



6 September 2017

Deputy Chair  
Productivity Commission  
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Melbourne VIC 8003

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### **Productivity Commission Inquiry in the Superannuation System**

The Financial Services Council (FSC) welcomes the opportunity to make submissions to the third stage of the Productivity Commission's (the Commission) inquiry into the competitiveness and efficiency of the superannuation system.

The FSC has over 100 members representing Australia's retail and wholesale 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 is a strong proponent of reforms that would enhance competition in the superannuation system. Theory and practice have demonstrated that competition policy delivers major benefits to consumers and this proposition holds true in the superannuation context.

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

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Blake Briggs', is positioned above the printed name.

Blake Briggs  
Senior Policy Manager

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## Introduction

The major barrier to a competitive superannuation industry is the industrial relations overlay that prevents consumers from choosing their own superannuation fund, and employers choosing the best default fund for their employees.

Reform is required to:

1. Stop enterprise agreements from preventing choice of fund; and
2. Remove superannuation from the modern award system and abolish the Fair Work Commission (FWC) process for allocating default funds to awards.

Previous FSC submissions have covered in detail how the industrial system stifles market contestability, by restricting default status to only those funds owned by industrial parties, and the barrier to entry this imposes.

This submission provides new analysis of APRA and FWC data to demonstrate the material, negative impact on the retirement savings of members that hold 1.7 million superannuation accounts as a result of the industrial system.

The FSC submits that the Productivity Commission (the Commission) must prioritise recommendations to reform the default superannuation system to make it genuinely contestable and to remove the political ideology that underpins the superannuation system.

This submission also provides new data relating to insurance in superannuation to underpin a recommendations that the Commission allows the cross-industry insurance in superannuation work group to complete its development of an industry code.

### Summary of Recommendations

**Recommendation:** The Commission conclude that the industrial default model is delivering poor outcomes for consumers and recommend to the Government an allocation model that allows consumers to switch to better performing funds.

**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.

**Recommendation:** The Commission recognise that the proposal for a central clearing house is unnecessary as the objectives underpinning the proposal are achieved through SuperStream.

**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.

## The industrial system leaves consumers worse off

Stage three of the Commission's inquiry will determine whether one or more of the alternate default models the Commission has developed should be recommended to the Government.

The Commission posed the question; how do the existing default arrangements mitigate the paramount risk of a consumer defaulting to a long-term underperforming default product?

The FSC submits that the current FWC default model does not mitigate this risk. To support this conclusion this section provides new analysis of APRA and FWC data to demonstrate that the FWC model entrenches a process where consumers are defaulted into subscale funds with systemically low returns.

The FSC submits that reform of the default system is necessary to protect consumers and the status quo is not sustainable. The current FWC model for allocating default contributions results in demonstrably poor outcomes for consumers.

It is more important for consumers to be empowered to leave an underperforming, subscale fund and join a better performing fund, than for the industry to continue the ideological battle over 'retail' or 'industry' status. The FSC supports a consumer being able to join any fund they choose, and recognises there are a number of strongly performing industry funds in the market, as there are strongly performing retail funds.

FSC analysis demonstrates that a more important issue facing consumers is the significant market presence of subscale and underperforming funds that are protected by the current default system:<sup>1</sup>

- There are 33 subscale funds listed in modern awards<sup>2</sup>;
- On average these funds manage \$3.3 billion, although 10 manage a very small amount, less than \$650 million each; and
- The subscale funds make up 153 modern award superannuation listings, which equate to 30.2% of all the award listings.

**Collectively subscale funds manage \$94 billion within 1.7 million consumer accounts. Subscale funds have a significant market presence, and present a major risk for superannuation consumers.**

FSC analysis also shows the negative impact that subscale fund underperformance has on consumers.

**The average performance of the default 33 subscale funds is 4.50% per annum over ten years.<sup>3</sup>**

The poor performance of subscale funds is clear when compared to other funds in the sector:

- Their performance is 0.64% lower than the average performance advertised by ISA funds;<sup>4</sup>

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<sup>1</sup> FSC analysis of FWC modern award data and APRA superannuation performance data.

