FSC FINANCIAL SERVICES COUNCIL

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Productivity Commission
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Superannuation: Alternative Default Models Interim Report

The Financial Services Council (FSC) welcomes the opportunity to make submissions to the Productivity Commission (the Commission) in relation to proposed models for introducing competition in the default superannuation market.

The FSC has over 100 members representing Australia's funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 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 fourth largest pool of managed funds in the world.

The FSC continues to advocate for a model that would allow any APRA-approved MySuper product to compete in an open market. We note, however, that that each of the models proposed by the Commission would promote competition, albeit at differing levels and timeframes, within the default market. This submission makes recommendations in relation to the models and concepts outlined in the Commission's interim report.

If the assessment is to be balanced and agnostic on structure, the FSC submits that a staged approach is needed so that funds with existing public offer MySuper products be able to compete in the interim without the untested framework that is currently embedded in the Fair Work Act.

The FSC submits, however, that the policy objectives outlined by the Commission can be achieved through a hybrid model, bringing together elements of the employee and employer choice proposed models. The hybrid model would be strengthened through the 'default once' proposal, in addition to measures to promote contestability of the market and promote consumer engagement. The FSC also supports the recommendation that any model has prospective application to prevent dislocation for existing consumers and providers.

The FSC submits that the proposed market intervention, through the creation of a new Government body to 'shortlist' MySuper products, is unnecessary to achieve the Commission's objectives. The FSC is also concerned that the creation of a new body may be prone to political intervention. The onus is on the Commission to demonstrate how a body susceptible to politicisation would be preferable to a model where each consumer and employer is empowered to choose a fund.

Please contact me with any questions in relation to this submission on (02) 9299 3022.

Yours sincerely,

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Introduction

The Productivity Commission's (PC) interim report is an important step towards introducing genuine competition in the default superannuation market. The FSC recognises the principle that competition policy is in the best interests of consumers is at the core of each of the four models proposed by the Commission. The evidence is clear; competitive markets drive prices lower, improves service quality and encourages product innovation.

The Financial Services Council (FSC) agrees with the argument put forward by the Commission that there are features of the superannuation industry that stifle competition. These include incomplete and asymmetric information that interact with consumers' cognitive constraints, which in turn impair engagement and undermine the quality of consumers' decision.

Barriers to competition are exacerbated by the current industrial overlay that discourage consumers from engaging with their superannuation. This is reflected in the proliferation of multiple consumer accounts, as well as the perpetuation of subscale, high cost superannuation funds that are reliant on disengaged members for ongoing liquidity. The FSC submits that barriers to consumer engagement should be removed from the superannuation system wherever possible.

The FSC favours a model of competition that promotes consumer engagement and the exercise of choice between providers. This will impose market discipline on industry participants, including funds and their service providers. A default market that provides information to members to help them become engaged and offers incentives for providers to facilitate engagement, will drive higher levels of consumer engagement over time.

The FSC has built on the Commission's proposals to develop a hybrid model that encourages more consumers to become engaged in the near term. The FSC supports a model, which we detail in this submission, taking the best features of the employee and employer choice models from the Commission's interim report. The hybrid model is intended to promote engagement whilst also providing robust consumer protections, thereby reducing the population of MySuper products that can be chosen and improving the overall quality of products.

The FSC views a hybrid model as a more effective solution than the establishment of 'heavy-handed' Government body to either create arbitrary shortlists or run auctions or tenders.

The FSC supports the introduction of a 'once only default' arrangement, underpinned by the ATO's Single Touch Payroll (STP) program, that ensures that where a consumer has previously defaulted into a fund they do not default again, thereby stemming the proliferation of accounts. It is critical, however, that any 'default once' model is accompanied by a competitive model that promotes engagement, so that consumers are not defaulted into an inappropriate fund that fails to meet their needs as they age.

The benefit of the STP framework for the 'default once' model is that it places a minimal burden and cost on employers due to the ATO being responsible for data-matching consumers' information and prepopulating their superannuation 'choice' form.

The FSC also supports the prospective application of any default model to new entrants to the superannuation system, which will remove the need to unnecessarily transfer existing default members to the new default product(s). Maintaining system stability and integrity is critical to consumer confidence in superannuation. The FSC is pleased that, unlike the current Fair Work Commission's 'Expert Panel' model, which would cause wholesale dislocation of consumers from their existing arrangements, the Commission has prioritised leaving undisturbed the current arrangements of consumers.

The FSC opposes, however, a Government body responsible for developing a shortlist of MySuper providers for consumers or employers to choose from. Rather, we support a stronger APRA MySuper approval process, in conjunction with competitive forces driving industry consolidation, which would significantly reduce the population of MySuper products. It would also result in a compression of the dispersion of MySuper product performance. The design of the approval process should operate in a way that is a 'gateway' rather than a selection process. That is, APRA would be applying similar, albeit more robust criteria, through administrative processes and protocols that currently apply to the authorisation of MySuper products.

