prospectively from the introduction of MySuper in 2013, and this necessitates the exclusion of historical data from prior to MySuper as it will cause a statistical break that would be methodologically unsound and undermine the credibility of the Commission's analysis. The Commission should have regard to the considerable regulatory change currently underway in superannuation by undertaking a prospective approach to assessing the industry.

- The proposed approach to vertically and horizontally integrated business models is based on a troublingly narrow, and almost political, 'bank-owned' definition. The Commission should take a balanced approach and consider the related party arrangements between industry funds and their wholly owned service providers, as well as whether consumers are protected by robust governance arrangements in all integrated models.

- The existing policy framework in the default superannuation market is a material barrier to improvements in operational, allocative and dynamic efficiency in the superannuation system.

The importance of life insurance within superannuation to provide cover and a safety net for Australians, particularly those that may not have thought about insurance, or been afforded cover on an individual basis.

- The industry's continued focus on delivering better value and protection for Australians, and the group insurance selection and review process and the important role of the trustee.

Financial System Inquiry and My Super: a post-reform review

The Financial System Inquiry (FSI) decided not to draw conclusions on the competitiveness and efficiency of the superannuation system due to the progressive implementation of the MySuper and Stronger Super reforms. As noted above, the *Super System Review* framework for MySuper remains incomplete more than six years after the conclusion of the review.

MySuper competitive framework not yet realised

The FSC agrees with the overarching principle that competition is necessary to drive better consumer outcomes, including optimising net returns. This is consistent with the original policy intent behind MySuper, which was to create comparable default products between which consumers could exercise choice.

Reform of the superannuation system to introduce greater competition, however, should begin with allowing all MySuper products to compete for employer contributions by removing regulatory barriers to competition inherent in the modern award system and enterprise agreements.

In July 2010, in response to the *Super System Review* which proposed that MySuper products be able to compete to compete in the marketplace, the government released its Stronger Super reforms which explained that the MySuper product parameters would be set out in legislation and enforced by Australian Prudential Regulatory Authority (APRA).

In addition, the Productivity Commission report in 2010 said that "the selection of default funds in awards largely reflects precedent and is not subject to a competitive process".

However, contrary to the *Super System Review and Productivity Commission recommendations* the MySuper legislation clearly continues to impose severe limits on competition between funds, with the process:

- creates unnecessary duplication by requiring MySuper products to be approved by APRA, then accepted for default listing by the Fair Work Commission (FWC) Expert Panel and then chosen from the list by the FWC Full Bench; and
- favours incumbent award default funds by restricting the right to make submissions in the second stage of the FWC review, which decides which fund is listed in each award, to only registered organisations (unions and employer organisations) that own funds.

The current FWC process fails to facilitate competition by only allowing unions and employers, which own the funds, to make submissions in relation to which funds are listed in each modern award. The FWC system is both conflicted and not transparent and must be abolished in favour of competition.

Furthermore, the current default system prevents consumers and employers from choosing to leave an underperforming MySuper product in order to join a more competitive product, a critical ingredient in creating a competitive market.

Recommendation: We recommend the Fair Work Commission process be abolished to allow competition.

FSI not drawing conclusions on the competitiveness and efficiency of the superannuation system

Recommendation 10 of the FSI instead provided for a review by 2020 for the purpose of understanding the impact that the Stronger Super and MySuper reforms had had on the system:

> Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.

The FSI recognised that the industry would have significantly different characteristics as a result of the implementation of MySuper. Over the past four years, significant regulatory changes have occurred as a result of Stronger Super and the Future of Financial Advice (FoFA) reforms.

The MySuper reforms are one aspect of the Stronger Super reforms which commenced transition in 2013 and will not be completed until at least July 2017 for many super funds. The reforms meant that new MySuper compliant products had to be established and approved by APRA to replace existing default superannuation products for members who have not exercised choice. Moreover, Choice products have also been enhanced considerably with the introduction of new prudential and trustee governance requirements.

The MySuper reforms have been designed to ensure that default superannuation products are simple and low cost, and easier to understand and therefore better for product comparison and competitive purposes.

In addition, the FoFA reforms impacted many choice products and financial advisers. The reforms prevented financial advisers from receiving conflicted remuneration for investment products. New investment products created under these reforms are fee for service only and many older style products were closed to new members. The introduction of FoFA led to new products while older products were closed to new members. Similarly, the introduction of MySuper has led to the transfer of default members to the new products. This process will be completed for most funds by 30 June 2017.

A prospective review: 2017 onwards

The key attribute of the FSI recommendation was that it is forward-looking, to the extent that it requires an assessment of the competitiveness and efficiency of the superannuation system following the introduction of the Stronger Super and MySuper reforms. Whilst these reforms commenced implementation in 2013, its implementation will not be complete until June 2017.

Any review should be measuring the post-MySuper and Stronger Super world from July 2017, including Choice and MySuper products. This would give three years of data until 2020. If more data is required by the Commission, we caution against extending the time period back to the commencement of implementation of MySuper in 2013, given the considerable amount of regulatory change undertaken by the industry. The Commission should therefore consider extending their time period forward, beyond 2020.

The FSC is concerned that elements of the Commission's interim report envisage a backward-looking assessment of the superannuation system that would be inconsistent with the purpose of the review and therefore methodologically unsound.

There is a clear statistical break in the data series upon the introduction of MySuper and Stronger Super in 2013. Many superannuation funds either ceased offering 'old' superannuation products upon the implementation of these reforms and commenced offering an entirely new product in the newly regulated environment or significantly updated their existing product suite.

The reforms during the four years of their implementation (2013-2017) are fundamentally altering the competitive landscape of the system. Collecting data on older products that may have been closed and are still subject to transitional arrangements, whilst the MySuper migrations are not yet complete, would not only fail to generate meaningful insights on competition in the post-reforms landscape, but also result in statistically invalid outcomes.

Stronger Super and FoFA reforms can only be assessed over a time period over which the reforms were in place. Assessing the efficiency of the market over a longer continuous historical timeframe would ignore various structural changes in the economy and regulatory settings, creating a statistical break in the data, and would not be appropriate for the stated purpose.

In summary, historical data would be inappropriate for the Commission's purposes as it creates a false impression of the present and future competitive landscape with an industry in the process of a major upheaval (the MySuper migrations) which will not be complete until June 2017.

The FSC recommends that to achieve the recommendation of the FSI, the Commission would be best to focus on understanding how MySuper has affected the competitive landscape from the completion of the implementation of MySuper in 2017. If a longer data series is desired, the Commission could collect data from 2013 (the introduction of MySuper) however the period 2013-17 is subject to major migrations and product rationalisation making data comparison over this time period difficult. Any data being used from this time period would have to be selected carefully to ensure comparisons are valid.

Recent research undertaken by Tria Partners concluded that across the financial services industry the past five years of regulatory reform has cost $2.75 billion, which is estimated to reach almost $3 billion once the current reforms being debated by parliament are fully implemented. In turn this creates a very real cost to consumers, estimated at $105 per superannuation account over the past five years – equivalent to 25 per cent of the typical fixed fee charged to superannuation fund members. We recognise these reforms are intended to improve consumer outcomes but their implementation and ongoing costs are substantial and will continue. We submit that this work and expenditure further complicates any industry assessment over the last five years and supports a prospective assessment of the industry.

Regard should also be had to the ongoing implementation of another major Stronger Super initiative known as SuperStream. The SuperStream reforms are focused on creating a consistent, electronic, and streamlined approach to the back office operations of funds as well as transmission of payments and data across and between funds and also employers. The investment is initially expensive but over time will provide a significant uplift in efficiency and, in relative terms, lower costs.

A prospective post-2017 approach will be the most useful in analysing other contemporary factors important to the competitive landscape, including trends for improvements in service delivery, better product features, lower fees and costs over time and stronger member engagement. All of these factors require forward looking data from once members are in a MySuper product.

Recommendation: The assessment of the system should be prospective from 1 July 2017 align with the recommendation of the FSI and recognise the significant impact of recent regulatory reforms (e.g. MySuper, Stronger Super, FOFA) on the competitiveness and efficiency of the system over their implementation period of 2013-2017.

Relying on APRA 'whole of fund' data will distort comparisons

The Commission contemplates using APRA's 'whole of fund' data over an extended period to provide insight into fund performance. As outlined above, historical data, including, APRA's 'whole of fund' data, is flawed as a tool for analysing the efficiency and competitiveness of the current superannuation system.

There is a further issue with using the APRA 'whole of fund' data. This data includes, for each superannuation fund, the net returns of all investment options offered by a trustee. This is not just for default investment options but includes choice investment options. For a superannuation fund where most members are in the default option, the return will be very close to the default return that MySuper members receive. Many super funds, however, have high proportions of engaged or advised members who have made an investment selection and are in a choice investment option appropriate to their individual circumstances. For these super funds, the APRA 'whole of fund' data will bear little relationship to the default investment return.

Using APRA 'whole of fund data' to compare fund returns fails to allow for the different investment options offered to cater to the investment needs and demographic differences between members of different super funds.

For example, a super fund where the trustee offers a conservative investment default incorporating a higher proportion of cash or fixed interest investments to cater to older members will have a lower net return than a super fund with a younger membership base, where the trustee offers a default that is predominantly invested in a 'balanced fund' or a 'growth' style default. APRA requires trustees to select an investment strategy taking into account, amongst other things, the demographics of the membership. The lower return of the first fund is not a reflection of poor investment performance of the trustee, but a reflection of the more conservative investment strategy undertaken by the trustee to protect its older members from negative returns close to retirement, from which it will be difficult to recover.

It is for this reason that many super funds have adopted a "lifestages" investment default structure can reduce the investment risk as members get older to protect their account balances.

Members of a super fund where the trustee channels all its members into a single diversified option into and through retirement may experience significant losses should there be a market downturn, potentially contributing to timing risk that that can have negative results for older consumers. However, if the Commission relies on the APRA 'whole of fund' data, such a fund would appear to have a better net return for older members over the medium term and would appear to be a better fund than the earlier fund with the trustee that, in the context of the fund's approach, may be better managing their members' risk.

In summary, using the APRA 'whole of fund' data to compare fund returns is flawed as it does not allow for the different investment strategies and, most importantly, the different levels of investment risk of different superannuation funds.

The FSC is concerned the proposed use of 'whole of fund' data, and other retrospective time series would distort comparisons that are statistically flawed and also lead to excessive risk-taking by consumers.