<sup>2</sup> Subscale funds are defined for this analysis as those that manage less than \$10 billion, the level that industry researcher Chant West has used to demonstrate that, on average, smaller not-for-profit funds charge higher fees and produce lower returns than larger not-for-profit funds. It also excludes funds that are not members of Industry Super Australia (ISA) to demonstrate the significant underperformance of subscale funds that are hidden by the use of industry average figures.

<sup>3</sup> APRA's ten year, whole of fund, performance data.

<sup>4</sup> Industry Super Australia published performance data, July 2017.

- Their performance is 0.80% lower than average 5.30% performance of all ‘Growth’ options in the market, including both industry and retail funds;<sup>5</sup> and
- Their performance is 1.4% per annum lower than the performance of the best performing MySuper products.<sup>6</sup>

The scope of underperformance is magnified when analysis focuses on the worst performing funds.

**The weakest performing fund returned only 2.7% per annum over ten years, and whilst it manages less than \$1 billion, it is listed in two modern awards.**

Whilst it is sometimes unhelpful to use comparisons of default performance, given the relative recent implementation of the MySuper framework, this analysis demonstrates the scale of the underperformance issue concerning default products in the industrial system.

The FSC submits that it is more important for consumers to be empowered to leave underperforming, subscale funds and join a better performing fund, than for policy to be based on whether a fund is ‘retail’ or ‘industry’.

**The performance gap between subscale funds and the best performing funds shows that a consumer could be over \$170 000 worse off by retirement as a result of the current industrial system.<sup>7</sup>**

For the 1.7 million consumer accounts that may be worse off in retirement as a result of the protection of subscale funds, those consumers would likely have little concern for whether their funds is retail or industry fund.

The FSC is concerned that proponents of the industrial model for superannuation are putting the interests of industrial parties over consumers as the model they support retains the protection from competition of these subscale funds.

The FSC submits that the Commission should recommend a model that allows consumers to exit underperforming, subscale funds and switch to a fund, regardless of whether it is retail or industry funds, which delivers consumers stronger returns and a more comfortable retirement.

**Recommendation:** The Commission conclude that the industrial default model is delivering poor outcomes for consumers and recommend to the Government an allocation model that allows consumers to switch to better performing funds.

## Legislative barriers to competition

The Commission should specifically have regard to the complexity of Division 4A of the *Fair Work Act 2009* (Cth) (the FW Act) and in particular, section 156T of the FW Act.

Section 156T of the FW Act only provides industrial parties the opportunity to make submissions in the second stage of the FWC default superannuation reviews. This provision:

1. Excludes funds from competing with industry superannuation funds for default listings; and

<sup>5</sup> Chant West ‘Growth’ category, ten year returns.

<sup>6</sup> The FSC used the average performance of the best three MySuper products.

<sup>7</sup> Analysis of the projected returns of a 31 year old with an income of \$80 000, net of fees, using ASIC’s Money Smart Superannuation Calculator.

2. Excludes one industry funds from competing with another if the former's sponsoring union or employer does not have industrial coverage of a specific industry.

The FWC process is therefore specifically designed to stifle competition between industrial parties, consistent with the demarcation rules that protect union coverage, and also protect industry funds from competing retail funds.

These statutory arrangements are evidence of the anti-competitive nature of the default system.

## Case Studies

The Commission should examine situations where:

1. Industrial parties have supported the industry fund they own being listed in modern awards, even where the fund was poorly performing, thereby resulting in avoidable, poor retirement outcomes for future default members;
2. Industrial parties have opposed application to the FWC by competing funds to be listed in modern awards in order to avoid the funds they own being required to compete;
3. Industrial parties using enterprise agreements to remove a consumer's right to choose their own fund, even where the fund named in the enterprise agreement was poorly performing, or had conflicts of interest related to financial transactions with the industrial party.

Each of these case studies would provide evidence of barriers to entry that have a dampening effect on competition. They also expose how industrial laws interact with entrenched conflicts of interest to prevent new entrants from competing with incumbents.