Collectively these policies will achieve the Commission's objectives, without the inherent risk of the conflicts of interest emerging from the inevitable politicisation of a new Government body established to 'shortlist' MySuper products.

The FSC is concerned that creation of a new Government body may be susceptible to political interference, given the often highly partisan nature of the superannuation industry. The onus is on the Commission to demonstrate how a Government appointed and controlled body would be preferable to a competitive model where politicisation is limited because the power of choosing a fund is vested in each individual consumer and employer.

The FSC is also of the view that if a consumer is comfortable with their existing default superannuation arrangements they should not be compelled to change their fund. The FSC supports the onus being placed on superannuation providers to 'win over' consumers through competitive MySuper and choice products.

Staged implementation of reforms

The Commission has proposed that the Stage Two report is intended as a 'top drawer' report, that is, it includes options for reform should the holistic review of the system undertaken during Stage Three demonstrate that the system is not adequately efficient or competitive. The FSC supports this approach.

The FSC acknowledges two of the Commission's findings in relation to the current industrial framework:

1. It has contributed to the proliferation of multiple accounts that, through duplicate administration fees and insurance premiums, may cost consumers up to $25 000 by retirement; and
2. It continues to provide protection to subscale, high cost superannuation funds that are reliant on their default status in modern awards and enterprise agreements to avoid merging with a more efficient fund.

The FSC submits that it is not tenable for the current default arrangements to remain whilst the Stage three process is underway as they will continue to result in these poor consumer outcomes.

The FSC supports the principle that all Australians should be able to choose who manages their retirement savings. As such, we believe that it is necessary for the Government to introduce legislation to remove default superannuation from the industrial system and to allow any APRA-approved MySuper product to complete in the default market.

The FSC notes that competitive forces may temper the reluctance of subscale funds, which are currently protected from competition, to merge and achieve economies of scale. Subscale funds would also be encouraged to consider mergers to gain efficiencies prior to detailed assessment in Stage Three of the Commission's review.

Opening the system up to greater competition can promote better long-term outcomes for members, through lower average fees, improvements in service quality across the sector and encouraging greater product innovation.

As such, the FSC supports the Commission's assertion that freedom of choice is a "necessary condition to realise the benefits of competition in the superannuation market" and that "it is therefore essential to extend genuine member choice to all employees".[1]

Legislation to remove default superannuation from the industrial relations system is consistent with the Commission's process as it would not interfere with the Stage Three review, nor the implementation of more significant reforms that are recommended by the Stage Two report, should Stage Three demonstrate shortcomings in the system.

Recommendation: The Government legislate to remove default superannuation from the industrial system as a matter of urgency to protect consumers, whilst continuing to allow Stage Three of the Commission's review to proceed and consider whether holistic reform is required.

[1] Productivity Commission Draft Report, *Superannuation: Alternative Default Models*, Overview p.7.

Hybrid Option

The Commission's proposed models raise a range of questions as to the best method to achieve particular policy outcomes, as well as conceptual questions around market design. In developing a hybrid model the FSC has focused on system design features that would practically achieve the policy objectives identified by the Commission.

To assist interpretation of the proposed model the FSC has attempted to articulate the objectives of reforming the default market:

1. Consumers are increasingly engaged with their superannuation over time;
2. Consumers are given the information to make more informed decisions;
3. Competitive pressure is maintained between providers over time;
4. Competition results in the consolidation of the superannuation industry in the near-term, so there is a smaller population of products from which consumers and employers can select;
5. Competition ensures the average quality of MySuper products is higher than is currently the case, and that there is lower dispersion in quality and performance; and
6. There is a robust safety net to protect consumers, both through the transition to a competitive market and on an ongoing basis.

The FSC submits that the elements of a competitive market design that would achieve these objectives are readily found in the employee and employer choice models in the Commission's interim report. This has formed the basis for the hybrid model outlined in this submission.

The FSC also submits, however, that elements of these options introduce significant, 'heavy handed' regulatory interventions that are unnecessary to achieve the policy objectives. They also introduce considerable risk of unintended outcomes, such as potential gaming by participants and the politicisation of the superannuation industry. The FSC's proposed hybrid model is designed to avoid these unintended outcomes.

The FSC broadly does not support options three and four. These options introduce Government intervention into a market which, if reformed in a manner consistent with sound competition policy principles, would deliver efficient outcomes for consumers. They would also significantly disrupt existing business models for little additional benefit to consumers that are not achieved through the employee and employer choice models. Finally, they exacerbate the risks of gaming and politicisation of processes that are inherent in any Government auction or tender.

Overview of hybrid model

The key features of the Hybrid model proposed by the FSC are:

1. Consumers have a universal right to choose their own fund:
    - Subject to an enhanced APRA approval process for MySuper products that raises the average quality of products;
    - A significantly smaller population (in the range of 20-30) of MySuper products to choose from within the next decade, removing the need for a 'shortlist';
    - Consumers would be nudged towards this smaller set of high-quality MySuper products; and
    - Improved data presentation by APRA to help consumers make comparisons.