Recommendation: Comparative analysis should only occur on a like-for-like basis and exclude APRA's 'whole of fund' data that aggregates investment options, thereby failing to reflect the demographic profiles and risk appetites of different consumers.

Objective of Superannuation

The FSC supports enshrining an objective for the superannuation system in legislation to steer future policy development.

The FSC notes that the Government has announced its proposed objective of superannuation, consistent with the recommendation of the FSI:

> To provide income in retirement to substitute or supplement the Age Pension.

The FSC is concerned that the proposed objective does not recognise the purpose of the system as aiming to deliver adequate retirement incomes, but instead portrays the superannuation system as an attachment to the social security system.

Recommendation: The proposed objective for the purposes of the Commission's review be extended to incorporate the concept of adequacy.

Framework for a contestable market

The existing policy framework presents a material barrier to competition

The FSC agrees with the Commission's contention that some barriers to competition are market-related and others are policy related. The Commission undertook to determine the materiality of these barriers, which the FSC submits are significant, particularly in relation to consumers who do not choose, or are prevented from choosing, their own superannuation fund.

The FSC supports a contestable market, within the population of APRA-approved MySuper products, which allows every individual to choose their own superannuation fund and every employer to choose the most suitable default fund for their workplace.

There are, however, clear policy-related barriers to competition that impede the efficient functioning of the market:

- Under the Fair Work Commission superannuation expert panel process, Australia's 122 Modern Awards contain mandatory default funds selected by the Commission. This may require different cohorts within a workplace to be defaulted into different products, reducing scale benefits.
- Enterprise agreements remove the capacity for approximately 800 000 consumers to choose their own superannuation fund and can often compel an employer to pay default contributions into different funds for different work sites; and

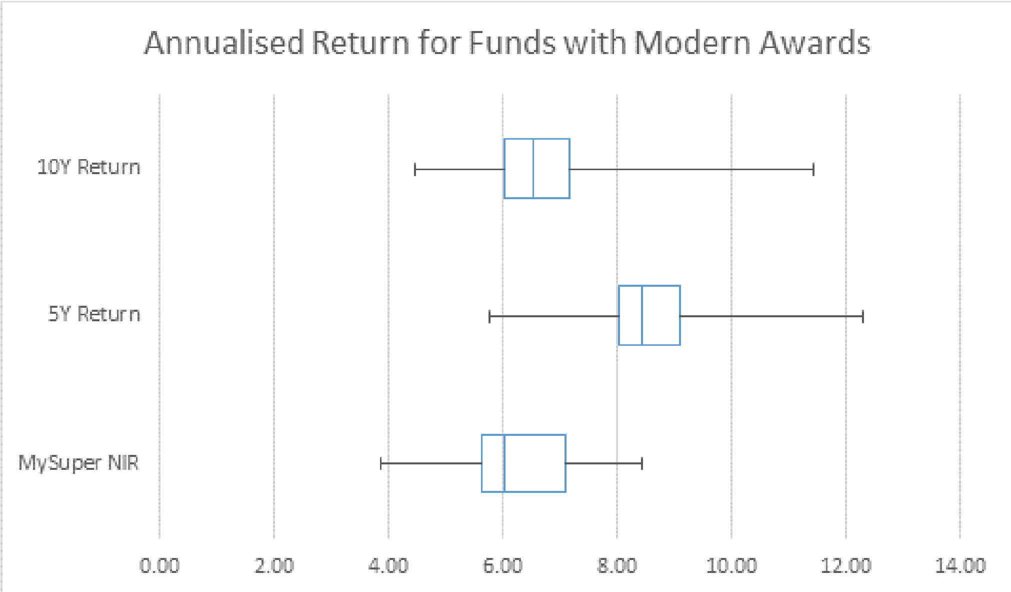
These instruments are negotiated or based on submissions from the trade unions who are related parties to industry superannuation funds. Further, the representation rules of trade unions that are recognised by the Fair Work Commission prevent one industry fund from readily competing with another industry fund where the trade union related to the fund does not have the 'right' to represent the industrial interests of those workers.

The policy framework has a clear conflict of interest at its heart, where industrial parties can and do place their own interests ahead of the interests of consumers (super fund members).

The existing policy framework is neither contestable nor competitive.

Furthermore, there is significant evidence to show that the poor performance of some superannuation funds listed in modern awards and enterprise agreements is undermining the retirement outcomes for members of those funds. The MySuper data reported in APRA's superannuation return data in Chart 1 demonstrates the significant variance in performance by different MySuper products that are listed in modern awards.

Chart 1. Annualised NIR or Whole of Fund returns for default products with Modern Award listings



Source: FSC Analysis of APRA and Fair Work Commission data

Chart 1 demonstrates that across three different timeframes – since MySuper started in 2013, the last 5 years, and the last 10 years – there is significant variance in the performance of the default products appointed by the Fair Work Commission to modern awards as default funds.

Chart 1 shows that there are poorly performing industry funds that have listings in the award system. As there are 16 modern awards that only name one MySuper product, an employer in that industry has no choice as to which MySuper product must be the default product for their workplace. Consumers are being defaulted into underperforming products under the current framework.

The FSC recommends that the Commission recognise existing policy is a clear barrier to competition that fails against the criteria of operational, allocative and dynamic efficiency:

- Operational: requiring two stages of MySuper vetting, through APRA and then the Fair Work Commission, is duplicative and inefficient, and creates barriers to entry from trustees that are not owned by industrial parties (employer groups and trade unions).

- Allocative: the current policy framework has resulted in the proliferation of subscale and inefficient superannuation funds and acts as a barrier to fund merging as they can rely on their default status and the resulting guaranteed inflows to support their liquidity.

- Dynamic: the industrial framework suppresses efficiency gains over time as it removes the pressure to reduce costs, lower fees and innovate to win default consumers.

Recommendation: The Commission identify the material barrier that is presented by the existing policy framework to competition and efficiency in the superannuation system.

The default framework does not protect funds from 'inefficient competition'

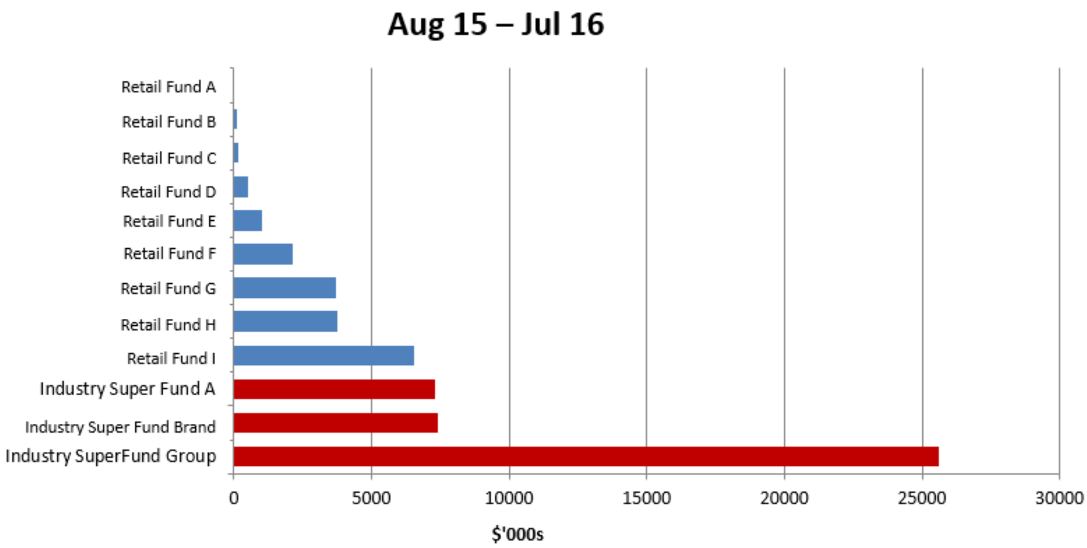
The FSC is also concerned by suggestions in the draft report that exposing superannuation funds to competition-enhancing reforms would lead to inefficient competition that is not currently experienced in the industry.

This argument appears to rest on the assumption that their protected status of industry funds provides efficiencies, such as not incurring the expense of advertising, which they would not experience should they be required to compete.

The argument in regards to industry funds incurring lower expenses on advertising is simply incorrect. Data presented in Chart 2, sourced from Neilsen AdEx, demonstrates that over the past twelve months Industry SuperFund Group, that is, the collection of 15 industry funds who co-brand themselves 'Industry SuperFunds', collectively spend $25 million on advertising.

The $25 million in advertising expenditure is far greater than all the remaining retail superannuation funds listed in the top 10 combined. It is also consistent with the annual advertising spend of the Industry SuperFunds group over the past three years.

Further, the brand managed by lobby group ISA, incurred its own expenditure of over $7 million, a sum greater than any retail superannuation competitor. An individual industry superannuation fund also outspent every other superannuation fund in the market, including any retail superannuation fund.



Source Nielsen AdEx

The FSC submits that in the context of increasing consumer engagement with consumers, advertising is an important activity and should not necessarily be discouraged. This data exposes, however, the assumption that industry superannuation funds incur lower advertising expenses as a result of being protected from competition under the current policy framework.

The FSC submits that the Commission view with caution claims that industry funds are more efficient for not having to compete for the default market when there is evidence to the contrary.

The FSC also submits that advertising expenditure funded by trustees, but delivered through related parties such as ISA, also be included in the Commission's assessment of the efficiency. The FSC is concerned that this behaviour reflects how guaranteed market share may cross-subsidise activities in the choice market.

Recommendation: The Commission recognise evidence that the current policy framework does not protect incumbent industry funds from 'inefficient' forms of competition and this evidence be accounted for in the proposed criteria.

Vertical and Horizontal Integration

Related party transactions and independent directors

The FSC is concerned with the reliance of the Commission's draft report on an outdated study of vertical integration of the superannuation system that was conducted by an APRA employee, but not endorsed by APRA. The claim that retail superannuation funds pay more for related party service providers relates to data that pre-dates important governance reforms implemented by the FSC.

The report does not reflect contemporary practice. Retail funds who are members of the FSC are required to have a majority independent directors and an independent chair under the FSC's enforceable Standard 20. Attempts to require higher standards of governance for industry funds, however, are being actively opposed by the sector.

Independent directors are important to ensuring consumers are protected from conflicts of interest when entering into outsourcing arrangements with related parties. The Commission is correct to emphasise the importance of high standards of governance to ensure the system is efficient and should recognise that the old 'APRA' study claiming excess cost in related party transactions is not reliable due to the governance reforms implemented by the FSC.