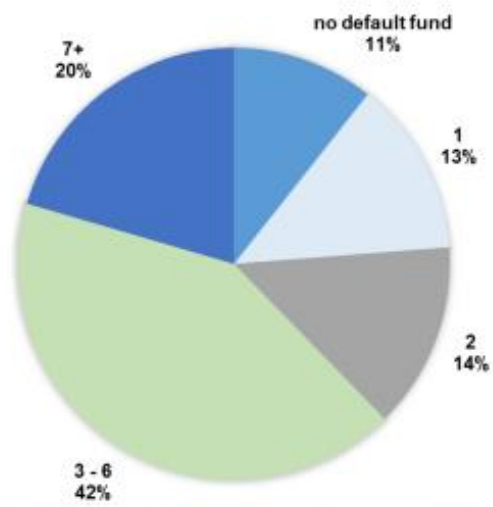
## Analysis

Deloitte Access Economics (DAE) recently conducted analysis into the default superannuation system for the FSC. New data in their report is relevant to the Commission's analysis, and the submission is attached for reference.

In particular, DAE demonstrated the extent to which options for employers and employees are reduced as a result of the award system.

A quarter of all industries covered by awards are only afforded a choice of two MySuper products, or no choice of fund at all. Over two thirds of industries have their options limited to six or less MySuper products.

**Figure 1. Number of default MySuper products listed in modern awards**

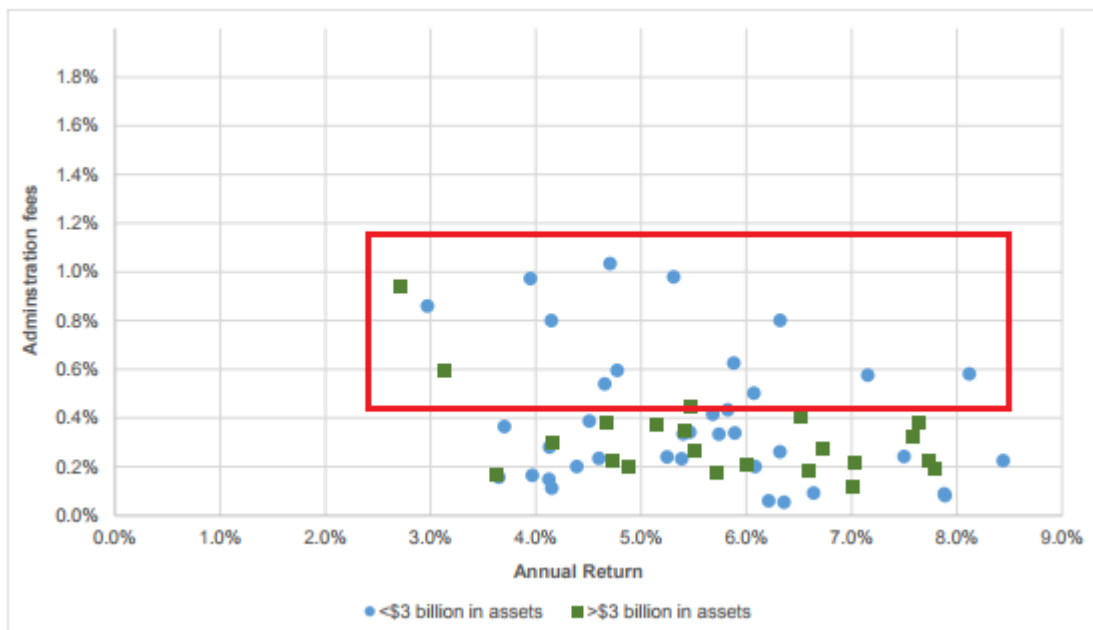


*Source: DAE analysis of FSC Audit of Modern Awards 14 January 2015*

DAE’s research also examined the cost and returns of funds listed in modern awards since the commencement of MySuper.

DAE concluded that smaller funds, under \$3 billion in assets, were more likely to have substantially higher administration fees, and were more likely to have below average returns.

**Figure 1. Fees and returns of award listed MySuper products**



DAE’s analysis led it to conclude that if increased competition in the superannuation system were to narrow the difference between the highest and lowest administrative fees applying to MySuper products, a reduction of at least \$292 million in administration fees paid per year across over 14 million MySuper product accounts could be realised.

This would represent a significant decrease (13%) in administration fees across these products.