2. Employer choice of a default for a workplace is retained in circumstances where a consumer does not choose their own fund, however:

- The MySuper population to choose from is significantly smaller and of a higher quality due to APRA's enhanced approval process;
- Penalties on funds and related parties for offering inducements to employers are stronger (a financial penalty, enforceable by ASIC, should be introduced); and
- Mechanisms for unions and employers to restrict fund choice through enterprise bargaining is removed by abolition of such terms in agreements.

3. The 'default once' proposal is also achieved through:
   - Removing default super from modern awards and agreements, which is a major cause of the proliferation of multiple accounts; and
   - Using Single Touch Payroll (STP) to automatically pre-populate the Choice form with a consumer's existing default account, preventing duplication without onerous regulatory requirement for employers.

Recommendation: The Commission consider how the competition and efficiency objectives, including a refinement of the population of MySuper products and a higher overall standard of product, can be achieved through a hybrid model of the employee and employer choice models.

Enhanced APRA approval process

The 'Assisted employee choice' model places the onus on consumers to choose their own superannuation fund, with safeguards to protect consumers. The FSC broadly supports this model with some variation, including recognition that MySuper products are prescribed in legislation and providers must receive APRA authorisation before they can take MySuper products to market.

The Commission recognised in its interim report that variability remains in the quality of MySuper products. This variability is largely attributable to the limited scope of MySuper product features and trustee capabilities that APRA can take into account when approving a MySuper product. The Commission has outlined the potential benefit of strengthening APRA's MySuper approval process in Table 5.3 of the interim report. The Commission proposes a range of measures relating to accreditation.

The FSC welcomes this approach, but has recommended amendments to what is outlined in the interim report.

The FSC submits that the accreditation should not be optional, subject to some variation of the proposed accreditation requirements. In a universal and compulsory superannuation system, all consumers should be subject to a high minimum standard for MySuper products.

The FSC submits that the enhanced APRA approval process outlined below should be mandatory for MySuper accreditation, which would help the enhanced assessment achieve two purposes:

- The quality of all MySuper products in the market would increase over time, protecting disengaged consumers; and
- It would complement APRA's prudential role for the MySuper authorisation process to drive industry consolidation through the merger of subscale funds.

The FSC submits that scale, fees and longer-term net investment returns should be the main criteria for a member outcome assessment, as outlined below. There are also ancillary criteria that APRA should be obligated to consider.

1. Scale and operational efficiency:
   - Trustees submit their s29VN scale assessments to APRA for objective consideration;

- Trustees demonstrate their risk management culture and compliance with SPS 220;
- Trustee has adequate capital capabilities with regard to risks specified in APRA's SPS 114 ORFR requirements;
- A trustee can show administrative efficiency, including call centre efficiency and ability to resolve pricing and administration errors should they arise;
- If APRA concludes that a trustee is failing to improve its operational efficiency relative to the industry, and its scale assessment demonstrates that it is not, and will not, achieve scale over time, APRA can withdraw a MySuper authorisation; and
- APRA would first be required to work with the trustee to help it change its strategy to achieve scale.

2. Fees:
   - The Government benchmark fees and net returns in the MySuper sector;
   - APRA should be required to issue quarterly MySuper product fee data against an industry wide benchmark, as well as category benchmarks, such as 'active', 'passive' or 'lifecycle stage'; and
   - APRA should be required to take into account the fees charged by a trustees in evaluating whether it is achieving its scale objectives.
3. Long-term performance:
   - APRA will be authorised to assess the net performance of a trustee's MySuper product[2] against the industry average, as well as category benchmarks, such as 'lifecycle' products or products catering to young or older members;[3]
   - If APRA forms the view that a MySuper product has underperformed over the medium term, and is not addressing the underperformance, APRA can withdraw a MySuper authorisation; and
   - APRA is required to work with a trustee to identify the causes of its underperformance before withdrawing an authorisation.
4. Ancillary criteria:
   - Trustee has a strategy to promote member engagement and increase members' financial literacy;
   - Trustee offers retirement products that provide income streams;
   - Consistent liquidity considerations across trustees when determine product sustainability;
   - Trustees have appointed a sufficient number of independent directors, have robust governance procedures and APRA is satisfied with a trustee's compliance with its governance standard;
   - A MySuper provider must have digital access and transaction ability for their consumers;
   - APRA must be satisfied that a MySuper provider has adequate capital to address operational issues or structural risk.

Table 5.3 also provides that the enhanced accreditation should only allow one accredited product per licensee, and that discounting of fees for large employers should not occur. The FSC opposes this variation from the current framework as fee reductions that reflect a competitive market and

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[2] Where a trustee has rebrand a default product as their 'MySuper', APRA should be authorised to take into account the historical performance of the default product. This would empower APRA to tackle underperformance and excessive fees amongst sub-scale funds immediately, likely bringing down industry average fees in the near-term as high cost products are removed from the system.

