

Response to the Financial System Inquiry Interim Report

August 2014

Association of Superannuation Funds of Australia (ASFA)

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Introduction

The Association of Superannuation Funds of Australia (ASFA) welcomes the opportunity to respond to the Interim Report of the Financial System Inquiry (FSI). Our response consists of four sections:

- An executive summary
- A discussion on the objectives of the superannuation system and how these link to the regulatory framework and impact costs, complexity and competition
- A discussion on the objectives of the retirement system and how these can be achieved
- A detailed response to those issues raised in the Interim Report that relate to superannuation and retirement.

Executive summary

While still not fully mature, the Australian superannuation system is significant and growing in importance, both to Australians, and to the Australian economy. Today:

- more than \$1.8 trillion of Australians' savings are held in the superannuation system; this is more than the annual GDP of Australia
- superannuation funds own more than 30 per cent of the shares listed on the Australian Securities Exchange (ASX)
- there are Australians retiring now with substantial superannuation balances, which have accumulated through compulsory superannuation
- 14 million Australians have superannuation accounts – either in the accumulation or retirement phase.

Following the FSI's release of their Interim Report, ASFA believes three key questions need to be asked:

- *Can we clearly identify the goals of the superannuation and retirement system?*
- *Is our tax-subsidised superannuation and retirement system on track to meet these goals?*
- *And if not, what do we need to do to ensure that the outcomes will be met?*

In answering these, we know that the environment in ten years' time will look very different to today. Demographics, structural shifts in society, the tax base, economic policy settings and regulatory settings in the financial system will all change. ASFA believes that the biggest challenge we face is the design of the retirement system. The Wallis Inquiry did not cover the appropriate design for the retirement phase. While superannuation policy has undergone almost continuous change, driven by its interaction with tax revenues, the same is not true for the policies around the retirement system. We are yet to fully develop the system design, the rules around how income streams are best provided, and to identify what success looks like and how it can be measured.

It is vital, however, that all policy and regulatory changes that affect the superannuation and retirement system are assessed against the outcomes or objectives that have been set for the system. To move in this direction, we need to:

- set high-level objectives that clearly define what the superannuation and retirement system is intending to achieve
- create a governance process for public policy setting around these objectives
- set long-term goals against:
 - » government expenditure as a proportion of GDP
 - » numbers of retired Australians retiring on the Age Pension
 - » the income replacement rate in retirement
 - » retirement quality of life.
- clarify the prudential or regulatory promise, the level of consumer protection and the way in which trustee obligations over these should be interpreted for Australians who hold savings in:
 - » defined benefit (DB) plans
 - » default superannuation accounts
 - » their own choice of investments in their fund, master trust or wrap platform
 - » SMSF accounts
 - » retirement vehicles.
- re-define the regulator and regulatory perimeters to be consistent with the above
- clarify the roles of industry participants, agents, structures and stakeholders so that regulations can be appropriately framed around superannuation and retirement objectives
- support the role of the Australian Securities and Investments Commission (ASIC), the Australian Taxation Office (ATO) and the Australian Prudential Regulation Authority (APRA) through levies across the broader financial services industry and promote more business-aware cultures within these organisations
- set clear and measurable short, medium and long-term targets against which the performance of superannuation/ service providers, regulators and public policy makers can be assessed.

Throughout this process, we must focus on moving to a more simple and transparent system that can be more easily understood by the community.

In this submission, we highlight the importance of the superannuation system in mitigating the problem of underinsurance in Australia. Insurance within superannuation provides a benefit to the government of social security savings of around \$400 million per year.

There are structural issues within the superannuation and retirement industry that result in real or perceived shortcomings in market competition. However, there is nascent competition, and the positive impact of Future of Financial Advice (FoFA), MySuper, the publication of APRA data and SuperStream reforms are yet to be seen. It will only be over the next five to ten years that we see the full effect of better competition on member fees and cost reduction driven by these reforms.

In international terms, Australian defined contribution (DC) members are paying fees consistent with members of similar funds overseas. Our analysis on this is presented as an attachment.

The advice process is critical to Australians in developing the right retirement income strategy. ASFA believes that we must work toward improving the consistent quality and availability of advice.

2050 objectives

Age Pension expenditure & tax expenditure on superannuation

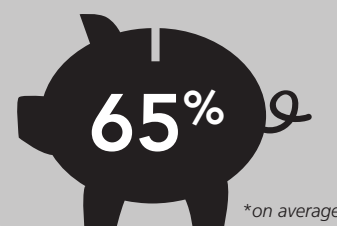
OF LESS THAN

6%
of GDP

Less than 20%

of retired Australians over Age Pension qualifying age relying solely or almost exclusively on the Age Pension

Australians retire with an income replacement rate in excess of



AT LEAST 50%

of Australians able to cover their expenditure in retirement and have a 'COMFORTABLE' lifestyle in retirement

as described in the ASFA Retirement Standard

1. Meeting the objectives of superannuation

The Interim Report raises some important issues to which ASFA wants to respond. These are:

- the need for clear objectives for superannuation
- questions around the alignment of regulation with the objectives of superannuation including the duty of care and prudential promises
- the focus on fee-based competition and cost-efficiency in the industry.

This section of ASFA's second submission to the Financial System Inquiry covers these three high-level issues.

1.1 The need for clear and measurable objectives for the superannuation industry

Without clarity of purpose, superannuation and retirement policy and regulatory architecture cannot be aligned and, therefore, cannot deliver the right outcomes. This ultimately drives up costs and complexity. ASFA believes that there must be better accountability and transparency of how the system delivers against key objectives. ASFA recommends:

- setting clear and measurable objectives for the system in both the accumulation and retirement phases
- identifying what success should look like and measuring the performance of the system against this
- ensuring that regulation is consistent with policy objectives and holding regulators to account by assessing their performance against appropriate indicators
- monitoring emerging gaps and risks in both system design and regulatory architecture and reach.

To be efficient and effective, the superannuation system must have a clear and measurable objective. There has been a lack of clarity around the objectives of superannuation. This has resulted in system design changes that have been ad hoc and not public-policy-driven, resulting in design inefficiencies, regulatory mismatch, more complexity and higher operational costs.

ASFA believes the overarching objective of superannuation must be described as both:

- **a fiscal imperative:** reducing the call on the public purse of retirement income for older Australians for future generations, and
- **a social imperative:** to ensure that all Australians are given the opportunity of having a dignified retirement.

These objectives must be viewed together as interdependent, rather than separately. There is clearly a duty of care to all Australians to promote their ability to have a dignified retirement. But it would be disingenuous to suggest that the fiscal imperative was not also an objective of public policy given our ageing population. The projections of the fiscal drag that the Age Pension will have on government budgets in years to come will not reduce unless the superannuation system delivers a superior alternative source of income in retirement for Australians. The indirect benefit of these twin objectives of superannuation is a pool of national savings that will ultimately benefit the Australian economy.

To enable accountability against these objectives, we must have clearly defined measures of success. ASFA believes that there must be long-term goals.

Superannuation and retirement system goals for 2050:

- Age Pension expenditure and tax expenditure on super (properly measured) of less than six per cent of GDP
- less than 20 per cent of retired Australians over Age Pension qualifying age relying solely or almost exclusively on the Age Pension
- Australians retiring with an income replacement rate in retirement in terms of household disposable income in excess of 65 per cent (on average)
- at least 50 per cent of Australians able to cover their expenditure in retirement and at least have a 'comfortable' lifestyle in retirement, as described in the ASFA Retirement Standard.

Detail on the approach ASFA has taken in coming up with these objectives and their interaction with one another is provided in Box A.

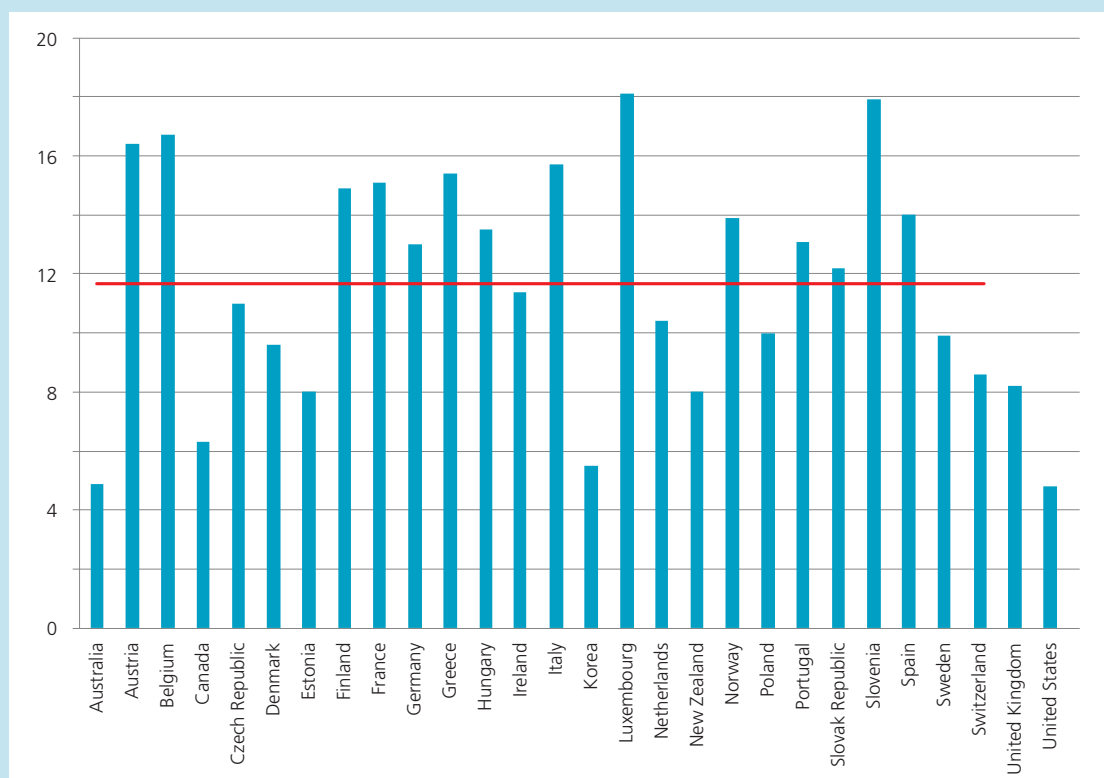
BOX A: 2050 goals

Limit Age Pension expenditure

ASFA propose limiting total direct and indirect public expenditures to no more than six per cent of GDP. This is around half the average projected level for OECD countries for public pensions alone. If achieved, it would be lower than just about any other developed country.