Industry funds, by comparison, regularly use related party service providers without the protection of independent directors on either the trustee board, or the service provider's board. There are also examples of directors from a trustee, who is a major shareholder in the service provider, also being a director on the board of a related party service provider, creating an unmanageable conflict.

It is unclear, however, whether the Commission has considered these contemporaneous issues of governance and vertical integration amongst industry funds, and instead focused on outdated conflicts amongst retail funds.

It is important to note that the risks related to industry fund governance are exacerbated as a result of consumers being forced to be members of industry funds as a result of the default system.

Recommendation: The Commission ensure governance criteria measures the conflicts that arise from their related party arrangements, and the extent to which they undermine the efficiency of those trustees.

The need for a clear definition of vertical integration

As noted by the Financial System Inquiry[1], the trend towards vertical integration is growing within the wealth management and superannuation sectors. However, there is no standardised definition of vertical integration in the context of Australia's financial services industry. This is a fundamental flaw in examining vertical integration and should be addressed by the Commission before undertaking an assessment of this dynamic.

We firmly believe that a vertically integrated business is one which operates in multiple parts of the industry value chain or production path. This can be evidenced by a group of related companies (at least two) which includes a manufacturer of financial services products, such as superannuation, investment management or insurance products, and a distributor of these financial products, such as a financial advice business. The FSC encourages the Commission to recognise that this type of business model applies to most entities that operate throughout the financial services value chain or production path. In addition, vertical integration is a common feature in many industries outside of financial services, for example manufacturing, resources, telecommunications, media and agriculture.

There are numerous forms of vertical integration which can be found in the superannuation industry. For example, most banks now have some form of wealth management division offering products and advice, superannuation platforms are increasingly adding asset management or advice subsidiaries, and industry super funds are now internalising their asset management and advice.

The table below outlines the main functions that may also be performed by a superannuation fund. Under our proposed definition where a fund performs one or more of these functions, we submit they are vertically integrated and should be included in the scope of the Commission's assessment. While this portrays many superannuation providers in Australia, the extent of vertical integration varies widely and is determined by the scope of a fund's operations and activities, as well as the specific products and services it offers. Vertically integrated institutions can, and should, co-exist with other providers ensure customers have the ability to select the provider who is best placed to meet their needs.

It is misleading to limit the consideration of vertical integration to a particular corporate structure such as consolidated banking groups. Adopting a narrower definition does not recognise the interconnectedness of the industry and will result in an incomplete assessment. Given the uniform application of existing consumer safeguards across superannuation, we are concerned this approach could result in ineffective regulatory and policy outcomes, and ultimately an uneven playing field.

Given the intermediated nature of the superannuation industry, nearly all funds have evolved to be vertically integrated in some way. This feature of the industry is critical in achieving a balanced and meaningful assessment of vertical integration, and should be recognised by the Commission.

Recommendation: The Productivity Commission adopt a comprehensive definition of vertical integration to include superannuation entities which operate in multiple parts of the financial service industry value chain or production path, allowing the Commission to obtain the most complete and clearest picture of the operating models.

1 Financial System Inquiry Interim Report July 2014

Table: Vertically integrated superannuation fund functions / production path (not exhaustive)

FUNCTION	DESCRIPTION
Trustee services	Acting as trustee of the fund and performing necessary legal and compliance functions.
Investment management	Invest the assets of the fund.
Financial advice	Provide advice to members of the fund, includes call centres etc.
Life insurance	Provide life insurance benefits to members of the fund.
Asset consulting	Advise the trustee on the appropriate asset allocation of the fund and investment manager selection.
Insurance consulting	Advise the trustee on appropriate benefit design and insurer selection.
Fund administration	Provide administrative support to the fund, including IT services, contributions processing, member records, providing information to members, processing claims and paying benefits etc.
Custody	Provide custodial, investment administration and related services to the fund.

Vertical and horizontal integration in superannuation

Within the context of superannuation, most organisations have been rapidly recognising the benefits of vertical integration over the last couple of years.

This has seen many funds (including industry funds) bring in-house asset management, administration and financial advice services. It has also seen some superannuation funds establish their own subsidiaries that offer banking or insurance services.

Additionally, the allocation of default funds under modern awards is a form of horizontal integration and an assessment of its impact on competition should be included as part of the review.

Recommendation: The impact to competition of default funds under modern awards be included as part of the review.

The Commission should also have regard to related party arrangements between superannuation funds and their wholly owned service providers. The FSC believes there are conflicts of interest that exist within some superannuation networks with the absence of independent directors undermining effective management of these conflicts.

In the current market, all retail and the majority of industry superannuation funds are structured with some aspect of vertical integration. The FSC contends that it is essential that a superannuation business which has any element of vertical integration has an independent trustee board. This will allow the super fund to manage the conflicts of interest that can arise in vertically aligned structures.

Recommendation: The impact of an independent board (or lack of) should be considered in determining the level of competition in the industry.

Vertical integration's benefits and existing consumer safeguards

Within the context of superannuation, most organisations have been rapidly recognising the benefits of vertical integration over the last couple of years. This has seen many funds bring in-house asset-management, administration and financial advice services. Some superannuation funds also choosing to establish their own subsidiaries that offer banking or insurance services.

Consumers today are often time poor and technology astute, often using online platforms to investigate ways to reduce their financial costs. A way that some consumers achieve savings is through transacting with a 'one stop shop', an institution who provides a suite of financial products. The administrative and transactional efficiencies of having a consumer with multiple financial products with one institution, can permit the institution to deliver savings to the consumer.

Vertically integrated institutions play an important role in providing competitive products and services through economies of scale, while also contributing to the overall strength and stability of Australia's financial system. The FSC notes the findings of the 2015 Financial System Inquiry which noted, vertical integration was not an issue provided the gatekeepers were sufficiently robust in ensuring conflicts were managed.

The FSC is concerned that the Commission's proposed focus on vertical integration is solely on assessing whether there are any material anti-competitive effects of vertical integration. Whilst we recognise there continues to be industry debate on this matter, consumers who access a financial product or service from a vertically integrated organisation will also benefit from a number of advantages, including the following:

- *Diverse products / services* - Vertical integration provides the customer with a wider range of products and services to meet their needs in one place. This is in contrast to single product companies who may be limited to providing a single product when an alternative product may be more appropriate to meet the customer's need.
- *Consolidated visibility* - Vertically integrated institutions have the ability to offer customers the convenience to access a consolidated view of their financial affairs. For example, the capability to view their bank balance and super balance online through their online banking website. The capacity to manage all of their affairs using a single portal or provider increases simplicity and can lead to greater customer engagement and understanding.
- *Economies of scale* - Vertically integrated institutions are often more efficient, through economies of scale and scope and are often able to offer better value to the consumer as a result.
- *Innovation* - Vertically integrated companies have a greater capacity to innovate and continually improve products for customers as they are able to consider needs across various traditional product classes. Moreover, vertical integration allows organisations

to develop a deeper understanding of their customers by leveraging data, for example by being able to provide the most appropriate products and services.

- *Safety* - Larger and more vertically integrated institutions have the capacity to invest a greater proportion of resourcing on risk management and compliance frameworks, including capital. They are generally perceived to be safer because they have the financial capacity to stand behind their advice and products, and facilitate remediation in the event that customers don't receive the services and products as promised.

We firmly believe that these factors should also be included in the scope of the Commission's vertical integration assessment.

As noted above, there are a range of existing safeguards applying in superannuation to protect consumers. This regulatory framework has been successfully developed to apply equally across vertically integrated and non-vertically integrated entities. Naturally, the Commission's assessment of vertical integration and its impact on competition should also have regard to these obligations and their effectiveness. In particular, this should include the recent Future of Financial Advice (FOFA) reforms, which places a number of obligations on advisers and product providers (including vertically integrated institutions), most notably the duty on financial advisers to act in the best interests of the customer.

These reforms are in addition to the existing statutory obligations on RSE licensees and REs to act in the best interests of fund members and should also be considered. In this context, funds should be acutely aware of these legal obligations and actively monitor and manage conflicts of interest that may arise in its business.

Recommendation: The vertical integration assessment should recognise and incorporate the benefits outlined above and the existing regulatory requirements on providers.

The relationship between the default system and infrastructure investment

Industry superannuation funds have openly promoted how being protected from competition is a source of competitive advantage that enables them to achieve stronger investment perform better than they otherwise would through investing in illiquid infrastructure assets.

Firstly, it is incorrect to allege that retail superannuation funds do not invest in infrastructure. Managers, such as CFS GAM, AMP and Macquarie are some of the largest infrastructure investors in Australia.

The critical point is that infrastructure investing is appropriate where it delivers the best outcome for superannuation consumers, consistent with the sole purpose test in superannuation legislation.

Cbus chairman, Steve Bracks recently advised *The Australian* that the $32 billion fund received guaranteed inflows of $100 million a month from default funds which provide an advantage when it implements its investment strategy:

> "It will be extremely difficult for industry funds to maintain that level of investment if they do not have the secure funding model that the default system provides through the Fair Work Commission, where a steady stream of funds have to be placed in a spread of assets."[2]

2 Kitney, D. and Hepworth, A. Funds sound infrastructure alarm, The Australian, 29 February 2016

Industry Funds Management chief executive Brett Himbury has made similar arguments[3], as has MTAA Chair, John Brumby[4], when arguing that consumers should not be afforded the freedom to choose their own superannuation fund and that this decision should be left with trade unions.

Mr Himbury and Mr Bracks also conceded that the anti-competitive arrangements that preference trade unions, and the industry superannuation funds they own, are a contributor to their net performance:

> "[Mr Himbury] and Mr Bracks said the allocation to infrastructure had helped industry funds outperform their retail rivals over the past decade."

The essence of this argument is that industry fund investment in infrastructure is dependent on being afforded legislative advantages. To use this as the basis to argue that their performance warrants continued protection makes this policy position circular.

The FSC agrees with the industry funds' contention that the protection afforded to them through the award default system is a competitive advantage. This roadblock to competition should be removed.

Legislation should not pick winners

The FSC contends that the corollary of the legislative advantage afforded to the industry funds via the modern awards system is that this legislation disadvantages customers of other superannuation funds.

Net returns that are dependent on protectionist policies are clearly inconsistent with settled principles of competition policy. It is unacceptable that legislation should confer a competitive advantage to one group of customers if other consumers are penalised as a result.