[3] Categories should reflect the risk appetite of the membership, so that defensive portfolios catering to older members are not seen to be underperforming aggressive portfolios designed to cater to younger members.

efficiencies that can be achieved through scale offer considerable benefits to consumers and would increase the effectiveness of competition reforms.

The FSC submits that tailoring of administration fees for large employers should be retained.

Failure to comply with enhanced APRA approval process

Under this proposal APRA would have an obligation to work collaboratively with a trustee to improve their performance if they are underperforming against any of the criteria. APRA would then have the authority to cancel a MySuper authorisation where a trustee fails to meet any of the first three criteria and has demonstrated incapacity or unwillingness to address its poor performance.

The effect of cancelling a MySuper authorisation would be that a trustee cannot accept new default members. To ensure stability for consumers, however, the trustee can continue to receive contributions on behalf of existing default members. The impact on liquidity that would result is intended to encourage merger activity amongst subscale funds.

Stronger consumer protections

There are currently concerns that superannuation funds and their related parties may offer inducements to employers to select a default superannuation fund. If this occurred it would be illegal under section 68A of the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

No evidence has ever been provided to substantiate claims that inducements have been offered. The FSC is concerned, however, that the only capacity for legal action against such conduct rests with individual consumers.

The FSC submits that where an employer retains the capacity to choose a default fund for their workplace the corporate regulator should have the power to take action for breaches of section 68A of the SIS Act on behalf of consumers, and that there should be significant penalties attached to such conduct.

Recommendation: The Commission strengthen the APRA approval process for all MySuper products, and increase penalties for inducements, as part of a hybrid model that promote consumer engagement with strong safeguards.

MySuper population

The FSC understands the rationale for the various options that support the creation of a Government body to shortlist MySuper products has two policy underpinnings:

1. Promote consumer engagement by reducing the population of MySuper products to a number of funds that consumers are readily able to select from; and
2. Facilitate industry consolidation by channelling consumers towards ‘the best’ funds.

The FSC supports the hybrid model for the default system as it would achieve these objectives without the need for shortlists or heavy handed government regulatory intervention.

The FSC submits, however, that the creation of a new Government quango to select between MySuper products and providers is unnecessary to achieve these objectives. This section details how the FSC’s proposed hybrid model would achieve industry consolidation and promote consumer engagement in a manner consistent with the policy objectives.

The FSC also submits that the policy objectives can be achieved without creating the risk of the politicisation of a new Government body, or by requiring a Government body to select between a population of increasingly competitive MySuper products in order to achieve a shortlist that is required to have only a fixed number of funds.

The FSC is a strong advocate for implementing competition reforms to drive consolidation of the current population of MySuper products. The FSC notes that each of the four competitive models proposed by the Commission envisages competition resulting in a significant reduction in the number of default products in the market. Our recommendations are intended to assist the Commission develop a framework that achieves this objective.

The FSC is concerned that there appears to be a misunderstanding over the existing number of MySuper products from which a consumer, or employer, can choose. The FSC will outline our concerns and demonstrate how the proposed hybrid model would reduce the total population of public offer MySuper products to approximately 25 MySuper products. This can be achieved without the heavy handed intervention of a Government auction, tender or shortlisting process.

Existing population of MySuper products

The FSC understands the basis for concluding that there are 110 MySuper products is APRA's quarterly MySuper statistics.[4] It appears, however, that the Commission has misinterpreted this report.

APRA's report shows 109 MySuper products. It is important to recognise that employer-specific products fall into two types:

- Tailored MySuper offers within a master trust/industry fund (e.g. Woolworths within AMP and IBM within Australian Super);
- Stand-alone corporate and public sector plans that are only open to employees of that employer to join.

Separating each of these 109 MySuper products where the offer is not employer-specific reduces the number of public offer MySuper products, which consumers can actually choose to join, to only 61. This is a significantly lower number of choices than the speculated 110 products that the Commission's interim report indicated that employees and employers face, which in turn is lower than the original 123 products when MySuper commenced in 2014.

Recommendation: The Commission recognise the population of public offer superannuation funds that can be chosen by an employer or consumer is smaller than stipulated in the interim report.

Achieving further industry consolidation

The FSC agrees that an efficient market would deliver a significantly lower number of MySuper products than the existing 61 open to selection by consumers and employers. The FSC notes, however, that within the population of public offer MySuper products there are:

- 31 industry fund MySuper products managing under $5 billion; and
- 19 retail fund MySuper products managing under $5 billion.[5]

The FSC submits that consolidation within this sector of the market would significantly reduce the number of MySuper product available to consumers. This may realise both the scale benefits the

[4] December 2016 edition - published 21 February 2017
[5] APRA's Quarterly MySuper Statistics for December 2016

Commission seeks to achieve, as well as reduce the 'size of the list' from which consumers and employers may have to choose.