Current expenditure on the Age Pension is around 2.7 per cent of GDP and is projected to grow to around 3.9 per cent of GDP by 2050, if current policy settings are not changed. A goal of total direct and tax expenditure of less than 6 per cent of GDP is proposed, but on the basis that tax expenditure are properly measured. Taking into account savings on the Age Pension bill and behavioural and other changes if tax concessions for super were removed, current tax expenditure on superannuation are just over 1 per cent of GDP. This tax expenditure is projected by ASFA to grow to no more than 2 per cent of GDP by 2050. This assumes the basic structure of current tax policy settings for contributions, fund earnings and benefits are kept in place, but with some refinements made to ensure that tax expenditure is appropriately directed.

Figure 1: Projected public expenditure on pensions (2050, percentage of GDP)



Halve the number of Australians reliant on the Age Pension

Currently, 40 per cent of Australian old enough to qualify for the Age Pension receive a full Age Pension. This 40 per cent of the population have very little other income. Halving this percentage would be a major achievement given that there is a substantial proportion of the population that has little, if any, paid employment during their life. Achieving this would make a substantial contribution to containing future public expenditure on the Age Pension.

Increase average living standards in retirement

Currently, the average replacement rate of household income in retirement is less than 40 per cent of household disposable income during prime working years. The proposed target of 65 per cent is a significant increase in average living standards in retirement by the year 2050.

Ensure more Australians have a dignified retirement

Currently, less than 20 per cent of single persons aged over 65 are able to support a standard of living at or above the ASFA Retirement Standard 'comfortable' level and only around 30 per cent of all couples able to support that level. Additional personal contributions and/or enhancements to government assistance will be needed to meet the proposed goal set by ASFA of at least 50 per cent of retirees achieving at least the comfortable standard. ASFA projections indicate that, on the basis of current policy settings and contributions, only around 20 per cent of singles and just under 50 per cent of all couples will be able to support the comfortable standard in retirement in 2050.

At the time of the introduction of compulsory superannuation, its principal objective was to deliver better retirement incomes for Australians, particularly the 60 per cent or so of employees who, in the 1980s, did not receive the benefit of any employer superannuation contributions. The Age Pension was deemed by the then government, unions and other interest groups alike as an inadequate means of funding a dignified retirement. Compulsory savings, in the form of superannuation, were designed to deliver the additional income required to provide dignity in retirement. Another objective was to reduce government expenditure on the Age Pension. Faced with an ageing population, and the prospect of ballooning Age Pension and other age-related costs, it made policy sense for the government to provide incentives and assistance for people to fully or partially self-fund their retirement, thus reducing future expenditure. However, there never was any expectation or intention that superannuation would entirely replace the Age Pension for many or most employees or that Age Pension expenditure in aggregate would decline in real or nominal terms. The proposal was about boosting retirement incomes, not fundamentally changing who was paying the cost of retirement incomes.ⁱ

Since the introduction of the Superannuation Guarantee, the objective of superannuation has been less clearly defined or articulated by governments. Indeed, the Charter Group, in looking at the adequacy and sustainability of the superannuation system, noted that there was a range of views on what superannuation is for. *"Some see its purpose as alleviating poverty (not a widely held view) while some see super more as wealth-building and even as building intergenerational wealth. The great bulk of opinion is somewhere in the middle; that is, that super is intended to provide more dignity in retirement, giving people a standard of living above the safety net afforded by the Age Pension."*

So, while there is a concept of 'dignity in retirement' and a general acceptance that we need fiscal sustainability as our population ages, there has been no overarching framework in place to ensure either the clarity of the objectives of superannuation policy, or delivery against these objectives.

System issues

The absence of an overarching objective for the system is creating four high-level issues which, as the system becomes larger, will become increasingly problematic. They are:

- instability in public policy resulting from the political process, leading to lack of trust and incomplete coverage of policy
- lack of alignment with other social security policy settings

- complexity and inconsistency in the regulatory approach to superannuation
- lack of accountability against clear and measurable target outcomes.

The first of these – **the instability in public policy setting around the superannuation system** – has been observed by the Financial System Inquiry Committee in the Interim Report. Superannuation policy has been reviewed, revised and amended many times by both sides of politics over the past 16 years, as Figure 4.2 (page 2-119) of the Interim Report demonstrates. This has resulted in a somewhat piecemeal and politically driven approach to superannuation policy, where aspects of the system have been examined through a particular lens, rather than holistically. Examples of this include: Simpler Super (2006), Choice of Superannuation Funds (2005), creation of Retirement Savings Accounts and income tax rebates for individuals making voluntary superannuation contributions (1992, replaced with co-contributions from 2003) and more recently, MySuper (2014).

Each of these individual reviews relating to superannuation has, by necessity, overlapped with other earlier reviews undertaken. The end result has been a lack of consistency in policy settings, inefficient policy processes with overlaps in policy reviews, and a muddying of the overall policy objectives.

There are several consequences of this:

- the community loses trust and confidence in the system because they do not understand the reason for the changes and feel they cannot plan for the future with any certainty. This may explain the significant uptake of SMSFs where the key driver to opening an account is control. It is also consistent with the success of SMSF advertising, which advocates that a self-managed approach saves the customer from paying the regulation levy that is being applied to many APRA-regulated funds members
- it creates the risk that gaps emerge. There is no single point of responsibility for superannuation and retirement system design meeting its stated objectives over the full timeframe against which the policy must be delivered. Outside the Financial System Inquiry – a once-in-fifteen-year-event – where does the responsibility for identifying and responding to these systemic risk issues within the system rest? It is not a regulatory responsibility, but is a gap in our current public policy setting
- it potentially inhibits innovation and product development in the system, as participants' investment dollars are concentrated on meeting the changed policy setting, rather than product development.

A second, and related, problem is that there has been **limited success in linking the objectives of superannuation consistently**, and sensibly, into other key government social security policy areas, such as access to the Age Pension, senior health care and aged care. Efficiency cannot be achieved unless policies around the key areas impacted by the ageing population are well aligned.

Thirdly, **the regulation of superannuation has not kept pace with changes in the system**. The current regulatory approach uses the superannuation vehicle as the starting point for regulation, rather than what duty of care is owed to money within superannuation. This means that, as structures change, the regulation struggles to keep pace, and complexity emerges in the regulatory treatment of the pools of money in the various structures and vehicles, which may be inside or outside the core APRA regulation framework.

APRA-regulated funds no longer make up the lion's share of the superannuation industry. The superannuation and retirement industry extends to banking, insurers, managed investments, SMSFs, property, gateways, clearing houses, financial advisers and more. The inability of regulatory policy to keep up with this changing environment has resulted in an inconsistent application of the regulatory burden, more gaps in regulation and greater opportunity for regulatory arbitrage. For example, there is no single body that is tasked with monitoring whole-of system/industry regulatory issues, particularly from a consumer view point. When failures have occurred across the system, for example Trio, to date there has not been an analysis of whether a more holistic approach to regularly risks would have mitigated the losses to consumers.

Finally, **the absence of an overarching framework with clear, definable objectives and measures of success** has meant that there has been no clear, measurable accountability of parties involved in the superannuation system. This includes policy makers, regulators and superannuation/retirement providers.

Box B: Comparison of regulatory requirements in certain areas for superannuation, banking and MIS

An interesting case study looks at the differences in regulatory burden across banks, managed investment schemes (MIS) and APRA-regulated funds. HWL Ebsworth Lawyers, on behalf of ASFA, have undertaken a comparative review of the regulations (statutory and APRA prudential standards) applying to banking, the managed investment scheme sector and superannuation. The report stemming from the review, which sets out all relevant regulations for the three sectors runs for more than 900 pages and demonstrates that, in terms of the legislative instruments, banking is subject to less than one-third fewer laws/sections than superannuation funds. We provide an extract of the report in the box over the page, which sets out six areas of regulation that potentially should relate to all three sectors, but where superannuation bears nearly all the regulatory burden.

The review demonstrates how far superannuation regulation has moved away from the model of prudential regulation as applied to banking. Although both are ostensibly based on 'principles-based regulation', the table demonstrates that banking regulation is subject to far fewer, and less prescriptive, regulatory requirements than superannuation.

Further, in addition to prudential guidelines issued by APRA, which are common to banks and superannuation funds, superannuation funds are subject to: SPS 114 Operational Risk Financial Requirement, SPS 160 Defined Benefit Matters, SPS 250 Insurance in Superannuation, SPS 410 MySuper Transition, SPS 450 Eligible Rollover Fund (ERF) Transition, SPS 521 Conflicts of Interest, and SPS 530 Investment Governance.