The FSC is also concerned that the protectionist policy prevents the achievement of greater economies of scale. Larger funds are in a position to allocate a greater proportion of their investments to illiquid assets.

One of the most significant barriers to greater investment in infrastructure assets is not the extent of the protection granted industry funds, but the barriers to mergers between subscale funds. The APRA-regulated superannuation sector is $2.1 trillion, however there are over 120 funds offering default MySuper products, and over 300 APRA-regulated trustees.

The FSC is particularly concerned that there continues to be a significant number of subscale industry funds managing less than $5 billion – Chant West research shows that only 14 of the 43 industry funds as at 30 June 2016 had $5billion or more in assets – creating a drag on the efficiency of the system and preventing more significant investments in infrastructure assets.

The FSC submits that merger activity would result in a genuinely competitive market would enable greater infrastructure investment than is the case under the current protectionist policies.

3 Kitney, D. and Hepworth, A. Funds sound infrastructure alarm, The Australian, 29 February 2016

4 Mather, J. Super debate splits senior Labor figures, Australian Financial Review, 14 March 2016

‘Nation building’ arguments expose governance issues

The FSC is also concerned with the willingness of some superannuation funds to link investment in infrastructure to “nation building” and use members’ retirement savings for this purpose. Mr Brumby, Chair of MTAA, for example, has argued that the current, anti-competitive regime should be maintained because “there is an important link between the default system, national savings and nation building.”[5]

Trustees are required to invest in the best interests of their members to helps them achieve adequate retirements savings. The FSC submits that trustees who take into account other factors when making investment decisions should be subject to competition so that the employers and employees can respond to these trustees’ possible flawed decision-making.

5 Mather, J. Super debate splits senior Labor figures, Australian Financial Review, 14 March 2016

Assessing the efficiency and competitiveness of insurance in the superannuation system

The Productivity Commission's Draft Report proposes one of five system-level objectives be that *"the superannuation system provides insurance that meets members needs at least cost."* The FSC understands that this proposed objective will provide a reference point against which the efficiency and competitiveness of insurance as it relates to the outcomes of the superannuation system can be assessed.

While the FSC clearly supports the need for insurance benefits funded by compulsory retirement savings to be made available to members at a cost which does not inappropriately erode retirement incomes, we are concerned that an objective that explicitly references "least cost" without considering the broader social and economic value of default insurance benefits may result in adverse outcomes for consumers.

Additionally, we note there are two distinct categories of insurance within superannuation:

1. Group insurance benefits offered to members in a MySuper product without individual underwriting on an opt-out basis – **true 'default' members**; and

2. Insurance which has been tailored by an individual member – either by 'topping-up' a default arrangement or via an individually underwritten policy held through superannuation (usually as a result of receiving personal financial advice) – **'choice' members**.

Therefore, in order to provide a meaningful assessment of the efficiency and competitiveness of the superannuation system and the role of insurance within it, the framework must be designed to accommodate these two different categories.

We believe this to be an important context in framing the following response on insurance-related issues raised by the Draft Report.

Recommendation: The proposed objective "*the superannuation system provides insurance that meets members needs at least cost" be amended to "the superannuation system provides insurance that delivers valuable protection to society and meets members needs at reasonable cost".*

The importance and benefits for Australians of insurance within superannuation

Background

The FSC's initial submission to the Productivity Commission stated that the provision of death and disability insurance benefits to Australians through superannuation on a default opt-out basis is a critical component of the system.

Funding insurance premiums within superannuation has become an important part of affording millions of Australians with cover and provides a safety net to those who would have otherwise not chosen, or been able to take out insurance individually. Group insurance, therefore, plays an important role in providing an economic and social benefit to Australia.

The provision of these benefits to members is a complementary feature of the superannuation system that enables an individual to manage the financial risks of an unintended absence from the workforce due to illness or injury either temporarily or permanently, or in the case of premature death provides a financial safety net for their dependents. Ultimately, in the case of temporary disability, insurance benefits can enable a person to continue to save for their retirement while recovering from a health setback as many offerings include replacement Superannuation Guarantee contributions.

The nature of default insurance typically available to members of a superannuation fund today is the result of the implementation of the Stronger Super reforms from 1 July 2013. Through these reforms, Section 68AA of the SIS Act prescribes that trustees must provide permanent incapacity and death benefits to members on a default, opt-out basis subject to reasonable conditions and in addition, trustees may also elect to provide temporary incapacity benefits to members on an opt-out or opt-in basis or not at all.

We note that the provision of insurance benefits by trustees on behalf of members is underpinned by the requirements of Section 52(7) of the SIS Act which prescribes that trustees must formulate, review regularly and give effect to an insurance strategy covering a number of matters and in particular, requires trustees to only offer or acquire insurance of a particular kind, or at a particular level, if the cost of the insurance does not inappropriately erode the retirement income of beneficiaries.

The operation of the insurance strategy requirement is supported by an APRA Superannuation Prudential Standard (SPS250). Combined, these requirements govern the provision of default insurance to members via superannuation and ensure an appropriate balance is met between accessibility of insurance, maximising retirement income and designing the default benefits offered taking into consideration fund member demographics.

Economic and Social benefit

Social security and welfare continue to be the largest source of federal government spending, budgeted at $158.6 billion in 2016-17, which is more than double the cost of health expenditure, and equating to 35% of total expenditure[6].

The transfer of financial risk associated with premature death and unexpected disability to the private insurance sector, achieving broad coverage for millions of working Australians across all sectors of the economy through the superannuation system, is vital in contributing to reducing the burden on taxpayers of publicly funded social security.

For people who may have simply not thought to obtain insurance protection outside of superannuation, the access superannuation members have to default levels of insurance can assume critical importance. Insurance benefit designs in MySuper take into consideration the demographics of the fund's membership and as such, the insurance is more likely to deliver better social outcomes than what could otherwise be expected if those members who do claim were to be reliant upon the social welfare safety net. Income replacement from insurance in these circumstances enables a person's current standard of living (in economic terms) to be broadly maintained.

Evolution of the value proposition of default insurance in superannuation

In partnership with superannuation funds, group life insurers have continued to evolve the products and services they offer to ensure they are meeting members' needs and delivering value for money. In assessing whether the insurance cover offered to members through superannuation meets their

6 Budget 2016-17 Overview, Appendix B, Revenue and spending, May 2016

needs and is efficient, a broader definition of insurance should be considered, beyond simply the financial benefit paid to members.

Australian and international research has consistently demonstrated that 'good work' is beneficial to people's health and wellbeing and that long-term work absence, work disability and unemployment generally, have a negative impact on health and wellbeing[7]. There are significant flow-on social and economic impacts of long-term 'worklessness', including a reduction in productivity to the whole Australian economy.

In particular, research indicates that if a person is off work for:

- 20 days, the chance of ever getting back to work is 70 per cent;
- 45 days, the chance of ever getting back to work is 50 per cent;
- 70 days, the chance of ever getting back to work is 35 per cent[8].

Life insurers have recognised the important role they can play in managing these risks for disability insurance customers. One of the most significant areas of insurance innovation has been in relation to the investment by insurers, for the benefit of consumers, in occupational rehabilitation, return to work support and in preventative measures.

Returning people to work or effectively providing early intervention support services to reduce the risk of long-term disability ultimately delivers a significant economic and productivity benefit to the Australian community more broadly. In the context of the superannuation system, it is vital in ensuring that those who can return to good work are supported to do so and as a result, can continue to save for their retirement reducing the burden on the Disability Support Pension, unemployment benefits and reliance on the Age Pension. The provision of disability insurance benefits on a default, opt-out basis makes the superannuation system an affordable and efficient mechanism to provide such services for millions of working Australians.

In response, group insurers in the Australian market have developed market-specific health and wellbeing initiatives, in many instances, designed especially for superannuation fund members to manage the sustainability and affordability of group disability insurance for all members and improve health and wellbeing outcomes for members who claim.

Recommendation: The Productivity Commission should incorporate a measure in the framework that can assess the efficiency of health and wellbeing programs and the value they deliver for members in order to provide a more holistic view of the benefits of insurance as part of the superannuation system.

Recommendation: The Productivity Commission should consider a broader definition of insurance within superannuation that goes beyond simply the financial benefit paid to members.

Providing access to cover where it may otherwise not be affordable or available

For millions of Australians the superannuation system has proved to be the most effective means of providing an affordable level of insurance cover to almost all working Australians and as referenced in the Draft Report, it is provided to those who would otherwise be unlikely to consider their insurance needs.

7 The Health Benefits of Good Work (HBGW) is an initiative from the Australasian Faculty of Occupational and Environmental Medicine (AFOEM) of The Royal Australasian College of Physicians (RACP). The FSC is a signatory to the Australian and New Zealand Consensus Statement.

8 Realising the Health Benefits of Work. Position statement of the Australasian Faculty of Occupational and Environmental Medicine)

The average 'opt-in' is very low for voluntary arrangements of insurance cover that is vital for Australians, such as income protection. Only 40% of all working Australians have income protection, the majority of members would not have adequate cover if it was not for their superannuation fund arrangements[9].

Superannuation has proved to be an important vehicle through which the majority of employed Australians have been able to access default group life and disability insurance regardless of their personal circumstances.

Group insurance offered through superannuation generally does not require an individual to complete comprehensive underwriting in relation to their individual circumstances, unless voluntary top-up cover is obtained. Group insurance is based on a pooling of lives that, in the absence of individual comprehensive underwriting, includes a selection of both good and bad risks.

This means that members who may have pre-existing medical conditions, are working part-time, casually or working in high-risk occupations are generally able to access insurance cover through group arrangements at an affordable price relative to restrictions and exclusions or premium loadings they would receive if they were to be underwritten for individual cover (if they were able to be underwritten and offered individual cover at all).

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% of the working population afforded some type of insurance coverage that would otherwise not be in place[10].

Recent research conducted by AIA Australia[11] highlighted that almost **one in two** of those with life insurance in superannuation believed they would not be covered if the cover was not provided automatically.

Without default cover offered or an opt-out basis, a potential gap of almost $1.9 billion[12] is created that superannuation members and their families would have foregone at their time of need.

According to research undertaken by KPMG, approximately 67% of death cover and approximately 56% of disability insurance in Australia is held through superannuation. The ability to access insurance affordably through superannuation is relatively unique to the Australian retirement savings system and is well supported by consumers.