## Competitive default model

The FSC submits that the key elements of a competitive market design are 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 MySuper regime is only three years old, and as such there is not a long history of performance for most MySuper products. This prevents meaningful comparison for tender or auction purposes, but favours a model where consumers, on an ongoing basis, are able to switch to highly performing funds.

The FSC submits that elements of the other options proposed by the Commission would introduce significant, 'heavy handed' regulatory interventions that are unnecessary to achieve the objectives of a competitive market. They also introduce considerable risk of unintended outcomes, such as potential gaming by participants and politicisation of the superannuation industry.

The FSC's proposed hybrid model is designed to avoid the risk of unintended outcomes inherent in Government intervention and provide a greater role for the markets in delivering efficient outcomes.

The proposed model would also prioritise encouraging consumer engagement. It would place consumers at the centre of the process for selecting a fund, and provide more information to assist consumer decision-making.

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 APRA's Member Outcomes Test, which will provide consistently higher quality MySuper 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 any MySuper product 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.

## Transitional arrangements

There would be no material transitional costs arising from this model as an employer or consumer can remain a consumer of their existing default fund indefinitely.

The proposed model puts the onus on providers to demonstrate value to consumers of switching to a competing fund, inherently creating a situation where the benefits to the consumer must outweigh any potential costs.

This model is superior to Government intervention in the default market, through a tender or an auction, as such intervention would require all funds that attempt to secure default status to not only develop new products to compete based on the criteria used, but also develop strategies to survive in the event they are not successful in a tender.

The FSC is not aware of how the transition cost of a tender or auction could be effectively mitigated.

## Politicisation of 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.

## Lessons from the Fair Work Commission process

The existing 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."<sup>8</sup>

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.

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<sup>8</sup> Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 36

## 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 of the day, who itself may have conflicts of interest or an ideological position on superannuation issues.

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 FWC 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.”<sup>9</sup>

**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.

## Centralised clearing house

The FSC submits that major reform to the network of clearing houses in the Superannuation Transaction Network (STN) is unnecessary as the implementation of SuperStream achieves the objectives that the Commission seeks to achieve through a central clearing house.

The FSC is a co-sponsor of the Gateway Network Governance Body Limited (GNGB), which was established in September 2016 as an industry-owned organisation to manage the integrity of the STN. The STN is the network created by the Gateway Operators who transact superannuation data under the SuperStream Data and Payments Standards.

The GNGB manages the governance of the STN by the operation of a Memorandum of Understanding between the Gateway Operators and the GNGB, which requires compliance with Gateway Standards and associated requirements concerning information security, service level standards, amongst others.

As a result of the implementation of SuperStream mandatory Data and Payment Standards across employers and the superannuation industry, most entities engaged Gateway Operators to meet certain obligations under those requirements. The Gateway Operators comprise a range of different types of organisations, including clearing houses, payroll services, specialist data management providers and self-administered superannuation funds, serving a range of client types.

Gateway Operators offer clearing services, integration into registry systems, data transformation into a standards-compliant format, data integrity screening services, integration into payroll systems, reconciliation services and transaction reporting and monitoring, to meet their various client needs.

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<sup>9</sup> Transcript of *Financial Services Council v Industry Super Australia* [2014] and Another at 50

These services, in a digitised transaction environment, provide vital structures to manage data integrity and payment reconciliation, and support efficient, straight-through processing. The transaction services provided are therefore a part of a broader landscape of electronic and data services, and meets already many of the objectives sought by centralising a clearing house.

The industry has made significant investment in electronic transaction capability, and the associated commitment to more efficient processes. The services the Gateway Operators provide have assisted and supported these improvements. The management of data, and at times payment, by these providers is part of the landscape of the superannuation industry, and is well-integrated into vital processes within the industry.

A consequence of the development of solutions available is that employers have access through a range of options, to low cost and no cost services that ensure that contributions can be sent compliant with the SuperStream mandatory Data and Payment Standards, and delivered by Gateway Operators across the STN to destination superannuation funds.

**Recommendation:** The Commission recognise that the proposal for a central clearing house is unnecessary as the objectives underpinning the proposal are achieved through SuperStream.