Subject of regulation	Superannuation	Banking	Responsible entities
Provisions relating to the governing rules.	Part 6 of the <i>SIS Act</i> (9 sections): <ul style="list-style-type: none"> • 51, 51A, 52(1)–(8)* • 52A(1)–(6), 52B(1)–(4) • 52C(1)–(4), 53(1)–(5) • 54(1)–(2), 54A(1)–(4). *There are a total of 51 sub-clauses (a), (b), (c) etc, under the 8 subsections of Section 52.	No equivalent.	Parts 5C.2 and 5C.3 of the <i>Corporations Act</i> (5 sections): <ul style="list-style-type: none"> • 601FC(1)–(5) • 601FD(1)–(4) • 601FE(1)–(4) • 601GA(1)–(4) • 601GB.
Record-keeping: 1) Duty to keep records 2) Offences relating to incorrectly keeping records.	Part 12 of the <i>SIS Act</i> (3 sections): <ul style="list-style-type: none"> • 103 – minutes and trustee records • 104 – changes to trustees • 105 – copies of all fund reports. Part 26 of the <i>SIS Act</i> (6 sections): <ul style="list-style-type: none"> • 300, 301, 303, 306, 307, 308 	No equivalent.	No equivalent.
Obligations of actuaries and auditors including: <ul style="list-style-type: none"> • compliance with directions • giving of information to the regulator • self-incrimination • attempts to unduly influence • giving false or misleading information to auditor • failure to implement actuarial recommendations. 	Part 16, Division 2 of the <i>SIS Act</i> (7 sections): <ul style="list-style-type: none"> • 129 • 130 • 130A • 130B • 130BA • 130BB • 130C. 	No equivalent.	No equivalent.

Subject of regulation	Superannuation	Banking	Responsible entities
Infringement notices – provisions regarding the use, payment etc of infringement notices if an infringement officer reasonably believes that a provision has been contravened.	Part 22 of the <i>SIS Act</i> (11 sections): <ul style="list-style-type: none"> • 223, 223A, 223B, 223C, 223D • 224, 224A, 224B, 224C, 224D, 224E. 	No equivalent.	No equivalent.
Monitoring and investigation (by the regulator) including: <ul style="list-style-type: none"> • information to be given to regulator • production of books • access to premises by regulator • investigation of financial position • deadline for and content of reporting • enforceable undertakings • power to freeze assets • powers if books not produced/concealed • legal professional privilege etc. 	Part 25 of the <i>SIS Act</i> (51 sections):* <ul style="list-style-type: none"> • 253, 253A, 254, 255, 256, 256A • 257 – 262 • 262A (enforceable undertakings) • 263 – 270 • 271 – 280 • 281 – 290 • 291 – 298, 298A, 299. *Comprising 9 Divisions .	Part VII of the <i>Banking Act</i> (4 sections): <ul style="list-style-type: none"> • 61, 62, 62A • 18A (enforceable undertakings). 	No equivalent.
Tax file numbers (TFNs) – quotation, use and transfer of TFNs.	Part 25A of the <i>SIS Act</i> (35 sections):* <ul style="list-style-type: none"> • 299A – 299C, 299CA, 299D, 299E • 299F – 299H, 299J, 299K, 299L • 299LA, 299LB, 299M, 299N, 299NA • 299P – 299S, 299SA, 299T • 299TA – 299TF, 299U – 299Z. *Comprising 5 Divisions .	No equivalent.	No equivalent.

Source: Scott Charaneka, HWL Ebsworth Lawyers.

1.2 Regulatory settings – do they match the objectives of superannuation?

ASFA recommends that:

- the regulatory framework is designed more flexibly, and/or re-assessed more frequently, with the objectives of the superannuation system front of mind, to ensure that it matches the way in which the system is evolving. This should be reflected in the mission statements of the regulators
- the prudential promise or regulatory commitment given to all superannuation members be reviewed given the development of SMSF arrangements and other areas of member choice, and that superannuation trustee obligations are clarified and revised to be consistent with these.

It is critical that the regulatory perimeters, prudential promises and trustee obligations of superannuation are consistent with the objectives of superannuation and with the policies which flow from these. This must be viewed in the context of an evolving market that has changed, and will continue to change depending on the market environment, technology developments and customer demands.

Given the evolving nature of the market, there are many emerging issues, to which we need to take a holistic and consistent approach consistent with the overarching objectives of superannuation. These include, but are not limited to, competition concerns, interchange fees, group insurance and the regulatory oversight of payment gateways. One issue, which we discuss in the section below, is the mismatch between new options for superannuation savings, which allow Australians to choose the way in which they meet their own retirement objectives, and the regulatory regime, which still maintains that a prudential promise is owed to these members.

Regulators need to be more than just rules-based. Critically, the interaction between the policymakers, regulators and other related areas of the economy must be efficient, and consistent with the overarching objectives of superannuation. However, as it currently stands, policy relating to superannuation is set by the government, primarily through the Department of Treasury. Then, APRA, ASIC and the ATO are responsible for developing the regulatory 'rules', to ensure adherence with that policy.

The APRA mission statement is:

"To establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system."

The regulation of the SMSF sector is similarly unrelated to the objectives of superannuation. The ATO acknowledges that it has *"an important role regulating SMSFs in accordance with super laws and administering the tax system as it applies to super funds and their members. [They] also play a key role in monitoring the performance of SMSF auditors."*

ASIC, as the conduct and consumer regulator, has the complicated role of regulating disclosure, as well as the delivery of superannuation and retirement advice.

There is no linkage or real consistency of these regulatory objectives with what ASFA believes is the objective of the superannuation system. For example, no regulator is focused on ensuring that superannuation investments are being managed in a way as to ensure that each member will meet the objective of dignity in retirement. Nor does the ATO's mandate call out its role in ensuring that employers comply with their responsibility to operate appropriately within the superannuation system. Within APRA-regulated entities, the difference between a member who chooses their own investment mix, a member in a DB fund, and a MySuper member is not clear.

ASFA recommends that the regulators' objectives are rewritten to reflect their obligation to assist the superannuation system to meet its objectives.

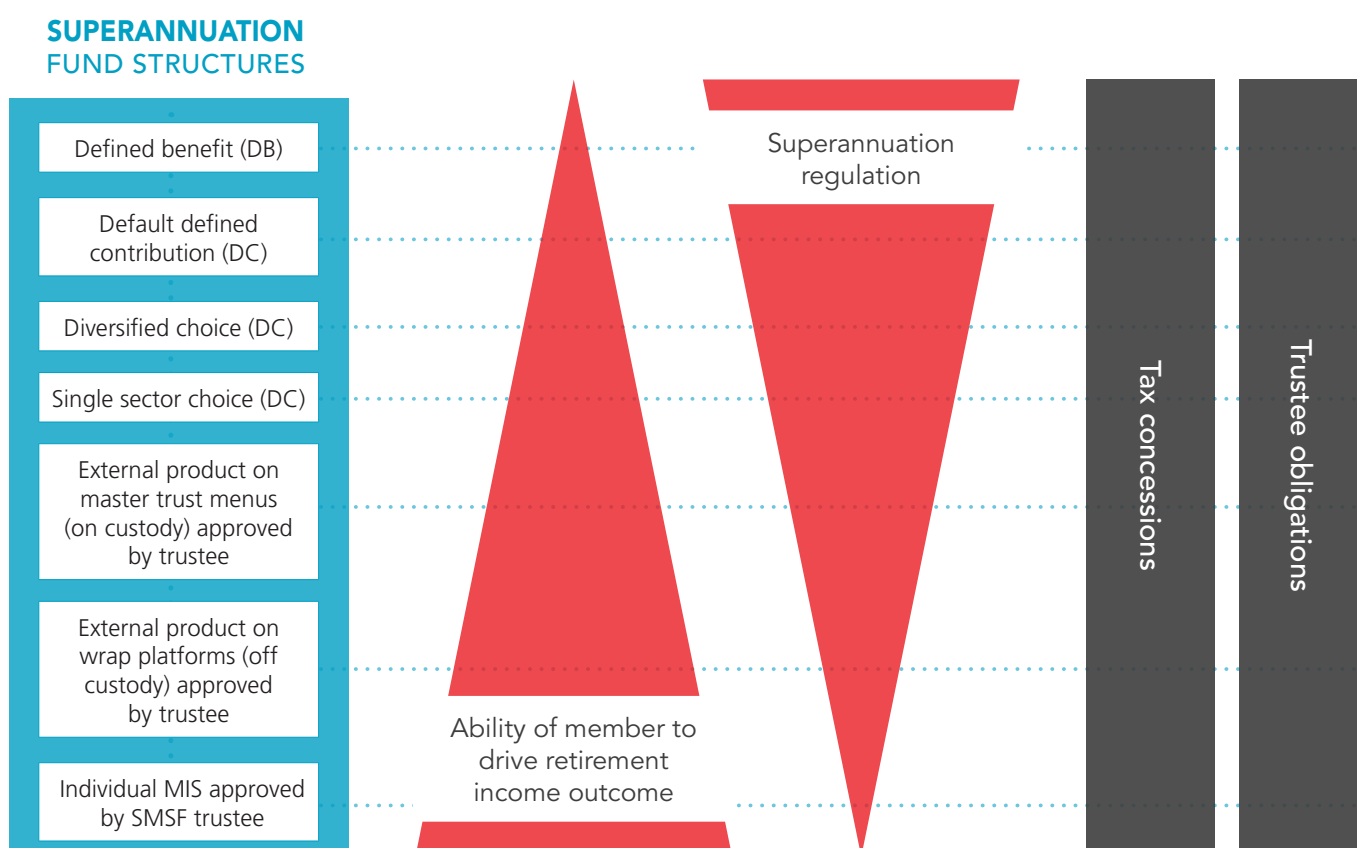
Consistency of regulation across the superannuation spectrum

In an efficient regulatory environment, the greatest effort is spent on the areas of greatest risk. We need to ensure that this philosophy is built into the regulatory framework to ensure that we get most "bang for our regulatory buck". As noted above, a particular mismatch has emerged between the regulation and oversight framework, intended to protect members' interests, and policies that allow members to choose their own investment mix.