Consumer research undertaken by GfK for the FSC in 2014 demonstrated this in that 42% of Australians without existing disability coverage selected the ability to purchase insurance through superannuation as being one of the top motivators that would persuade them to take out cover[13]. Australians remain chronically underinsured against these risks. According to research undertaken by KPMG for the FSC, 35% of employed people in Australia have no private disability insurance at all and 19% of families do not have any life insurance[14].

9 Rice Warner – Underinsurance in Australia – published in August 2016

10 Rice Warner – Underinsurance in Australia – published in August 2016

11 AIA Australia – Life Today study – published July 2016

12 This represents 50% of members who would not have cover if default cover was not provided as a percentage of the $3.85 billion that is aid by life insurers to superannuation funs in 2015/16

13 FSC/MetLife -Apathy to Action research

14 KPMG/FSC – Underinsurance – Disability Protection Gap in Australia – published in January 2014

On aggregate, the level of disability underinsurance was estimated to be $304 billion per annum while the level of underinsurance of the lives of employed people against premature death in Australian families is estimated to be $800 billion[15].

By enabling affordable access to insurance that protects an individual against the economic risks of injury, illness or disability individuals are more likely to be able to continue to save for their retirement through ongoing income replacement benefits and take advantage of insurer provided occupational rehabilitation ad return to work support rather than accessing retirement savings earlier than they would have otherwise due to loss of income as a result of disability.

High payout rates across the industry

In the year to June 2016, group insurers paid $3.85 billion in claims to members of superannuation funds[16]. Without this financial safety net, these families are likely to suffer poor social and economic outcomes and will most likely fall back on the social security system placing further pressure on the federal budget.

Although a significantly high proportion of claims are paid to members, the relative margins earned by insurers providing group insurance is low[17]. This means that any changes to coverage and definitions, how insurance inside superannuation functions or significant disruption to risk pools, should be carefully considered to enable stable and sustainable outcomes. While there is work to do to continue to improve engagement and awareness levels of members, these figures demonstrate the value that has been delivered to superannuation fund members.

The group insurance selection and review process and the role of the trustee

Under paragraph 22 of the SPS250 Prudential standard, a trustee must develop and implement a selection process for choosing an insurer that considers the reasonableness of the premiums, terms and conditions and performance of the insurer.

The trustee may use a market tender process to adhere to its prudential obligations; or some other form of benchmarking exercise where an incumbent insurer is in place. The objective of this process is to ensure the fund membership has access to the best overall value proposition available. Typically, this will involve a combination of terms and conditions, service, the insurer’s claims philosophy, as well as the cost of the insurance cover. On completion of the review, the agreed pricing arrangement will usually be guaranteed for a period of time with contract conditions subject to guaranteed renewability requirements.

Each fund will have a strategy in place to outline its approach to reviewing its group insurance arrangements. These guidelines will generally address frequency and preferred benchmarking methodologies. The review process is complex and can be time and resource consuming, with the fund having the following options:

- To engage directly with the incumbent Insurer/reinsurer
- To engage with a select group of insurers (limited tender benchmark)
- To engage in an open market tender

15 KPMG/FSC – Underinsurance – Disability Protection Gap in Australia – published in January 2014

16 APRA Quarterly Life Insurance Performance Statistics – Published in August 2016 – http://www.apra.gov.au/lifs/Publications/Pages/quarterly-life-insurance-statistics.aspx

17 Ibid.

Given the capabilities required to run the review, the fund will often appoint a consultant to support the process. This support will extend across the operational elements, benchmarking and assessment support of the submissions received. A consultant will often determine the selection criteria along with the fund and facilitate interactions throughout the review and negotiations that occur.

During a review, APRA would expect the following areas to be addressed[18]:

- The cost of insurance and the other terms and conditions of the insurance contract.
- The sustainability of the premium rates and terms and conditions of the insurance contract beyond the initial guarantee period.
- The insurer's claims philosophy.
- The services offered by the insurer under the agreements accompanying the insurance policy, including claims and data management, underwriting and reporting provisions.
- The terms of any outsourcing of functions to an administrator or other entity.

In addition, APRA via a review of the LPS 320 report prepared by the appointed actuary of the tendering insurers, will assess the adequacy of premiums being charged by the insurer to cover the risk that they are quoting for.

If the review involves a tender, the fund will outline their desired terms and tender requirements within the request for proposal (RFP). Generally, the RFP will contain details such as the fund's strategic priorities, history and profile of the fund, service requirements, product features, selection criteria along with the tender procedures and timelines.

A typical tender process will be made up of multiple rounds of offers, designed to initially gauge interest from insurers through to a shortlist with more detailed discussions and negotiations on the tender requirements and transitional terms. A typical tender can take between two to six months to complete.

Benchmarking is seen as an efficient method to drive competition throughout the group insurance market and will directly impact on overall market conditions. The selection criteria and requested product terms will directly influence the sustainability and suitability of the outcome on members within the fund.

It's important that the trustee is able to demonstrate how they have achieved the preferred benefit design and how it meets member's' best interests.

The role of a tender and the participants involved

There are a number of participants involved in the market tender process, playing critical decision-making roles which will impact on the overall efficiency of the market. The key participants are outlined below:

- ***Fund or trustee*** – the central decision maker and policyholder, responsible for the best interests of the policy beneficiaries or members. Will outline requirements and preferred design along with the timeframes for implementation.
- ***Consultant*** – role is to support fund or trustee in both the review and potentially select the insurer. Funds will often rely on a consultant's expertise and capability, in particular around benchmarking, market insights and selection criteria. They will often engage with multiple

18 APRA Prudential Guide LPG 270 – October 2014

insurers for quotations and heavily support the provision of data and information to insurers.

- ***Administrators*** – responsibility for the administration of the fund on behalf of the trustee. Their involvement generally relates to the ability to implement the policy on which the trustee is seeking offers from insurers and the transition to the new terms and conditions once the appointed occurs. System capability and flexibility is often a key driver of benefit design, and thus the terms of the review conducted by trustees. The capabilities (or lack thereof a fund's administrator) will influence to what extent the fund will make changes to their existing design (both from a timeline, pricing and terms perspective).
- ***Insurers*** – insurers are the core service provider in terms of insurance for members. They will compete for business seeking a balance between competitive pricing and terms and prudent risk management. Insurers will often engage with a reinsurer (through a similar tender process) to share a proportion of risk associated with a particular scheme or group of schemes, as well as to supplement their insights and internal capabilities.
- ***Reinsurer*** – will share in the risk of policy, pooling different policies and risks across the market. A reinsurer will impact the pricing and product terms that a direct insurer is able to offer. More transparent with funds given the influence on end terms and condition.

Selection Criteria

The benchmarking and/or tender selection criteria has a significant impact on market developments and overall efficiency, driving the behaviour of both insurers and reinsurers and the ultimate level of market sustainability and profitability. Ultimately the tender selection criteria will vary between each trustee, depending on the nature and needs of their membership. Whilst pricing will typically be allocated a majority weighting in the decision process, trustees will focusing on achieving the most appropriate overall balance between price, conditions, member experience and service propositions.

A typical tender selection criteria is outlined below:

- **Price** – of the overall outcome will be based on the cost of insurance.
- **Benefits** – of the overall outcome will measure the level of features or benefits available to members under the policy terms proposed.
- **Automatic Cover** – of the overall outcome will measure the level or amount of automatic cover (cover provided without underwriting) provided to members.
- **Conditions** – of the overall outcome will measure conditions like claim definitions and eligibility criteria.
- **Service/member experience** – of the overall outcome will be based on the ability of the insurer to provide a suitable level of service to the trustee and their administrator in managing the business once they are on risk.

Generally, the method of assessment by the trustee and/or their consultant is to qualitatively assess the relative competitiveness of one insurer versus the others. A comparison between competitors within the tender is conducted with the best overall outcome for members generally resulting in appointment (or retaining) of an insurer. Mandates are usually awarded to the most advantageous offer which may include the most competitive pricing (which may not always be the lowest price), the level of benefits provided, the amount and type of any automatic cover available, and the most favourable policy terms in terms of breadth of cover and minimisation of exclusions. The criteria set by trustees are critical drivers of better outcomes for members and overall efficiency within the system.

Corporate Superannuation tender process more broadly

Whilst on the subject of group insurance tenders, it is worth pointing out that the Corporate Superannuation tender process is a highly competitive and robust process, requiring funds to compete on many more aspects than insurance alone. This is, in our view, the most efficient end of the superannuation market, where large employers “audition” a range of superannuation providers across the spectrum of their offers.

Funds typically compete and are assessed across investment options and performance, insurance, fees and charges, extra benefits and services, service providers, administration and financial planning services.

The process promotes the tailoring of the corporate super product offering to better target the needs of the members of particular employers, for example by targeting education seminars or insurance offerings.

Competition at this level can lead to funds offering very comprehensive service suites and extremely competitive prices. The Commission should note that the prices at which these tenders are awarded are treated as commercial-in-confidence and are not available in the market. The FSC suggests that the Commission talk to a number of large employers and the key superannuation consultants regarding the arrangements they have put in place via this corporate tender process.

The Corporate tender process has clearly shown that increased competition will result in more targeted and competitive offerings which ultimately result in better retirement outcomes for large numbers of Australian employees.

Continual improvement across the industry

As an industry, we recognise that despite the significant social and economic benefit that group insurance affords many Australians, there are areas that can be improved to ensure that members derive the most value from this protection, while not unnecessarily eroding their retirement savings. Areas that continue to be a focus across the industry include:

- Addressing low awareness and understanding by superannuation fund members
- Assisting Trustees to better tailoring insurance cover to match members’ needs

Addressing awareness and understanding

Member awareness of life insurance has improved over the past decade - largely driven by super funds giving more attention to communicating the benefits of their insurance offering. Together with the Stronger Super reforms, there has been increased competition between funds on the basis of insurance. This has helped raise member awareness. This increased awareness in turn partly contributed to the spike in claims volumes from 2012.

Much of this awareness is triggered at the time members suffer an event and contact their superannuation fund seeking financial support. There remains a significant awareness issue for many members at an earlier age, where engagement with insurance (and superannuation more generally) is low, however, recent research conducted by AIA Australia reported that **three** in **four** of those with life insurance in their superannuation see its inclusion as a real positive and almost **one in two** would not have considered taking out life insurance if not provided automatically[19].