Policies to drive consolidation of industry funds

There are two policies levers in particular that can achieve consolidation in the MySuper market that require a less heavy handed intervention than the proposed auction models:

1. A requirement for independent directors and an independent chair to be appointed to all trustee boards; and
2. Removal of default superannuation from modern awards and enterprise agreements.

The FSC supports a legislative requirement for all trustees to appoint independent directors and an independent chair to their boards.

In relation to industry superannuation funds, this would remove a major and well documented roadblock to industry consolidation – the incidence of appointed directors putting the interests of a nominating trade union or employer association ahead of the interests of consumers.

Removing superannuation from the industrial system, including enterprise agreements and modern awards, will also materially support industry consolidation.

There are a significant number of industry funds which are reliant on the guaranteed flow of new members and contributions to remain solvent, effectively removing any obligation on them to consider whether they have a viable business going forward. Genuine competition will force trustee boards, including their independent directors, to consider the ongoing viability of their funds.

It is reasonable to conclude that, through the combination of a requirement to appoint independent directors and the introduction of genuine competition, the population of industry funds' MySuper products will likely fall by as many as 20 funds.[6] This would result in a reduction of the total MySuper population from 61 products to closer to 40 MySuper products.

Policies to drive consolidation of retail funds

The motivations for retail superannuation funds to merge or cease offering their product to consumers are different to industry funds. It is primarily a decision whether to continue to commit shareholder capital to compete in the superannuation market.

It is reasonable to conclude, however, that introducing a more competitive framework will drive lower margins for commercial operators and force reconsideration of whether the investment is generating sufficient return on capital.

The FSC cautiously estimates that the number of retail providers in the MySuper market will also reduce over time should competition be enhanced. Even if only a third of the retail providers were to exit, this would further reduce the number of MySuper products by 5-10, to approximately 30 MySuper providers in total.

A population of 30 funds would reflect a new average fund size with considerably more scale than is currently the case, achieving the scale efficiencies sought by the Commission.

[6] This conservatively assumes only two-thirds of the subscale funds managing under $5 billion merge with each other or larger funds. This results in a net reduction of approximately 20 funds.

These benefits can be achieved without the heavy handed approach of a Government auction or tender process, but instead through higher standards of governance and a more competitive, market-based framework.

Recommendation: The Commission recommend a requirement that all funds appoint independent directors and an independent chair, in conjunction with market based competition reforms in line with proposed hybrid model, to facilitate industry consolidation.

Fund of last resort

If the Commission were to adopt the hybrid model outlined in this submission it would be unnecessary to have a scheme of last resort. A consumer would be responsible for choosing their own fund, and, where they do not elect to make a choice, an employer would have the choice of a default fund from a significantly reduced population of accredited MySuper products.

The FSC is concerned that including the option of either an eligible rollover fund (ERF), or the Future Fund, as a last resort fund would create a disincentive for consumers to engage with the superannuation system. This would undermine the objective of achieving a competitive market, as effective competition requires engagement and informed choice.

Further, should the Future Fund be used for this purpose, relying on a Government run fund to nudge individuals to roll-out of a last resort fund into an approved superannuation product is unlikely to be effective.

As a result the Commission should be clear about the potential long term ramifications of opening the default market to the Future Fund. It would be an active decision to move some or all of the responsibility for managing default superannuation monies from the private sector to the Government. The implications of this on consumers, the Government balance sheet and the private sector are not considered in this submission, but would be significant.

Recommendation: If the hybrid model is adopted a fund of last resort is not required.

Central clearinghouse

The Commission contemplated abolishing the role of the Superannuation Transaction Network, which was established by the Government as part of the SuperStream reforms, and is operated by the ATO, in conjunction with governance arrangements overseen by the Gateway Network Governance Body (GNGB).

The FSC recommends the Commission consider the current operation of the STN and the extent to which the policy objectives that it contemplates can be achieved through a centralised clearing house are currently being achieved by SuperStream.

The current arrangements allow an employer to make a single contribution on behalf of all their employees, including when their employees are consumers at different funds, to a single clearing house. The clearing house and the gateway providers are then responsible for ensuring the contributions are allocated to the correct funds, reducing administrative complexity and cost for employers.

Recommendation: The Commission assess whether the current STN is achieving the objectives outlined as the basis for a central clearinghouse.

Conflicts undermine a Government body

The FSC is concerned that a common feature of the options proposed by the Commission is the establishment of a Government body to select a shortlist of MySuper products from which either a consumer or an employer can choose. The FSC is concerned that the highly partisan superannuation industry would result in the politicisation of any Government body that the Commission may recommend be established to carry out the shortlisting process.

The FSC submits that the responsibility is on the Commission to demonstrate how a Government body that may be susceptible to politicisation would be preferable to a competitive model where each individual consumer and employer is empowered to choose their own fund, or their workplace's default fund.

Lessons from the Fair Work Commission process

The existing Fair Work Commission (FWC) process is an important example of how the nexus between the superannuation industry and political appointments are impacted by actual or perceived conflicts of interest.