The diagram below illustrates this mismatch. There is a spectrum of superannuation products available to Australians. At one end of this spectrum is DB products, where the sponsoring employer determines the investment profile of the assets and members wear no investment risk. At the other end of this spectrum are SMSFs and superannuation investments via wrap platforms, where individuals may choose their own investments, and effectively self-determine the appropriateness of those investments to meet their retirement objectives.

The intensity of the superannuation regulation decreases as individuals make more of their own investment decisions and move outside the regulated financial services system. This reflects a system where the focus of prudential regulation is on the financial institution delivering on its 'promise', rather than the superannuation system ensuring the best retirement income solution. Further, the tax concessions and the trustees' obligations remain the same, even though the control over the retirement outcome has moved to the individual, rather than the trustee.

Figure 2



The current regulatory perimeters are a legacy of the Wallis Inquiry. Wallis determined that superannuation would fall within the prudential regulatory framework. The following table summarises the justification for this in the Wallis report, and the challenge to the relevance of these assumptions today.

	Wallis justification for prudential oversight	Relevance in 2014
1.	The system is compulsory	Still relevant today
2.	The system lacks choice for members	Not relevant today. Members typically have many choices, both in choice of fund and choice of investment including alternative structures (SMSF), choice of risk profile, direct equities, bank deposits and so on.
3.	The system is designed for long-term investment	Less relevant today. While benefits are preserved; members may determine their own investments and these may not be consistent with long-term objectives.
4.	The contribution to superannuation was tax revenue foregone	Still relevant today, especially as tax benefits apply to: <ul style="list-style-type: none"> • all choice investments, without reference to their appropriateness for generating retirement income; and • balances which may exceed that required to achieve dignity in retirement.

The level of prudential regulation in relation to members who have not exercised choice over their superannuation fund and/or the manner in which their investments are invested may need to be different for members who have exercised choice. This would be the case for DB funds, or the default MySuper options where trustees are making decisions on their behalf.

This thinking should also be extended to the retirement income system. What promise are we making to Australians about the safety of their retirement savings and its ability to deliver the income that they expect to have over their lifetime? Where do the risks lie in delivering the right retirement outcome? As we develop the policies around retirement system design, we need to consider what level of oversight and regulation is consistent with the objectives of the retirement system, being mindful of where the greatest risks lie. Our discussion on retirement income is provided in Section 2.

The regulatory perimeters need to be reassessed in the context of the objectives of superannuation and retirement, and in the context of the broader universe of service providers and entities that impact the system's delivery against these objectives.

1.3 Does the superannuation industry demonstrate competitiveness?

ASFA recommends that:

- the recent initiatives of MySuper, Stronger Super, the publication of APRA data, FoFA and SuperStream are given time to demonstrate effectiveness as initiatives that will drive greater efficiency in the superannuation industry
- a review of the cost efficiency of industry is undertaken after a period of, say, three or four years.

While there is no doubt that there are structural factors that work against 'perfect competition' in the superannuation market, we are observing continual improvements in industry competitiveness and efficiency, aided by policies that are promoting greater comparability of products for consumers and trustees. In particular, we note:

- significant competition at the institutional level in fees paid to fund managers
- improvement in member retention
- more account consolidation
- competition in the development of MySuper offerings
- better member engagement – particularly through easier access to accounts
- more members choosing to stay in their own fund when they change jobs
- sector competition between industry funds, retail funds and SMSFs
- the development of retirement and income stream options.

We are also seeing evidence of fees being reduced and recent policy reforms – MySuper, FoFA and SuperStream, in particular – should generate cost savings over the next few years. Superannuation trustees must ensure these are passed through to members. And, contrary to the observation in the Interim Report, ASFA research shows that on a like-for-like basis, the Australian defined contribution (DC) member is actually paying less in fees than most of their OECD counterparts.

Critically, ASFA reiterates the need for the industry and public policymakers to focus on net of fee returns, rather than absolute fee levels, as it is this measure that will ultimately determine the level of income available in retirement.

Superannuation: an efficient market?

The absence of clear and accountable objectives of public policy for superannuation will inevitably add cost and complexity to the system, and reduce efficiency. In a 'normal' market, this might be ameliorated by competitive market forces at work. However, by its nature, the superannuation system has a number of structural factors at play which impact the real or perceived market efficiency. These structural issues can be summarised as:

- **demand-side issues**, particularly around consumer behaviour
- **supply-side issues**, especially the differences in business models of service providers
- **ancillary benefits built into superannuation**, such as insurance, which have been linked to the provision of superannuation products.

Demand side issues: consumer behaviour

The Interim Report has drawn on the observations of the Super System Review of consumer behaviour, which led to the development of the MySuper default policy. These are listed in Box 4.1 of the Interim Report and can be summarised as:

- failure to exercise choice
- lack of price awareness
- lack of interest
- agency and structural issues
- complexity
- lack of comparability
- frictions.

MySuper has looked to solve this problem for disengaged members, by making the trustee act in their stead. Trustees are expected to understand the complexities, to draw appropriate comparisons and to have interest where the members do not. Key to the success of this approach will be the actions of trustees to act positively in the best interests of members, not just to avoid damage to the underlying membership, and for the regulators to hold trustees to account in meeting this responsibility. Transparency and comparability of the product and its performance will help trustees with these obligations.

Beyond MySuper, the Stronger Super policy changes will also improve the comparability of all superannuation products. Providing consistency in the way risk is described, in the disclosure of fees, including performance fees, all help the consumer to better compare one financial product with another. That said, we do have some way to go in improving the product disclosure arrangements. Despite the new 'short form' product disclosure statement (PDS) arrangement, customers are still subject to documentation that is not consistent across providers and contains an excess of legal terminology, in some cases prescribed wording by the regulator.

The MySuper policy will not address all aspects of consumer behaviour that impact the superannuation industry. For example, an equilibrium position might be that smaller corporate superannuation funds without access to scale benefits need to merge for the system to achieve greater efficiencies. In an efficient market, consumers (members) would move away from less cost-efficient funds to more cost efficient funds, eventually driving merger activity. However, without engagement, the expected customer movement away from these higher cost funds will not happen, removing a potential driver of merger activity.

ASFA believes that the disengaged nature of many Australian superannuants does create an absence of price demand elasticity that is necessary for an efficient market. However, recent initiatives (of MySuper in particular), the additional obligations placed on trustees to act proactively in members best interests, and better transparency of fees and return outcomes will assist the demand-side competitiveness of the market. ASFA recommends that a review is undertaken after the recent reform initiatives have had time to demonstrate their effectiveness.

Supply side issues: superannuation system framework

The supply side of the superannuation industry can be characterised by some competitive factors and its underlying structure of a mix of retail, not for profit and SMSF funds. Without fully engaged members creating a competitive-demand environment, it is unlikely that the supply side of the industry is also going to look perfectly competitive. The highly regulated nature of the industry will also work against a landscape of visible competition.

Competition by service providers is usually evidenced by: margin compression, rapid product innovation, and merger/acquisition activity. Similarities in the underlying business structures may also be important in generating competition as they are more likely to produce similar products that promote competition through simpler comparability of products and their features. We discuss these factors, in so far as they are evident in the Australian superannuation industry, over the page.

Margin compression

Rice Warner has estimated that the margin in superannuation fees over expenses has declined by 11 basis points over the last 10 years. They attribute this reduction to competition amongst funds to reduce fees, relative to competitors, and the increasing market share of not-for-profit funds. In particular, the margins of retail funds have reduced by around double the industry average. Rice Warner suggests that this reflects greater competition for members with the introduction of Choice of Fund in 2005.

The costs or expenses associated with running a superannuation fund, however, have not fallen as far, or as fast, as some market participants would have expected. Market participants point to the costs of regulatory change and systems changes as contributing to the lag in cost reduction.

Recent Rice Warner research on superannuation fund expenses indicates that average operating expenses per member have increased from around \$140 a year in 2010 to around \$190 a year in 2013, with an annual average rate of increase in costs of 11 per cent a year over three years. Similar cost increases were recorded for industry, public sector and retail funds. These funds cover the bulk of Australians with superannuation.

The Rice Warner research also provides a breakdown of the operating expenses per member, based on the median fund. This indicates costs of approximately the following amounts per member per year:

- \$25 for technology
- \$36 for administration
- \$19 for marketing and communications
- \$25 for compliance and trustee support
- \$3 for financial planning services
- \$3 for investment in operations and strategy.

Advertising and sponsorship made up only \$2.60 per member per year and are not a driver of overall fund expenses or growth in expenses. More significant marketing and communication costs were \$5 per member per year for regular member communications, \$8.60 per member per year for marketing and business development and \$2.70 per member per year for printing.

Administration covers a variety of activities. The research indicates that contribution processing costs an average of \$9 per member per year, pension administration \$1.70 (although clearly not all members receive a pension), insurance administration \$8, other benefit processing \$6 and member contact centre \$12.