Meeting members' needs

Divergence in benefit designs is more evident which is in marked contrast to the behaviours seen in the mid to late 2000's where imitation was more prevalent. For example, many trustees have extended the benefit period from two years to at least five years, and in some cases to age retirement age, on their default income protection and reduced TPD cover levels to better align the disability benefits offered to the needs of their members. Many examples can be evidenced of this emerging. Others have incorporated support for retraining and occupational rehabilitation within a staged TPD design. This is driven by an understanding of members needs and wants through consumer research and market testing.

Claims experience analysis is increasingly used by funds and insurers to develop more targeted benefits where, for example, it identifies gaps in benefit design that deny benefits when they should be paid or highlights where benefits are paid in circumstances outside of the intended scope of the policy.

A continued focus on evolving the way in which group insurance can best meet members' needs is essential to the industry and must take into account the complex nature of group insurance and the differing demographics of risk pools.

By continuing the ongoing evolution of group insurance to address the areas noted above, this will help to rebuild the trust of the Australian consumer with their insurance. It will help them to more fully understand what cover they have, what protection it offers, the cost and the impact on retirement savings, and the value it provides in potentially preventing illnesses or in supporting them through their recovery should they ever need.

19 AIA Australia – Life Today study – published July 2016

Appendix i: FSC comments on each of the criteria

Competition: system-level objective, assessment criteria and indicators		
Assessment criteria	**Indicators**	**FSC Comments**
Is there sufficient member engagement to exert competitive pressure?	Member account monitoring activity (use of websites, call centre enquiries)* (input, behaviour) Member awareness of key features of their superannuation, including insurance* (input) Switching rate between and within default and choice funds and between institutional funds and SMSFs, by age and wealth (behaviour) Default rates for funds, investment and retirement income products, and insurance (behaviour) Information collection by funds on key member characteristics* (input) Duplicate accumulation accounts and insurance policies (output) Active member ratio (input)	The FSC recommends that these indicators be amended to include a clear delineation between default and choice consumers, and recognising the role of advice. A lot of the answers to the member engagement questions are different depending on whether you are referring to default or choice. Under default, trustees are more paternalistic, products are simpler and it stands to reason that members will show lower levels of 'engagement' - this is because trustees assume part of that role for them and may discourage engagement and create barriers to consumer decision making. In the choice market, it's a different scenario with advisers and members sharing a level of engagement which is higher than that in default. Trustees have the same obligations but permit advisers (as intermediaries) and members to build their own investment strategies and choose from a range of product features depending on circumstances. Hence the value of advice is evident and the Productivity Commission need to acknowledge that defaults are not suitable for all people at all stages. Members with higher balances will drive more competitive pressure than younger members with lower balances, so the Productivity Commission's proposed approach of looking at members as a whole may not provide an accurate view. Insurance – choice members would have actively purchased insurance whereas default is likely to mean the member has not made the active decision.

		Duplicate accumulation accounts and insurance policies can be a sign of engagement OR disengagement. This information may not be particularly useful, without finding out the reasons behind the multiple accounts/policies. There are other indicators of engagement which should be considered, such as: • Salary sacrifice contributions • Provision of Choice form • Interactions with the fund eg. logging into online account, calling the fund, transactions etc are acts of engagement (given ATO considers this for lost/uncontactable, is lost an indicator of engagement?) For active member ratio, should define what 'active' means – i.e. contributing members.
Are members and member intermediaries able to make informed decisions?	Availability, cost and quality of information on fees and investment risks at product level* (input) Financial literacy and numeracy compared to an 'adequate' standard (input) Use of advisers by members and/or member intermediaries (input) Capacity and willingness of employers to select a default fund (input)	The FSC recommends that these indicators need to focus on value (which is customer specific) rather than focusing just on fees. Publishing fees may drive competitive pressure, but does not necessarily consider the value of services provided. Additionally, 'adequate' standard of financial literacy and numeracy needs to be set at the right level and reflect different cohorts (eg. should recognise cognitive decline in old age). Other qualitative measures/parameters could be collected by research agencies (beyond just willingness of employers to select default funds).
Is there low market segmentation along member engagement lines?	Fund expenditure on member retention relative to overall marketing expenditure (input) Fee dispersion (between default & choice products, comparable products within a fund, and within products) (output)	The FSC is concerned that providing information about fund expenditure on retention raises commercial in confidence issues. Large dispersion of fees also do not reflect inefficient market but rather differences in member needs.

Do active members and member intermediaries have sufficient countervailing power?	Fund and product switching costs (administrative, search and learning costs) (input) Size of the SMSF sector (funds and members) relative to institutional sector (output) Switching rate from institutional funds to SMSFs (behaviour) Changes in market shares of funds (output) Corporate fee discounts (output)	In assessing this criteria, it will be important to differentiate between different segments, for example, default / MySuper, choice and SMSFs, as the conclusions will differ. The FSC would like clarification of why these criteria are only limited to active members. Given the ability to choose a fund applies to most members, we believe any assessment should include default members. We note that looking at switching into SMSFs demonstrates countervailing power, but net transfers from industry/retail funds to SMSFs is tapering off. We suggest the Productivity Commission look at the motivation behind switching to SMSFs (via survey) rather than just strictly looking at switching rates. We also suggest the level of competition within sectors rather than just between sectors should be looked at.
Are principal–agent problems being minimised?	Existing ratings of system-wide quality of governance* (input) 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* (behaviour) Contraventions of regulator governance standards by trustees, employers, service providers and financial advisers* (behaviour) Level of skills and standard of performance for trustee boards and investment committees, including review processes* (input) Member satisfaction and trust* (outcome)	The FSC is mindful that these indicators do not consider the principal-agent that can arise from trade union representation. Conflicts can occur when a union negotiates an enterprise agreement or modern award, and includes the industry fund it owns. We are concerned that it may be acting in the interest of the union, reducing the efficiency of the system and undermining competition. The Financial System Inquiry (FSI) concluded that high-quality governance is essential to organisational performance. Whilst there is no legislative requirement to have independent on superannuation fund boards, the FSC's governance standard requires all members to have a majority of independent directors and an independent chair on their boards. We believe measuring Board composition and the number of independent directors should be included as an indicator.

		Data should be readily available through FWC databases, trustee annual reports and APRA data. Professional standards applying to advisers should also apply to trustees (especially, if they are not independent).
Is there rivalry among incumbent providers?	Market concentration (Herfindahl-Hirschman Index and market shares of largest providers) (output) Number of institutional funds (input)	The FSC is of the view that market concentration in particular service areas (custody, auditing, insurance, actuarial services etc) is not necessarily negative. We would also suggest adding another indicator around looking at the process of nominating default funds in awards and whether there is a correlation with market share growth. The essential element is whether industry funds service providers, which are owned by industry funds, are subject to competition for the default consumers they service.
Is the market contestable?	Height of barriers to entry — effect of default rules on market entry (input) Height of barriers to entry — market impediments to funds accessing distribution channels (input) Mergers prevented by bulk transfer rules (behaviour) New entries into and exits from the market (behaviour) Capacity and willingness of employers to select a default fund (input) Prosecutions of fund trustees for contraventions of SIS Act on inducements (output)	The FSC recommends this criteria focus on the default market. We believe the current legislative framework governing the selection of default funds under modern awards prevents the superannuation industry from operating in a competitive market. We welcome the inclusion of this matter in the Commission's indicators. The FSC believes is that ongoing capital gains tax relief is needed to support further rationalisation in the industry. Existing industry data would reflect very little merger activity post MySuper. Furthermore, the FSC is comfortable with most of the indicators in this criteria. However, looking at prosecutions for contraventions of SIS Act on inducements will unlikely yield much in the way of results – as shown by the recent ASIC

		investigation of FSC members, the ISA report on alleged inducements failed to show any actual examples of inducements being offered. For these reasons, the FSC believes that this indicator should be omitted.
Are there material anticompetitive effects of vertical and horizontal integration?	Alignment in the structure of member fees and underlying costs (output) Proportion of funds required (by trust deed) to outsource to related-party providers (input) Process used by funds to make outsourcing decisions (input) Cost and member fee differences from outsourcing administrative and insurance services to related versus unrelated parties (output) Transparency and efficacy of fee disclosure by funds, including for distinct services (behaviour)	The FSC does not support this criteria without amendment and further clarification from the Productivity Commission. Whilst there is no universal definition of Vertical Integration, it is increasingly common and reflected in many operating models across the superannuation industry. For example, most insurers and banks now have some form of wealth management product and advice, superannuation platforms are increasingly adding asset management or advice subsidiaries, and industry super funds are internalising their asset management and advice. We recommend the Productivity Commission adopt a broad definition of vertical integration to include entities that operate in multiple parts of the financial services value chain or production path. We are also concerned with the Productivity Commission's negative premise of the assessment criteria and believe there should also be recognition and assessment of the benefits, including: • Economies of scale • Reduce complexity • Investment in systems and IT infrastructure • Efficiencies across the value chain • Increased consumer confidence through a strong, well-regulated / capitalised and a trusted brand. • Convenience of managing financial affairs with one provider or portal <u>Horizontal integration</u> We believe the selection and allocation of defaults funds under modern awards is a form of horizontal integration and should be assessed by the Commission.

		The awards system appears to be operating to the benefit of a limited number of funds with close traditional ties to the industrial system and processes. For example the old system has resulted in industry funds comprising 88 per cent of all current MySuper listings across the 122 modern awards. In addition, of the 122 modern awards created by the Fair Work Commission: • There are 16 awards that only name a single MySuper product that an employer must select to be the default fund for their workplace; and • In another 27 awards, an employer's selection is restricted to only two or three funds. <u>Vertical Integration in the retail sector</u> Review needs to consider services valued by members in addition to fees and performance (see APRA report on this issue). Also, transparency of fee disclosure needs to bear in mind that the choice product dashboard regime is yet to be implemented. Difficult to define outsourcing arrangements. In some cases outsourcing to related party is simply a structural matter e.g. investment management outsourced to Advance but managed by external.
Do funds compete on costs?	Costs relative to assets and member base: wholesale (by service) and retail (by segment)* (input) Margins: wholesale (by service) and retail (by segment)* (output) Investment management fees by asset class compared to other countries* (output) Alignment of the structure of member fees and underlying costs (output) Transparency and efficacy of fee disclosure by funds, including for distinct services (behaviour)	The FSC does not support this criteria without recognition of current trustee governance and fiduciary requirements. The Productivity Commission should also recognise the role of trustee governance and decision making in determining the level of fees - what is passed through to members or what is retained for investment and profit. The factors informing this decision will vary across funds and at different points in time, making an assessment very difficult. Fiduciary duties in place mean there is already a heavy burden on trustees to ensure that the level of costs and fees is done in accordance with SIS laws, general law and APRA standards.