The Federal Court has provided useful commentary on the currently legislated process, which requires an 'Expert Panel' to review MySuper products. Of the three 'Expert Panel' members on the FWC, the FWC President stood down two Panel members as a result of potential conflicts of interest, which gave rise to legal action before the Federal Court.

The Full Federal Court was scathing in its assessment of the current default allocation model and provides an important lesson to the Commission for any attempts to design a future Government body. Justice Perram observed that "the qualification provisions are likely to generate problems of the very kind which have arisen. Most of the people who are qualified will also be disqualified."[7]

The FSC submits that the Commission should heed the advice of the Federal Court in considering whether any 'expert panel' can be adequately quarantined from the politics inherent in the industry.

Politicisation of a Government body is inevitable in superannuation

The FSC submits that it would be poor public policy for the Commission to recommend the creation of a new Government body that, in our view, would inevitably become politicised through potential conflicted appointments. The power to appoint individuals, be they domestic or international experts, inevitably rests with the Commonwealth Government.

It would not be appropriate for the Commission to base policy recommendations on how the Commission may wish for the industry to operate in an ideal world, rather than its actual operation. The FSC submits that it is not possible to structure a Government body so as to remain independent and free of conflicts given the current partisan state of the superannuation industry.

The Federal Court counselled in relation to the Fair Work Commission process that "it's obvious that this legislation has not been thought through in its practical operation. I'm just not sure that it's the role of this court to try and bend it back into the shape of something which works."[8]

[7] Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 36
[8] Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 50

Recommendation: The Commission recognise that it is not possible to establish a Government body to shortlist funds in a manner that would be free of the conflicts of interest as a result of the partisan nature of the superannuation industry.

Prospective application

The FSC supports the prospective application of any of the default models implemented by the Government as a result of the Commission's inquiry.

Our primary concern is that retrospective application could cause the dislocation of consumers' existing arrangements, which itself may cause the duplication of accounts and insurance premiums. This was a significant concern in relation to the existing FWC 'Expert Panel' process, which could potentially cause wholesale changes to the default arrangements of millions of Australian consumers.

Prospective application would also avoid the interruption of investment strategies that have been made with particular expectations of near term retention and contribution rates. Disruption of these arrangements would potentially have a significant impact on returns on invested assets if there was a sudden change to existing membership numbers.

The FSC submits that prospective application would still achieve the Commission's objectives in a relative short time-frame. It would be the prospect of uncompetitive funds steadily losing consumers and contributions to more competitive funds that will drive the innovation, changes in strategy and industry consolidation that is required. This outcome would also be supported by the appointment of independent directors who are less likely to be conflicted when confronted with the decision of whether or not to consider merging their fund with a larger, more efficient fund.

Recommendation: The Commission recommend any default model has prospective application.

Engagement and Account Proliferation

The FSC broadly supports the concept that consumers are 'only defaulted once' to avoid account proliferation. The Commission should be careful, however, that there remains contestability between funds after an individual has defaulted, so that a consumer is not inadvertently defaulted into a fund that becomes a poorly performing fund over time or, one which is less suitable for them at different lifestages.

The risk of a default regime can be avoided by encouraging increasing levels of consumer engagement over time. The hybrid model proposed in this system is intended to achieve this outcome by placing the onus on the consumer to make an informed choice. In contrast, the auction and tender models promote disengagement by introducing the Government as the agent for consumers, and may undermine the engagement objective over time.

Single Touch Payroll

Single Touch Payroll (STP) is designed to make employers report to the ATO on their superannuation obligations more frequently and improve the data matching capacity of the ATO. As a result STP will help the ATO enforce employer compliance in regards to superannuation obligations.

STP is expected to be fully implemented for medium and large employers from July 2018. There is currently no public timeframe for the extension of STP to smaller employers.

Under STP employers will have to report wages, PAYG income tax, withholding tax and SG contribution information at the same time that they make these payments. This is a significant improvement from the current lag in reporting timeframes, and inconsistent reporting arrangements across payment types.

This will also provide the ATO with regular information on a consumer's superannuation arrangements, and allow the ATO to pre-populate their superannuation choice form with an active account details when they start with a new employer. As a result, unless a consumer chooses a different fund, they will only default once under the STP model.

The FSC supports this model, but notes that it is only one element of the Commission's proposal. The FSC submits the STP framework should be adopted regardless of the final model proposed by the Commission.

Recommendation: The Commission adopt the STP model of pre-population for choice forms to avoid account duplication, in addition to other measures aimed to promote consumer engagement.

Auctions and Tenders

The FSC continues to have reservations about options that include auctions or tenders a part of their design. The concept of a tender in the Australian context has never been fully tested, but would inherently produce significant market upheaval, introduce major new distortion into the private sector and risk introducing poor policy outcomes for consumers.

The genesis of the idea of a tender was a methodologically flawed Grattan report that concluded that fees came down in Chile as a result of introducing auctions. Grattan's research failed to reconcile the fact that auctions were introduced in Chile as a means of attracting new entrants to a market, where there was a small number of providers. By pooling future entrants to the labour market the auction was intended to attract new entrants in search of a larger 'prize.'