Administration expenses contain the largest 'variable cost' component (expenses that are scalable depending on the size of the operation). Compliance and trustee support, and technology fall mostly into the 'fixed overhead' category. These expenses expressed as an expense per member decrease as the fund size increases. Marketing and communications, and financial planning services are largely discretionary costs (not all funds offer these services), although it is increasingly recognised that for large public offer funds it is essential to provide these services to maintain scale.

ASFA also notes the reference to the Grattan Institute Report in the Interim Report and suggests that the data in this report perhaps does not provide a full picture of the fees and costs tensions that are playing out in our market. In particular, they paint too dim a picture of the fees paid in the Australian market relative to other jurisdictions.

ASFA has prepared a research paper on international fee comparisons. It is provided in Appendix A. This demonstrates that fees for Australian superannuation funds are around the level in most other countries when like-for-like funds are compared. It is certainly true that defined benefit funds mostly invested in bonds and funded by one employer have lower costs than most Australian superannuation funds; however, this is not a realistic comparison. In a range of developed and developing countries fees for defined contribution funds mostly invested in equities and open to multiple employers typically are in the range of 70 to 100 basis points per year. In a number of countries, including the United States (US), Canada and Hong Kong, costs and fees are in excess of 100 basis points, sometimes substantially more.

Product innovation

There has been some innovation in superannuation products in recent years, both at a whole of product level, and as product features. Examples include the:

- use of age cohort products
- drawdown protection features built into diversified funds
- use of 'smart beta' in markets with inefficient index structures
- introduction of direct equity offerings on master trust menus and industry fund product ranges
- use of mobile applications linked to superannuation and banking accounts.

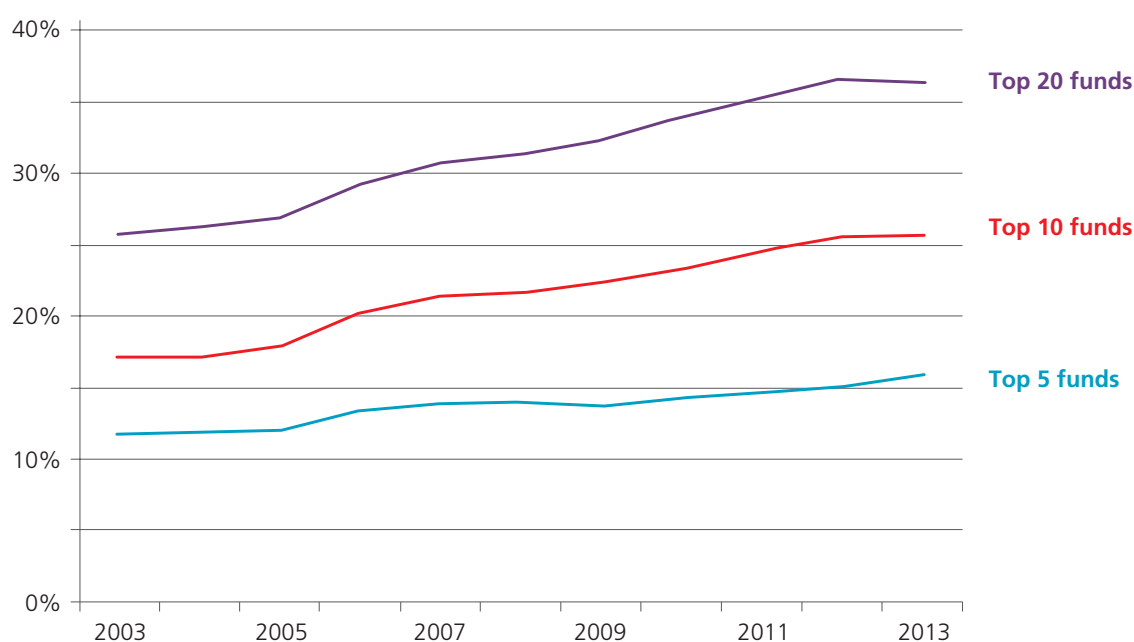
Market participants believe that the instability in regulatory and policy settings has worked against greater innovation in the market. In a capital-constrained environment, the legal requirement to respond to changes in regulation and policy will supersede investment in product innovation. Many ASFA members have noted that their total spend on system changes required to meet the new standards have limited the budget for product development.

Mergers and acquisitions

There has been a large drop in the number of APRA-regulated superannuation funds, particularly in corporate funds, where closures have been more common than mergers. As a result, the concentration of assets under management amongst larger superannuation funds has increased significantly over the past 10 years, with the top 20 funds moving from holding 26 per cent of total industry assets to around 37 per cent.

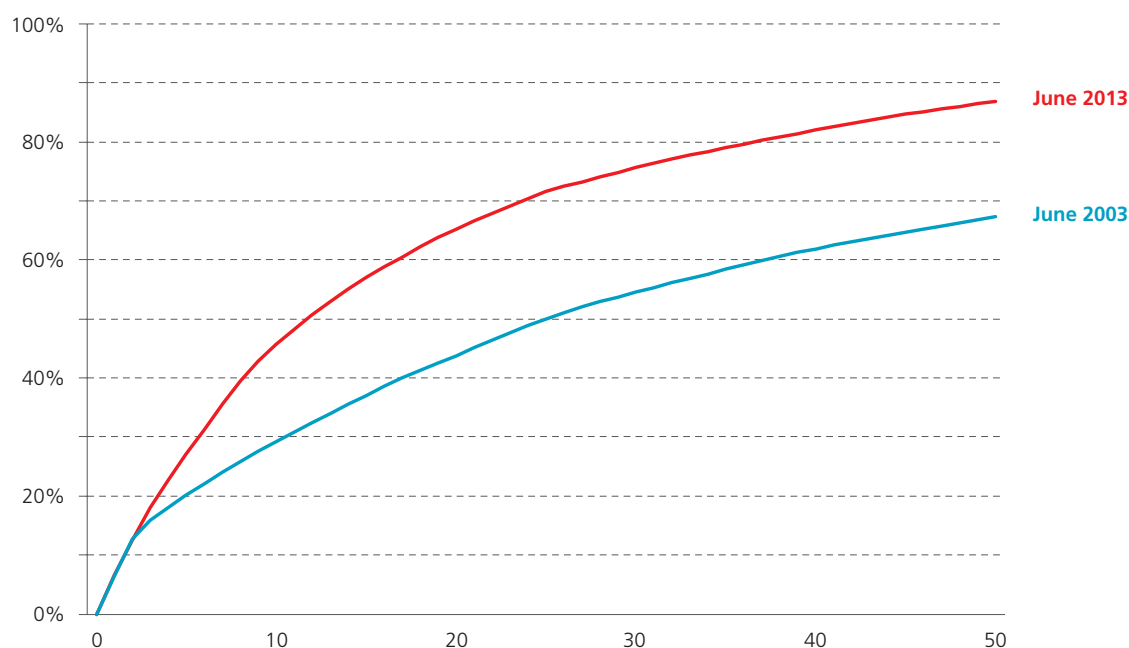
There have been a large number of mergers and fund closures (with the transfer of members to successor funds) in recent years. For instance, AustralianSuper now encompasses members from more than a dozen predecessor funds, First State Super merged with Health Super, and Care Super merged with Asset Super. Retail funds have also merged as the result of takeover activity, with AXA funds now part of AMP. Further, when particular funds have put themselves up as candidates for a merger, there has been significant activity/demand in the bidding process for these funds.

Figure 3: Concentration of the largest funds across entire superannuation industry (June end data, 2003 to 2013)



Source: APRA.

Figure 4: Cumulative concentration of funds across the APRA-regulated universe



Source: APRA.

Regardless, many financial services industry observers have been surprised by the recent lack of merger activity in the superannuation market. So why has the merger activity dropped off? One reason may be that the industry has needed to focus on implementing the various reforms and that merger activity occurred in anticipation of these. Another reason may be that certain mergers may trigger the re-pricing of group risk policies, which will substantially impact member costs. A further reason may be that the 'low hanging fruit' has already been taken, and that there are barriers to further merger activity. These barriers may include some of the difficulties of legacy rationalisation. This is discussed further in this second submission to the Financial System Inquiry on page [x](#).

Heterogeneity of product providers

Another factor that may be contributing to the real or perceived view that the superannuation industry is not competitive is the significant differences in the business models of the various superannuation providers.

Providers of superannuation products in Australia are varied and their market share has changed over time. As ASFA's first round Financial System Inquiry submission noted, the superannuation landscape has changed significantly since 1997, when the Wallis Report was finalised. Particularly: there are less DB funds and more DC funds; there are fewer superannuation funds and more SMSFs, and there are far fewer corporate funds. In the current environment, the providers of superannuation products to Australians can be categorised into three groups:

- retail and for profit
- not-for-profit including employer-sponsored corporate, government and industry funds
- the SMSF industry.

Each of these are subject to their own unique combination of environmental factors that influence the way they offer superannuation products and the consumer sector that they dominate.

	Retail	Not-for-profit	SMSFs
Business driver	Profit.	Number of members.	Control/lower costs.
Consumer segment	Broad, includes master trusts, wrap platforms and outsourced corporate superannuation.	Linked to employment sector, for example, linked to awards in particular industries, linked to a specific employer such as the Government of Western Australia or Qantas.	Affluent, pre and post retirees.

But while the business models are different, we are seeing evidence of competition.

Within the segments, we see signs of competition in the form of tendering for master super trust business, successor fund activity and positioning across various award agreements. Across segments, there is also evidence of competition, for example in the areas of account consolidations and the offering of corporate superannuation services. The attraction of SMSFs also provides significant competition to both retail funds and industry funds.