		There are also commercial in confidence issues that arise from disclosing information about costs relative to assets, member base and margins (i.e. confidential data that funds would not ordinarily disclose to the market). The FSC recommends the Productivity Commission should focus on fees charged to members rather than costs.
Are economies of scale utilised and the benefits passed through to members?	Unused scale economies at wholesale level (administration and investment management) and at retail level (output) Effectiveness of scale test (number of fund consolidations and magnitude of realised benefits) (output) Mergers prevented by bulk transfer rules (behaviour) Pass through of benefits from scale economies (wholesale and retail) to members* (output) Improvements in service quality in administration due to growing scale (output) Increased diversification due to growing scale (input)	The FSC would encourage the Productivity Commission to look at the industry analysis on the impact of fund size on a per member cost of administration and investment that was conducted by Rice Warner[20]. The Productivity Commission should also consider the impact of fund size and scale on the level of fees they pass on to members. We acknowledge that used (and unused) scale economies are difficult to measure and demonstrate. The Productivity Commission could potentially look at product and system proliferation as an indicator of use of scale. Fees alone not reflective of value to members. The review could also look at entities' capacity to invest (and possibly actual spend) on capabilities/processes/IT systems to generate scale efficiencies. Additionally, it is worth noting that regulatory and compliance costs have increased at a faster rate than scale efficiencies for many large funds, which has resulted in delays in fee reductions flowing to members. Tria partners recently concluded that regulatory compliance spend for the superannuation industry at $3 billion in the last eight years.

20 Rice Warner – Superannuation fund expense analysis - 2016

		The FSC believes that the system needs more time to convert recent and current reforms to reduced fees eg. SuperStream benefits, as these will not be fully realised for some time (perhaps not before 2020). Furthermore, data on mergers prevented by bulk transfer rules may be difficult to obtain.
Do funds compete on relevant non-price dimensions?	Fund marketing expenditure (size, composition and share of operating expenses) (input) Information collection by funds on key member characteristics* (input) Availability, cost and quality of information on fees and investment risks at product level* (input) Comparability of insurance product information disclosed by funds* (input) Member awareness of key features of their superannuation, including insurance* (input)	The FSC does not support the suggested indicators, without amendment as they do not answer the question. Any assessment of advertising should include advertising undertaken directly by funds and advertising indirectly undertaken by other groups on behalf of funds. As noted above data sourced from Neilsen AdEx, demonstrates that over the past twelve months Industry SuperFund Group, that is, the collection of 15 industry funds who co-brand themselves 'Industry SuperFunds', collectively spend $25 million on advertising that should be included in the scope of the Commission's assessment. Advertising should also be subject to a member cost / benefit analysis by the Commission, particularly as to whether broad/mass market advertising is efficient and cost effective to the member? The FSC suggests that other examples of non-price dimensions that should be considered by the Productivity Commission consider such as choice, flexibility, access to adviser services and usable websites. Also, the 'type' of marketing expenditure (not just the size) needs to be considered. Many funds' marketing expenditure focuses on their 'brand', not the specific aspects that differentiate one fund from another, which reflects a lack of engagement with and understanding of super by the general public (and is indicative of an absence of true competition). If superannuation was highly a

		competitive market, you would expect to see advertising focusing more on product specifics/benefits.
Is there innovation and quality improvement in the system?	Declining number of products over time (accumulation) (output) Introduction of new retirement income products and development of more tailored default products* (output)	The FSC supports these indicators and would welcome the inclusion of the following innovation topics under the criteria. • Online capability and digital execution - can an individual easily access account, balance details, disclosure documents, and forms online? To what extent is there integrated online service function • Regular electronic member communication – ability to receive communication electronically? • Access to quality advice services / network – does the fund provide access to advice? Is there fund equipped to deal with all spectrums of advice, including limited, digital and comprehensive? • Unit pricing – how transparent, timely and efficient is the fund's pricing of assets? Does underinvestment in credit rate systems result in unfairness and consumers cross-subsidising one another? We believe ongoing innovation with regards to these features and capabilities will enhance a member's fund experience and should be measured by the Commission. Other indicators of innovation and quality improvement that could be looked at include: • How often are insurance definitions updated? • How often does a trustee review its product features? The review needs to also consider system and process improvements to existing products (not just new products being developed). There are impediments to developing new retirement and default products (eg. MySuper) which need to be recognised.
Are outcomes improving at the system level?	Growing voluntary consumption of superannuation services (investment, retirement products, advice, insurance) (output) Member satisfaction and trust* (outcome)	We note that the increase in retail and choice products indicates growing voluntary consumption.

		The FSC would recommend that the Productivity Commission refrain from using levels of insurance as an indicator of system improvement, as default levels of insurance are declining at the industry level (AAL today is less than it was four years ago). Member satisfaction and trust is difficult to measure consistently across the industry. Survey should measure relative results (i.e. between funds) as opposed to satisfaction with the industry as a whole. The FSC suggests that the Productivity Commission could look at different types of advice offered and what members are willing to pay to receive quality advice as a possible indicator of satisfaction.
Efficiency: system-level objectives, assessment criteria and indicators		
Assessment criteria	**Indicators**	
Are net investment returns being maximised over the long term, taking account of service features provided to members?	Long-term (5, 10 and 20 year) historical net returns from the system and market segments compared to benchmarks (output) Long-term (5, 10 and 20 year) historical net returns to specific asset classes at system level compared to asset-class benchmarks (output) Dispersion of funds and products from a frontier of best-performing funds and products (based on historical long-term net returns) (output)	The FSC does not support these indicators without modifications to assess comparable investment options and recognise risk adjusted returns. Net returns are influenced by other factors than just fees in isolation. Given asset allocation and risk profiles are uniquely different in every MySuper/default and choice option. We are concerned with the Productivity Commission measuring returns at a whole of fund / sector level. There are a number of key differences between investment portfolios at a sectoral level that influence returns and make the assessment of whole of fund returns very problematic: Investment tailoring: Almost 85 per cent of retail fund assets are 'choice', therefore selected by a member with their adviser. In the choice environment, a member's investment strategy is tailored according to their objectives and risk appetite rather than dictated by the trustee (as in default / MySuper). The consumer does not actually invest in a fund, the consumer invests in multiple investment options across the fund. A member's portfolio return in choice is not necessarily going to be evident by the return achieved by one investment option. They may have an allocation across a range of options. Whole-of-sector or fund returns are unhelpful as a point of comparison because it is influenced by the asset allocation decisions of countless members making individual decisions.

		Different demographics / asset allocation: Moreover, retail funds generally have a greater number of older and retired members, who tend to invest in more conservative portfolios such as cash and fixed interest. In fact, almost a quarter of total member benefits in retail funds are invested on behalf of members aged over 65. In contrast, industry funds generally have a young, default accumulation membership with a comparatively higher weighting to growth assets. Whole-of-sector or fund returns reporting are unhelpful given the range of investment options offered to cater to the investment needs and demographic profiles. Comparability even within peer grouping is problematic for this reason given the diverse range of min/max limits per asset class and the demographic factors outlined above. Risk adjusted returns is a critical metric used by trustees to assess whether an option is performing as expected over various timeframes. Moreover, it is much more meaningful to focus on performance against objectives (rather than peers) over the long term. Cannot compare a retail and industry funds across last 20 years as reflects a non-normalised fee, so there needs to be an allowance for this. The FSC believes that the long-term net returns should also be measured over a 10 year period or longer, a five-year period is not long enough.
Are costs incurred by funds and fees charged to members being minimised, taking account of service features provided to members?	Investment costs and fees across equivalent products and between market segments (input, output) Investment management fees by asset class compared to other countries* (output) Relationship between investment fees and returns (output) Use and disclosure of performance attribution by funds (behaviour)	The FSC does not support the number of proposed indicators on fees and costs. We are also concerned that there is no measurement of member service features. The first four indicators relate to arm's length negotiations with service providers, as well as existing prudential governance requirements that oblige a trustee. We question whether APRA's oversight here should be the focus. The Productivity Commission should also recognise the role of trustee governance and decision making in determining the level of fees - what is passed through to members or what is retained for investment and profit. The factors informing this decision will vary across funds and at different points in time, making an

	Administrative costs and fees at system level and for market segments (input, output) Cost savings from SuperStream (output) Relationship between level of administrative fees and quality of member services (output) Costs relative to assets and member base: wholesale (by service) and retail (by segment)* (input) Margins: wholesale (by service) and retail (by segment)* (output) Pass through of benefits from scale economies (wholesale and retail) to members* (output)	assessment very difficult. Fiduciary duties in place mean there is already a responsibility for trustees to ensure that the level of costs and fees is done in accordance with SIS laws, general law and APRA standards. Moreover, often there are commercial confidentiality considerations with regards to this information, so data collection may be difficult. We are also concerned that the proposed indicators are not sector neutral and appear to be targeting retail funds (particularly the final three). How do you assess a margin in not for profit funds? Should we look at the associated company? The Productivity Commission appears to ignore money paid from industry funds to their related-party unions or their campaign funds, as donations, 'sponsorship fees' or Super Liaison Officers, from its assessment. Are these not considered profit being returned to a shareholder? Why are they excluded from the Commission's assessment? On the global benchmarking of asset management fees, it's important to consider the same products across different jurisdictions. Note the FSC's submission to the FSI interim report provided a useful survey of global fund managers and their fees. We conducted research to ascertain the relative level of fees in Australia compared to other parts of the world. Specifically, we conducted a survey of several large global fund managers on their fees charged for the same products in Australia and other jurisdictions. Collectively, the surveyed manager's funds under management (FUM) in Australia total around $110 billion and $7.1 trillion globally. In order to gain an accurate comparison we collected the actual fees charged (and not the published rates) on products that are sold in multiple jurisdictions. This means we compared the same product sold around the world. The products used were: global equities, global property securities, emerging markets and global bonds. The jurisdictions compared were Australia, US, Europe ex UK, UK, Asia ex