The Financial System Inquiry, in its analysis, also failed to give the significant differences between the Chilean and Australian default markets consideration, and the FSC is concerned the Commission may be headed down a similar path.

The Australian market is different in that there are too many providers, but major barriers to competition between those providers. An auction is not required to attract new entrants. The objective in the Australian context is to exclude underperforming funds from the default market and simplify and improve consumer decisions.

An auction or tender is not required to reduce fees and increase net returns in the Australian context. Australia requires reforms to deliver genuine competition between providers.

Auctions fail to accommodate consumer differences

The FSC's primary concern with an auction model is that any selection criteria developed and implemented by a Government body would necessarily approximate the needs of a diverse body of default consumers.

There are significant demographic differences within the default market, such as ages, income, cost of living and non-superannuation assets. The criteria developed for an auction model would be blind to many of the differences between consumers in the default market and lead to homogeneity of products between providers participating in the auction.

Consumers would be worse off under this model as consumers would be defaulted into products that may not reflect their individual needs and circumstances. Whilst a consumer may still be eligible to choose to switch out of the default option, the design of the model discourages consumer engagement by creating an administrative barrier to exercising choice, and an implicit assumption that the Government has chosen for them, and the Government makes the best decision.

The FSC is concerned that this introduces a new structural impediment to consumers arranging their financial affairs in the way that best suits their individual needs.

The FSC agrees with the analysis of the different needs of consumers put forward by the Chair of the Productivity Commission at a recent Senate Economic Committee Inquiry:

> Mr Harris: Again, this is a question of relative versus absolute performance. It depends on what their aims are, doesn't it? We have, in the course of this default fund process, which is in its early stages, been around to see a number of individual funds as well as the representatives of different elements of this debate on superannuation. In the course of those discussions with individual funds it has quite often come up that, depending on the objectives of those funds, they have perhaps a lesser performance. The answer might be that it is an ethical fund, for example, or one that has particular religious objectives. There are such funds whose performance would obviously be less than those of some other funds because they are meeting, nevertheless, the terms of what they have said to their members, which is: 'This is how we will try and deliver product.' So, relative performance is hard to judge. I am sure that there are poor-performing funds on all sides if you have a particular benchmark about what is good. But it is not necessarily a simple question of what it good; it is what you promised your members you would do.[9]

The complexity in understanding the needs of individual consumers was put clearly by the Deputy Chair of the Commission:

> Ms Chester: It is. And it is made even more difficult when you think of it purely from a member's perspective—for example, someone who is doing their superannuation through SMSF. That individual member knows their personal circumstances—do they own the family home, do they have other private savings and what is their tax position. So it is very difficult for us to have a fuller view as to whether someone's outcomes through their super—when they are making the decisions themselves—are truly optimal, unless we knew everything about them.[10]

The FSC recommends that the Commission emphasises the advantages of encouraging consumers to exercise choice. The Commission should be cautious of an auction model that causes consumer disengagement.

Recommendation: The Commission recognise that compared to models that support consumer engagement, auctions and tenders cause disengagement and fail to accommodate the discrete needs of consumers.

Consolidation will narrow performance dispersion

The hybrid model proposed by the FSC will drive industry consolidation, which in turn will narrow the dispersion of product performance. This will achieve a robust safety net as there will be few products in the default market where one population of consumers would be considerably worse off than others as a result of a choice.

[9] Senate Economics Committee, 20 October 2016, page 21
[10] Senate Economics Committee, 20 October 2016, page 22

Chart 1 graphs the dispersion of the current top 20 MySuper products since the commencement of MySuper and over the past 10 years. It demonstrates that, should industry consolidation narrow the MySuper population to only twenty products, even under current arrangements there would be little variation in their net returns.