From a public policy perspective, it is critical that this activity is driven by competition and is working towards the twin objectives of super, namely fiscal sustainability and retirement dignity. It is not desirable if changes in market share are being driven by non-competitive factors such as differences in tax structures or incomplete member information.

Ancillary benefits built into superannuation

Earlier, we stated that there would be few participants who would argue that the principle objectives of superannuation policy should be fiscal sustainability and dignity in retirement. While superannuation is principally for the purpose of providing income in retirement, the *SIS Act* acknowledges that there are “other ancillary benefits” that may be incorporated within a superannuation fund.

The core purposes, as noted in the *APRA Superannuation Circular No.III.A.4*, are:

- provision of benefits for each fund member on or after they retire or reach their preservation age
- provision of life insurance benefits if the member dies before they retire or reach their preservation age.

But alongside these core purposes, a superannuation fund may also:

- provide benefits in the event of the termination of employment (which includes resignation, redundancy and so on) and provide benefits in the event of temporary or permanent cessation of work on account of physical or mental ill-health
- provide life insurance benefits if a member dies after retirement or after reaching their preservation age.

The provision of life and total and permanent disability (TPD) insurance in particular has long been associated with superannuation funds. The rationale is straightforward: in preparing for your future financial needs in retirement, you need to consider what will happen if you are unable to contribute to superannuation until you retire. Any good financial planner will be having this conversation, alongside discussing investment strategy.

And yet, this aspect of the Australian superannuation system is seldom discussed as part of the policy debate around superannuation. Typically, the headline measure of performance of the superannuation system is how well it is providing for Australians in retirement. The insurance benefit needs to be included in any assessment of the superannuation system, alongside the administrative costs that it adds to the members’ total fee experience. International comparisons need to take into account the differences in the provision of insurance benefits within the various superannuation systems. The OECD data used by the Grattan institute includes fee data from many defined benefits markets, where products typically include some kind of death benefit, but will not include temporary or permanent disability insurance. Further, insurance coverage in defined contribution pension schemes is relatively uncommon. For instance, it is not part of the KiwiSaver superannuation funds in New Zealand, generally is not part of 401(k) offerings in the US, is not part of Registered Retirement Savings Plans in Canada, and is not part of defined contribution employer schemes in the United Kingdom.

In terms of the benefits, default and chosen insurance cover through superannuation has led to a much greater insurance coverage of the Australian population. In quantitative terms, superannuation group insurance arrangements amount to:

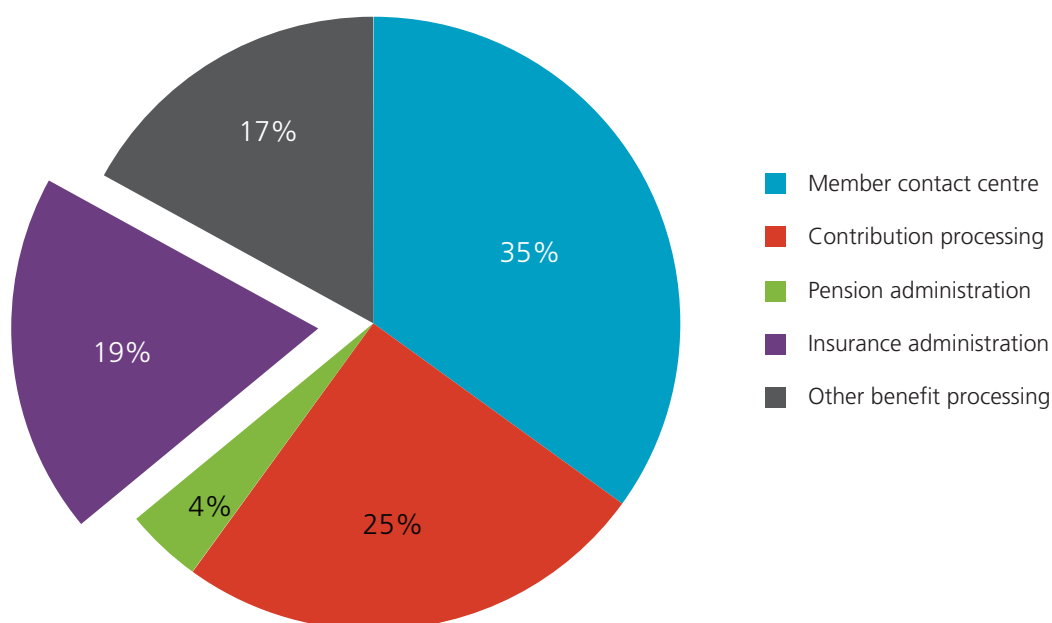
- 71 per cent of total death sums insured in the community
- 88 per cent of aggregate TPD sums insured
- 59 per cent of total income protection monthly benefits insured.

Rice Warner has estimated that the gap between the actual insurance cover of the Australian population based on the age and income of individuals, and the coverage that they have is large. In order to close this gap, another \$1,553 million per annum would be needed in insurance premiums. However, the gap would be much larger without insurance coverage through superannuation.

Clearly, the benefits of higher insurance coverage come with costs, in terms of both insurance premiums and additional costs of administration. Some of these cost components – particularly around administration – are very difficult to quantify. That said, the quantifiable components are largely with claims processing and underwriting costs, that is assessing applications for insurance coverage and pricing them appropriately. The administration costs of insurance coverage represent around 20 per cent of total superannuation administration costs.

Surveys of Australian superannuation funds indicate that identifiable costs for insurance administration are about \$10 per member per year, with this amount higher in some funds. This is equivalent to around two or three basis points of the account balance of the average fund member. Insurance administration costs represent around one-fifth of total administrative costs and are almost as large as contribution processing, as shown in the chart below.

Figure 5: Administrative expenses per member by component
(as at end-June 2013)



Source: Rice Warner.

Within the MySuper framework, the insurance premiums paid out of members' accounts will be visible and returns (net of administrative fees but gross of insurance premium) will be able to be calculated. However, for the superannuation provider, the costs of supporting the insurance benefits are often difficult to separate from the operational costs of running the fund.

There are significant benefits to linking insurance with the compulsory superannuation system. Absent this approach and disengaged members are likely to be underinsured, and they and/or their dependents may face hardship in the event of a personal tragedy. Further, supporting these uninsured individuals would add significantly to the call on the public purse via social security benefits such as disability payments, single parent allowances and so on. Rice Warner estimates that the annual benefit to the government of these savings is in the order of \$400 million.

Another ancillary benefit within superannuation in Australia, which is often unrecognised, is the provision of intra-fund advice. This is not provided in many other countries by pension funds. This limited form of advice, generally paid for out of the administration fee charged to fund members, is equivalent to around two basis points of assets.

A copy of the Rice Warner analysis of Insurance Administration Expenses is provided in Appendix B.

2. Meeting the objectives of retirement

This section of ASFA's second submission to the Financial System Inquiry covers the issues of the retirement system: where it is currently and what needs to be done to ensure that it meets the right outcomes.

2.1 Today's retirement income system

ASFA believes that the retirement income system needs to be designed in line with the high-level goals we have identified for Australians in retirement. Specifically, ASFA recommends:

- learning from our experience with superannuation system design and developing a simple framework that is assessed on a holistic basis
- linking retirement outcomes with other government responsibilities for older Australians such as the Age Pension and health care
- higher educational standards and other measures, and thereby safeguard the trust of customers and raise the quality and consistency of financial advice
- a principles-based approach to the regulation of new retirement income products to facilitate innovation and avoid unnecessarily complex regulation.

Around 90 per cent of Australian employees are in defined contribution (DC) funds but we are still grappling with the retirement system design that will best meet the needs of these employees in retirement.

As identified in ASFA's first submission, defined benefit (DB) schemes do a great job of transitioning members to retirement income, by providing a known level of income for the remainder of a person's life. Unfortunately, they do have other flaws and have declined in number to now only represent only a small proportion of the superannuation system. Only around 10 per cent or so of current employees in Australia will retire with a DB income stream. These are mostly government employees and employees in some large companies, and the investment and longevity risks for these individuals are managed by their employer sponsor.

However, almost all such funds are now closed to new members. Around 90 per cent of current members of superannuation funds are in DC schemes and that percentage will gradually increase in the future as practically all new employees will be members of DC schemes. These individuals will wear the investment risk of decisions made by trustees or by themselves through their choice of investment profile. These individuals are also exposed to their own longevity risk, unless they are amongst the very few who have chosen to invest in a product which has an annuity-type structure.

DB schemes are well established and operating in other countries. However, the retirement phase of DC private pension systems is generally underdeveloped internationally. We can't point to a global economy that has effectively solved the conundrum of how to design an effective DC pension system to meet the risk management needs of retirees. This is not an Australia-specific issue.

One reason for this is that most DC pension systems are relatively immature. They have not been operating for a sufficient period of time for many or most retirees to accumulate sizeable balances, which can be converted into income streams, to achieve dignity in retirement for most or even many persons in retirement. In these economies, and Australian is one, the greatest risk for individuals is not having enough savings at the time of retirement to support a dignified retirement for the rest of their life.

With average retirement payouts in 2011/12 of the order of \$197,000 for men and only \$105,000 for women, it is clear that most recent retirees will need to substantially rely on the Age Pension in their retirement. Many will not be able to achieve the objective of dignity in retirement. ASFA calculations indicate that a single person needs around \$430,000 at the time of retirement and a couple needs \$510,000 in order to support a lifestyle in retirement consistent with the ASFA Retirement Standard 'comfortable' level.