		China and Japan. As fees can changed based on the size of the investment, the fee rates collected were based on a $100 million mandate. The results showed: • Global equities rates are almost 11 bps lower on average in Australia than the other jurisdictions. • Global property securities are 6 bps lower on average in Australia than the other jurisdictions. • Emerging markets are 13 bps lower on average in Australia than the other jurisdictions. • Global bonds are marginally more expensive in Australia (less than .1%) on average. We would be pleased to share this work with the Commission and believe a similar approach should be adopted by the Commission. Given the proposed criteria is also looking at the 'service features provided to members', we are concerned with the balance of the proposed indicators and that there are no measures of member service features (e.g. investment tailoring, admin, advice, insurance, automatic contributions, disclosure, online functionality etc.). We also note that the full benefits of SuperStream are not yet realised. Funds are still making significant investments and the benefits will be realised over the coming decade. Margins and other indicators would be commercial in confidence.
Do all types of funds have opportunities to invest efficiently in upstream capital markets?	Asset allocation in SMSFs compared to institutional funds (input) Retail investment management costs compared to wholesale (input) Minimum transaction values (input)	There are some asset sectors that SMSFs would have difficulty in accessing e.g. infrastructure. The Productivity Commission need to look beyond a strict comparison of SMSFs asset allocation as compared to APRA funds, which could be explained by member

		preferences (and the fact that more SMSF members are in retirement phase) but may not give any meaningful insight into structural impediments to SMSFs being able to invest in particular investments. Need to consider the reasons behind the differences in asset allocation.
Is the system effectively managing tax for members, including in transition?	Use of tax strategies by funds for members in transition (input) Average effective tax rates across market segments (output) Tax advantages as a motivation for setting up an SMSF (input) Take-up rates of co-contributions and offsets (input)	The FSC suggests adding another indicator around tax deductibility of insurance premiums and whether benefits are being passed on to members.
Are member preferences and needs being met by minimising unpaid contributions and lost accounts?	Unpaid Superannuation Guarantee contributions (input) Delayed Superannuation Guarantee contributions (input) Number and value of lost accounts (output)	The FSC notes that ASIC's forthcoming product distribution and intervention powers will strengthen the criteria and may need to be factored into the Productivity Commission's assessment. The FSC is largely comfortable with the indicators. However, the data on unpaid/delayed SG should be collected from ATO. The ATO has a significant role to play around enforcement, active investigations etc. The Productivity Commission also seems to suggest that a trustee should be responsible for pursuing employers for unpaid super. This would be a significant cost burden to trustees, responsibility for pursuing employers for unpaid superannuation currently rests with the Commonwealth.
Are member preferences and needs being met by funds collecting relevant information to ensure their product offerings are suitable for their	Information collection by funds on key member characteristics* (input) Response rates to funds' member surveys (behaviour)	The FSC recommends that the Productivity Commission amend the criteria to recognise the differences between the default and choice markets. We would suggest that diversity of product offering be added to the list of indicators, as it is generally indicative of funds catering to members' preferences.

diverse member bases?		
Are member preferences and needs being met by the system providing high-quality information and financial advice to members to help them make decisions?	Availability, cost and quality of information on fees and investment risks at product level* (input) Members acting on intrafund financial advice (behaviour) Member account monitoring activity (use of websites, call centre enquiries)* (input, behaviour) Cost of funds' member engagement activities (input) Take-up rates of co-contributions and offsets (input)	The FSC believes that take-up rates of co-contributions and offsets indicator is not an appropriate measurement, as there is no provable link between members making personal contributions just to receive co-contribution payments and offsets.
Are member preferences and needs being met by the system providing products and information to help members optimally consume their retirement incomes?	Introduction of new retirement income products and development of more tailored default products* (output) Take up of different retirement income products (output) Drawdown rates in transition and retirement phases (output) Unclaimed superannuation (output)	The FSC recommends that the Productivity Commission use the findings from Treasury's current investigation into the structural impediments to the introduction of new retirement products in their review. Although it is difficult to fully assess until the barriers for retirement income and longevity products are addressed. We note government have committed to addressing these barriers, although the timeframe is unclear. The FSC recommends that access to advice be used as an indicator instead of drawdown rates, as there are different reasons for drawdown rates, and members could have other investments.
Are member preferences and needs being met by member balances being allocated in line with their risk preferences and needs?	Introduction of new retirement income products and development of more tailored default products* (output) Asset allocations by age cohort (across different market segments and products) (output) Member awareness of investment, sequencing and longevity risk (input)	The FSC believes that it is important for the Productivity Commission to differentiate between choice, SMSF and default products. The role of financial advice should be considered as it is essential in tailoring an individual's investments according to their objectives and risk appetite. The FSC anticipates that the results of surveying member awareness of sequencing risk will be very low, and we are not convinced this information will be very useful. The review could consider the prevalence of Lifestage investments as an indicator of meeting customers' needs.

Is the system using lessons from behavioural finance to design products and 'lean' against well-known biases in how people make decisions?	Funds' application of the lessons from behavioural finance to design products, the effectiveness of fund strategies and whether lessons are being transmitted to other parts of the system (behaviour, output)	The FSC is of the view that this indicator would be difficult to measure. Whilst an important factor, behavioural finance is one of many considerations in designing products so we query why this has been emphasised? The FSC believe it should not be its own criteria as it would bias the overall findings.
Are trustees acting in the best interests of members?	Existing ratings of system-wide quality of governance* (input) 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* (behaviour) Contraventions of regulator governance standards by trustees, employers, service providers and financial advisers* (behaviour) Level of skills and standard of performance for trustee boards and investment committees, including review processes* (input) Member satisfaction and trust* (outcome)	Given this is a regulatory requirement for the trustee, isn't the key measure APRA's supervision and enforcement activity? <u>Governance</u> The Financial System Inquiry (FSI) concluded that high-quality governance is essential to organisational performance. Whilst there is no legislative requirement to have independent on super fund boards, the FSC's governance standard requires all members to have a majority of independent directors and an independent chair on their boards. The FSC believes measuring Board composition and the number of independent directors should be included as an indicator. <u>Risk management</u> We believe that only institutions with sound risk management behaviour can remain viable through the economic cycle in a free market environment. As a result, the Productivity Commission should be examining the robustness of fund's risk management practices, including: • Level of compliance with APRA's risk management requirements (SPS & SPG 220) • Implementation of the three lines of defence model These indicators are more about trustee qualifications rather than trustees' acting in members' best interests. For example, the indicators around directors' experience/skills/qualifications do not say anything about why merger negotiations between some funds have fallen through in recent years when the merger would have been in both funds' members' interests. At present, education levels for trustees are lower than those required for a financial planner.

Are there material systemic risks in the superannuation system?	Market concentration (Herfindahl-Hirschman Index and market shares of largest providers) in upstream service provider markets (input) Levels of leverage in SMSFs (input)	The FSC strongly supports this assessment criteria– we believe this criteria should be expanded to measure the following other areas that may have an impact on systemic risk: 1. The impact of restricting the selection of default funds to a small number of funds listed under modern awards, who often have related party arrangements with one another, and whether this presents any market concentration risks? 2. The level of exposure to and concentration of associated entities or outsourced providers that are owned by industry funds and provide services such as administration / IT, advice and funds management. The level of capital, including provisions for economic capital, and capacity to invest in systems. Indicator should look at the prevalence rather than the levels of leverage in SMSFs.
Do funds offer insurance products that meet members' needs?	Duplicate insurance policies by insurance type (output) Rates of insurance take up in choice products and SMSFs relative to default products (output) Member awareness of key features of their superannuation, including insurance* (input) Level of unclaimed insurance (output) Ease of members opting out of insurance (input) Time to respond to members compared to retail provider benchmarks (input) Information collection by funds on key member characteristics* (input) Use of member information by funds to target insurance products (input) Comparability of insurance product information disclosed by funds* (input)	APRA has established a number of insurance covenants that already compel trustees and should be considered by the Productivity Commission (including Prudential Standard SPS250). The FSC recommends that the ease of members opting out of insurance be replaced with a measure of the ease by which members can amend their insurance arrangements, as this is broader than simply opting out. Duplicate insurance policies may not be a reliable indicator of efficiency – some members might choose to have separate group life/TPD insurance with different funds. As such during the survey process it will be very important to understand whether duplicate accounts are a result of apathy or of a conscious decision by the member. The FSC would suggest that the Productivity Commission look at alternative indicators such as: • Aggregate level of protection provided through group arrangements as a % of need

		• Private and public costs of underinsurance arising from reduced levels of group insurance coverage The FSC suggests replacing the indicator on 'time to respond' to measures the service levels embedded in contracts between insurers and trustees and the degree to which they meet prudential standard obligations. The Productivity Commission also needs to consider the structural differences that would exist between retail and group and the role of the trustee in decision making – which needs to be independent to the insurer's decision. The FSC is concerned that the last two indicators are not directly relevant to the question/assessment criteria. As alternatives, there are a myriad of case studies the industry could provide but these would require trustee consent to disclose. In addition, trustees have obligations to consider these in formulating its insurance strategy and benefit design and the Productivity Commission could speak to APRA to understand to what extent this was evident in their MySuper applications.
Are the costs of insurance being minimised given the type and level of cover?	Insurance premiums inside and outside of superannuation (output) Insurance expenses (incurred by funds) (input) Erosion of member balances due to insurance premiums (output) Ratio of claims to premium revenue (loss ratio) within superannuation over 5 and 10 year periods (output) Fee and premium differences from outsourcing insurance services to related versus unrelated parties (output)	The FSC suggests that the Productivity Commission consider the inherent structural differences in coverage between group and retail – as simple as the broad coverage with automatic acceptance relative to restrictions, exclusions or loadings that may be applied to some The Productivity Commission should also be aware that the insurance expenses (incurred by funds) indicator alone may be skewed since trustees are increasingly considering which insurance activities it insources relative to what it requires the insurer to do. This could move cost from the administrator to the insurer or vice versa so true costs may be masked. The FSC believes that the erosion of member balances due to premiums is not appropriate indicator as it is more about the cost of insurance relative to account balance rather than appropriate capping of premiums. The FSC recommends using an alternative indicator that looks at the policy terms that exists that take into account a members balance as a cessation provision for coverage Also, focusing on minimising costs and the erosion of member balances needs to be balanced against the benefits of having insurance cover. There is currently a significant underinsurance problem – the provision of default insurance within

		superannuation is an important mechanism to address this. It may be useful to try to measure instances/trends of people dying or becoming TPD without any (or sufficient) insurance. We recommend that the loss ratio should be measured over a minimum 10 year period – ideally it should be measured over a longer period of time. In addition, it needs to recognise that a significant proportion of a loss ratio will be open claims and IBNR largely based on best estimates assumptions. This will mean some inconsistency between how these may be reported and opportunities to 'game' the system without some standardisation.

*Indicators marked with an asterisk are common to both competition and efficiency

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