Chart 1. Dispersion of performance of top 20 MySuper products

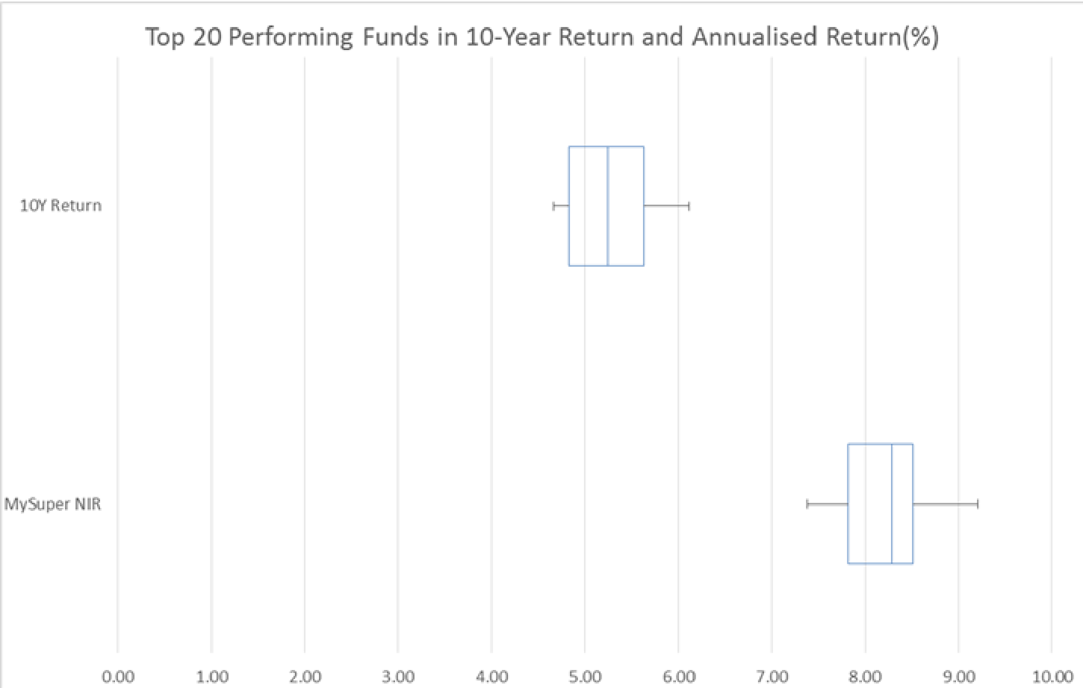

Chart 1 also demonstrates that any Government body responsible for selecting 4-10 products from a smaller population of MySuper products that all perform at a high level would be required to undertake a very difficult, if not impossible, assessment.

The FSC submits that it would effectively be an arbitrary distinction to separate the top 4-10 from the next cohort, yet be a distinction that would potentially have a catastrophic effect on existing businesses that do not make the shortlist.

Issues relating to tenders and auctions

The FSC submits that there are other threshold issues that the Commission must address before it recommends a tender or auction as a suitable model, including:

a) Tender:
   - Depending on weighting given to fees, funds could focus on reducing their margins at the expense of customer service in a bid to be lowest cost fund; and
   - Risk that weightings may not reflect the needs of all default members.

b) Auction:
   - High costs associated with funds participating in auction processes; and
   - Investment performance may suffer due to funds avoiding or decreasing exposure to higher-cost illiquid investments, like infrastructure.

Recommendation: The Commission recognise that consolidation of the superannuation industry will reduce dispersion of fund performance, undermining the role and utility of an auction or tender process.

Common structure of industry funds

There has been considerable focus on the impact of vertically integrated structures on competition on the superannuation industry. This debate, however, fails to acknowledge the different forms of vertical integration that exist.

The FSC represents a range of different superannuation funds, some of which are vertically integrated financial institutions, and others that are stand-alone businesses that do not have related parties. The common factor to each of these businesses is that they compete with one another for market share.

This arrangement is distinct from industry superannuation funds, which have discrete corporate trustees, but a common vertically integrated system of service providers owned collectively by the industry funds that has the effect of stifling competition between industry funds. This system, broadly under the umbrella of commonly owned Industry Super Holdings, includes:

- A bank (ME Bank);
- A funds management business (Industry Funds Management);
- A financial advice business (Industry Fund Services);
- A mortgage broker;
- A credit control business;
- An eligible rollover fund (AusFund);
- An investment platform;
- A political advocacy and advertising body (Industry Super Australia); and
- An online newspaper (the New Daily).

The FSC submits that, should the Commission recommend a model that shortlists superannuation trustees, if there are multiple industry funds on that list then the Commission should be fully aware of the competition-stifling impact that this common structure introduces.

The evidence of this arrangement can be seen in the current Fair Work Commission model where even though multiple industry funds may be listed in a modern award, there is currently a low degree of competition between those industry funds, and a high degree of alignment between the industry funds membership and the demarcation rules of their sponsoring unions.

In effect, industry funds keep to their respective unions' 'turf' and elect not to compete, but instead pool resources to reduce their costs through common ownership of service providers. The Commission should have regard to this collectivist culture when designing a model that is intended to promote competition, as it is inherently anti-competitive.

Recommendation: The Commission recognise that industry funds' common ownership of their service providers stifles competition between industry funds, having ramifications on the extent to which each competitive model would achieve the competition policy objective.

Group Insurance and sequential allocation

The FSC is concerned that the models involving tender or auction introduce sequence allocation that may have unintended implication for group insurance.

Sequential allocation is essentially a randomised method of allocating new members. This would make risk assessment for life insurance purposes virtually impossible at least in the early years of implementation. The result would be the increasing cost of life insurance and reduced access to life insurance. We are concerned that the models that incorporate this feature would impact on the sustainability of insurance in superannuation for default members.

The FSC submits that the preferred model for members as well as the boarder community would therefore be the hybrid model outlined in this submission, which avoids sequence allocation.

Recommendation: The Commission note that sequence allocation would undermine risk assessment for group life insurance policies.