Although Australian compulsory superannuation arrangements have been in place since the late 1980s in regard to award superannuation and from 1992 in regard to the Superannuation Guarantee, it will not be until 2050 or beyond that most retirees will have received the benefit of contributions at the rate of 12 per cent of wages for a considerable period of time.

For those retiring in the near future, currently the main choices available at the time of retirement to people in DC funds in Australia are to take one or a combination of:

- a lump sum
- an account-based income stream
- a term or life annuity.

Each of these options differs in its ability to deal with the risk management needs of retirees. However, the suitability of each option and the optimal combination of each of these and other possible options will depend on the circumstances of the retiree, their needs and their attitude to risk. Generally, the amount of their retirement savings also will be relevant.

A number of commentators have asserted that there is a 'lump sum' mentality in Australia and that many (or at least a significant number) of retirees take a lump sum superannuation benefit, spend it on consumption goods or a holiday, and then fall back onto the Age Pension. Individuals taking lump sums generally take an amount that is not material to the amount of Age Pension they will receive.

Retirees with any significant amount of superannuation generally will take some sort of income stream in retirement, albeit usually an account-based income stream with little or no protection against the financial risks of longevity or investment volatility.

Previously unpublished data, produced by Rice Warner, based on fund surveys and other evidence, indicates that the great bulk of accumulated superannuation assets are taken as income stream rollovers at the time of retirement, although a majority of members take lump sums. The data indicates the average lump sum taken is less than \$50,000 and those taking an income stream option have account balances averaging around \$290,000.

Number and amount of benefits taken at time of retirement 2012-13

	Assets (\$billion)	Members
Lump sums	8.1	181,877
Pension rollovers	44.7	155,478
Total	52.8	337,355

Source: Rice Warner.

These estimates differ from the lump sum and pension payments published by APRA and are, we argue, more meaningful. The lump sum benefit figures that APRA publishes includes benefits paid in the case of death, TPD, financial hardship, compassionate release, departed temporary residents, and unclaimed monies.

The pension rollover amount also is different from the pension benefit payment data published by APRA. The APRA data relates to pension payments for all retirees (including those who may have retired years or decades earlier) and those who are receiving a pension on the grounds of temporary or permanent disability or as part of a Transition to Retirement Pension arrangement. More specifically, only around four or five per cent of the pension rollover amount of retirees in the last year would be included in the APRA pension payment data as that is all that is required to be drawn down in the first year for most retirees.

As the Australian system matures, a greater percentage of Australians will take an income stream option at the time of retirement as more Australians will have an account balance for which there are clear advantages in taking an income stream. However, already a large proportion – around 85 per cent of retirement account balances – is taken as an income stream.

The real issue for Australia is in regard to the type of income streams taken rather than the amount of superannuation assets flowing into income streams at the time of retirement being far too low.

2.2 Practices overseas

Australia is not alone in finding that there are challenges in dealing with the retirement phase of DC schemes. There has been considerable attention given to the issues involved by the OECD and other policy and research groups, but final and definitive solutions are generally yet to emerge.

Recent research by the Pensions Policy Institute in the United Kingdom notes the diversity of practices in regard to post-retirement income arrangements in DC schemes around the world. Box C provides details.ⁱⁱ

BOX C: Post-retirement arrangements around the world for DC members

Factors affecting the demand for annuities and other post-retirement products across different countries include:

- underlying cultural attitudes and the appetite for a secure and guaranteed source of income in retirement
- the structure, variety and perceived value of other retirement income products on offer in the market
- the timing and framing of the decisions about how to allocate pension savings and the perceived attractiveness of the annuity rates on offer.

In Switzerland, where unlimited access to private pension saving is allowed and annuity rates are seen as good value, around 80 per cent of DC savings are put into lifetime annuities at retirement. In Denmark, where decisions in some voluntary pension saving vehicles on how to allocate savings are taken well ahead of retirement, around 85 per cent of voluntary pension savings are allocated to either lifetime or fixed-term annuities. However, in other countries, such as Canada and the USA, lifetime annuities currently play only a small or negligible role in the market.

Within countries in which ‘annuitisation’ levels were medium to low (30 per cent or under), annuities are often not perceived as a ‘good deal’. Annuities in these countries are less likely to involve any form of government backing or other intervention to ensure that annuity rates look attractive when compared to other retirement income products.

Countries with lower levels of annuitisation also tend to contain a wider range of other available products that allowed the drawdown of income as well as savings and the potential for bequest. These products tended to be more developed in the countries where annuity markets were reported to be under-developed or small (Ireland, USA). However, popularity is growing in the USA for annuities that can be used during the accumulation period and during retirement for tax-advantaged saving and draw down, while still allowing access to lump sums and the possibility of bequests.

A key feature of countries with lower levels of annuitisation is that they tend, on the whole, to have fewer restrictions on accessing DC savings, although this is not necessarily the deciding factor. In Switzerland, which allows free access to lump sums, around 80 per cent of DC savings is used to purchase a lifetime annuity. However, countries with low levels of annuitisation all had a state pension.

2.3 Good practices for retirement systems

In seeking to assist countries to strengthen retirement income adequacy in a DC environment, in 2012, the OECD Working Party on Private Pensions identified elements of good design and public policy. This roadmap for the good design of DC plans consists of ten recommendations, which were covered in ASFA's first submission to the Inquiry. Box D sets out the recommendations most relevant to the design and regulation of the retirement income phase.

BOX D: OECD recommendations on retirement income

Ensure the design of DC pension plans is internally coherent between the accumulation and payout phases and with the overall pension system.

This suggests that the target retirement income in DC plans should be determined consistent with the benefits provided by the other components of the pension system. To define and achieve this target, all possible risks (that is, labour, financial and demographic risks) affecting retirement income of DC pension plans should be monitored.

For the payout phase, encourage annuitisation as a protection against longevity risk.

A certain level of annuitisation of balances accumulated in DC pension plans should be set as the default mechanism for the payout phase, unless pay-as-you-go public pensions or the old-age safety net already provide for sufficient regular pension payments. A combination of programmed withdrawals with a deferred life annuity (for example, starting payments at the age of 85) that offers protection against inflation could be seen as an appropriate default. The demand for annuities could be also promoted by financial education initiatives stressing that they are insurance products designed to protect people from outliving their resources. Lump-sum payments may have to be discouraged as a form of benefit pay-out, except for small DC account balances.

Promote the supply of annuities and cost-efficient competition in the annuity market.

Different providers, such as public schemes, non-profit occupational plans, and insurance undertakings may provide different arrangements of risk-sharing in the payout phase that may help strengthen benefit adequacy and diversify risks in retirement income. Competition among different providers in the market for individual and group annuities should be promoted to ensure cost-efficient provision for plan members and to help develop the annuity sector as a whole.

Develop appropriate information and risk-hedging instruments to facilitate dealing with longevity risk.

The market for annuities would benefit from certain actions aimed at making the management of longevity risk easier. Firstly, reliable life tables should be made available by public statistical agencies; they should be regularly updated and incorporate stochastic forecasts of future improvements in mortality and life expectancy. Secondly, capital market solutions to longevity risk management could be promoted by producing standardised, publicly and readily available longevity indices. While there has been no successful example of longevity bonds thus far, governments could also consider issuing a meaningful number of longevity indexed bonds and very long-dated bonds.

www.oecd.org/finance/private-pensions/designingfundedpensionplans.htm

2.4 Framing the right policies to deliver on retirement income

Sound public policy for the provision of income in retirement must be framed in line with the objectives of the superannuation system and consistent with the promise or promises that retirement income product providers and their regulators provide – or should provide – to their customers.

As has been indicated earlier in this submission, ASFA considers that the overarching objective of superannuation is both:

- a fiscal imperative of reducing the call on the public purse for the retirement income of older Australians and for their health and aged care needs
- a social imperative of ensuring that all Australians are given the opportunity of a dignified retirement.

Our submission has set quantitative targets and measures of success for both of those areas.

We have also described the regulatory and prudential framework that should apply in achieving these goals, together with how this translates to the fiduciary duties of superannuation fund trustees.

This general framework has implications for the provision of retirement income. Both the overall regulatory framework and the promises made by fund trustees should be consistent with that framework. In particular, there is a continuum of regulatory oversight and trustee obligations depending on the extent to which a fund member is engaged and/or has exercised retirement income product and/or investment choice. It is not so much a matter of what products can or should be offered, it is more about the duty of care that must be exercised by regulators and trustees in meeting the needs of fund members.

Given the diversity of the needs and circumstances of fund members, a variety of retirement income solutions will need to be facilitated and offered.

The interests of fund members must be paramount. This implies that a good system for providing retirement incomes should:

- deal with the financial needs associated with longevity
- be simple to understand
- inspire consumer confidence through being stable and fair
- allow products to be easily compared
- support competition between providers in order to foster product innovation and fee reductions
- deal with investment volatility, in particular lowering that volatility when fund members are risk adverse and/or are unable to recover from past investment losses
- provide flexibility in terms of access to capital to meet unexpected or unpredictable needs such as aged care or health costs or accommodation bonds
- deal with both those highly engaged and exercising choices and those who cannot make or do not want to make a choice.

The system should be all about the provision of retirement income. It should not be about opening up opportunities for estate planning, wealth accumulation or tax planning. It should not be about the accumulation of assets for purposes other than supporting income in retirement.

As well, regulatory and tax provisions should not be such as to allow regulatory or tax arbitrage through choice of superannuation structure or retirement income product.

That said, the differing promises made in respect of different retirement income products and the differing level of involvement of fund members in making choices about their retirement income requires some variations in approach by superannuation fund trustees and other product providers.

For instance, the promise made by providers of life and deferred life annuities is a very strong promise that needs to be backed with adequate capital and subject to continuing close prudential supervision. At the other end of the spectrum,

members of pooled superannuation funds who have exercised investment choice involve a lesser promise by trustees and a different set of duties and responsibilities.

Options for managing the needs of an ageing population

There is a strong case for regulatory arrangements and for funds with more options being available to individuals to meet the varying risk management and longevity needs of retirees. This should be facilitated by allowing funds to offer products on a suitably regulated basis, rather than by specifying what products should be offered. The ultimate test is whether what is offered addresses the objectives of this system.

Currently, the great bulk of superannuation accounts in the retirement phase are account-based income streams. While these meet the needs of one group of retirees, the circumstances of other retirees mean that their risk management needs are not well met. In particular, account-based income streams do not necessarily manage the risks of longevity or investment return variability well.

One option for better dealing with the financial consequences of longevity, especially meeting the extra care and health costs that can be associated with advanced age, has been put forward by the former prime minister Paul Keating, one of the original architects of compulsory superannuation. He has called for an extra compulsory superannuation contribution to assist in meeting the needs of people aged over 80. He first unveiled this proposal at the ASFA National Conference held in Sydney in November 2012.

He argued that the existing compulsory superannuation system has the potential capacity to meet the needs of people aged 60 to 80, but more is needed as Australians continue to live longer. He suggested that there be an additional superannuation contribution of two to three per cent of wages, which could be pooled to help pay the income needs, accommodation and healthcare costs of people aged 80 to 100. In essence, the new arrangements would focus on the needs of the future 80-to-100-year old cohort while the existing compulsory and voluntary superannuation arrangements have their primary focus on the income needs of retirees aged between 60 and 80. His argument is that the 60 to 80 age group is all about retirement living and lifestyle, but dealing with the 80 to 100 age group is more about maintenance and disability and less about lifestyle.

Provision of advice

Improved financial advice is a necessary but not sufficient step to deliver the retirement outcomes that Australians want and need.

Many purchases of retirement income products are influenced by financial advice. Provision of high-quality advice, based on adviser knowledge of a range of financial products and options, is necessary for appropriate decisions to be made by individuals receiving advice. The increasing number of fund members and assets in the retirement phase, together with increasing average account balances and increases in life expectancy, makes it even more important for advisers to have the requisite skills to deal with the varying needs of retirees. The skills of financial advisers need to evolve along with these developments.

In our response to the question posed by the Inquiry at 3-69, we have stated that ASFA supports higher educational standards and other measures designed to safeguard the trust of clients and raise the standards in the financial advice industry. Suggestions are made on how to achieve that.

Removal of impediments to product provision

The removal of current impediments is also a necessary but not sufficient step needed in order to broaden the range of retirement income products that can be provided. Current impediments mean that the retirement income products on offer are largely limited to account-based income streams, term annuities and life annuities.

ASFA has previously identified a number of current impediments to financial products dealing with the financial consequences of longevity and certain other financial risks. These are set in the first ASFA submission to the Inquiry and are also available on the ASFA website.

ASFA considers that a principle-based approach should be taken, not one that deals only with specific products such as deferred lifetime annuities. However, the case of deferred lifetime annuities and how they are currently treated in superannuation regulations and for taxation purposes highlights the nature of impediments to new products being provided.

Australia is not alone in the need for regulatory and taxation reform for such products. For instance, recent changes have been made in the United States of America (US) to accommodate the provision of deferred lifetime annuities through the structure of 401(k) retirement savings accounts.

Provision of incentives to take up certain income stream products

The provision of incentives to encourage retirees to purchase products dealing with longevity and associated risks would be desirable. However, ASFA appreciates that any decision to introduce such incentives would be subject to Budget priorities and constraints.

When there was a full and then a partial Age Pension asset test exemption for certain lifetime or very long-term duration income streams, purchases of annuities were much higher in number and aggregate dollar value. Once the partial exemption was discontinued for the purchase of new products, the take-up of such products dropped very substantially.

However, clearly there is a need to balance the cost of any means test concession against the public policy outcomes such as enhanced private incomes at advanced ages with lower Age Pension expenditure. At the very least, there is a case for means test treatment for the Age Pension of deferred lifetime annuities and like products that acknowledges the special characteristics of such longevity products, such as no access to capital at all and even no access to income for a lengthy period. Exempting such products from inclusion in the asset or income test during the deferral period would provide neutrality of treatment relative to other retirement products. That said, appropriate controls are needed, so as to avoid estate planning and other strategies such as arrangements within SMSFs that do not provide any genuine pooling of risks.

Provision of default arrangements

While a particular default should not be mandated for fund members, trustees' fiduciary responsibilities should extend to consideration of longevity, market and inflation risk when they make a decision whether to have a default or not and in their designing of any defaults. Even with improvements to the cost and efficacy of delivering advice, it cannot be assumed that all fund members will receive advice and exercise choice at the time of retirement.

In addition, some longevity products can be purchased during the accumulation stage, with pricing benefits to individuals. Accordingly, regulatory provisions should contemplate this in default design with the extension of MySuper to a whole-of-life approach being permitted.

Accordingly, trustees should have the ability to default members to a retirement benefit but there should not be a requirement to do so. Trustees should exercise their fiduciary duty in designing post retirement arrangements in much the same way they need to consider investment risk and insurance needs throughout the accumulation stage.

As well, the overriding goal should be that fund members have the knowledge and advice at the time of retirement to

make the best choice. Such choices might include access to a MyPension or other standard retirement income product, but it should be up to the trustee to determine which products are offered and how they are offered. Funds offering a MySuper accumulation product should not be required to offer a MyPension product as the trustee may have other arrangements involving, for instance, informed choice by members supported by financial advice, in place. Consistent with the approach taken for Stronger Super, it will be critical that customers are able to compare the features and risk/reward characteristics of different retirement income products.

There also would be a need to deal with a range of practical issues if default members-to-retirement income solutions were to be possible. Current legal impediments in regard to when and how disclosure is made and how member consent is obtained would need to be dealt with as they in effect rule out the possibility of a default arrangement for a defined contribution fund member.

Funds also would need to have reliable processes to determine when fund members have retired as cessation of contributions is not necessarily evidence of retirement, even when a person is over preservation age. Details of a bank account for the payment of income stream benefits also would be needed, or an equivalent destination for benefits put in place. In essence, there would be a need to have the 'plumbing' of the system dealing with information and benefit payment in place.

There also would be a need to have in place arrangements to allow an individual to opt out from a product that they have been defaulted in without adverse consequences to the member.

Should there be mandating of how retirement income products must be used?

The mandating of particular retirement income products would not be sound public policy given the diversity of the needs and circumstances of fund members.

Product design and arrangements for offering them to members should be the responsibility of trustees, who take into account the characteristics of the fund membership and exercise their fiduciary responsibilities. Some retirement income products may be expensive to develop and deliver, and may not be of interest to sufficient members of a fund to justify their adoption. As well, some products may need a critical mass of purchasers to spread longevity or investment risks and a third-party provider may be needed in order to achieve that.

Equally, members should not be required to purchase particular retirement products. What is needed are more and better retirement solutions, and informed choices by fund members. This can include default arrangements where the fund member can opt not to take-up the default option or to switch to another product (or to a lump sum benefit) at some later point.

One or even several retirement products will not necessarily be suitable for all fund members given their differing needs and differing financial and other circumstances.

3. Responses to questions in the Interim Report relevant to the superannuation and retirement industry

3.1 Growth and consolidation

Chapter 3: Funding

The effect of Basel III on bank funding

2-81

The Inquiry seeks further information on the following areas:

- What effect is the implementation of the Basel III capital and liquidity regimes in Australia expected to have on the cost of funds, loan pricing and the ability of banks to finance new (long term) loans? How large are these effects expected to be?
- What share of funding for ADIs is expected to come from larger superannuation funds over the next two decades? What effect might this have on bank funding composition and costs? What effect will this have on the ability of ADIs to write long-term loans?

As outlined in ASFA's initial submission to the Inquiry, superannuation funds are already heavily invested in the banking sector; firstly, as deposit holders in Australian Deposit-taking Institutions (ADIs) such as banks and building societies, and secondly, as holders of bank equity. As of December 2013, superannuation funds had invested about \$217 billion in deposits accepted by banks. A further \$22 billion was invested in the bonds of financial corporations (bank and non-bank), and \$159 billion invested in the equity of financial corporations (bank and non-bank). This means a total of around \$398 billion of superannuation funds are invested in Australia's banking sector, representing 22 per cent of total superannuation (ABS). This is an important source of liquidity for Australian banks and it reduces the need for them to source wholesale funding from overseas (Levine).

As indicated in the Interim Report, the superannuation sector will become an increasingly large source of deposits for the banking systemⁱⁱⁱ. As seen in chart 3.8: Source of bank deposits in the Interim Report, superannuation now represents around mid-teens in percentage terms.

It is difficult to predict with any confidence the likely share of funding for ADIs to come from larger superannuation funds over the next two decades.

Factors that may impact this include:

- relative growth of superannuation balances and bank balance sheets
- greater investment in fixed- yield type investment as the proportion of Australians in the retirement phase increases
- concerns regarding concentration risk to individual bank names held within superannuation
- investment opportunities in alternative assets and alternative markets
- developments in the funding structures, for example, alternative long-term debt instruments and so on.

A best guess, given the uncertainties, is that we expect funding from superannuation funds to increase

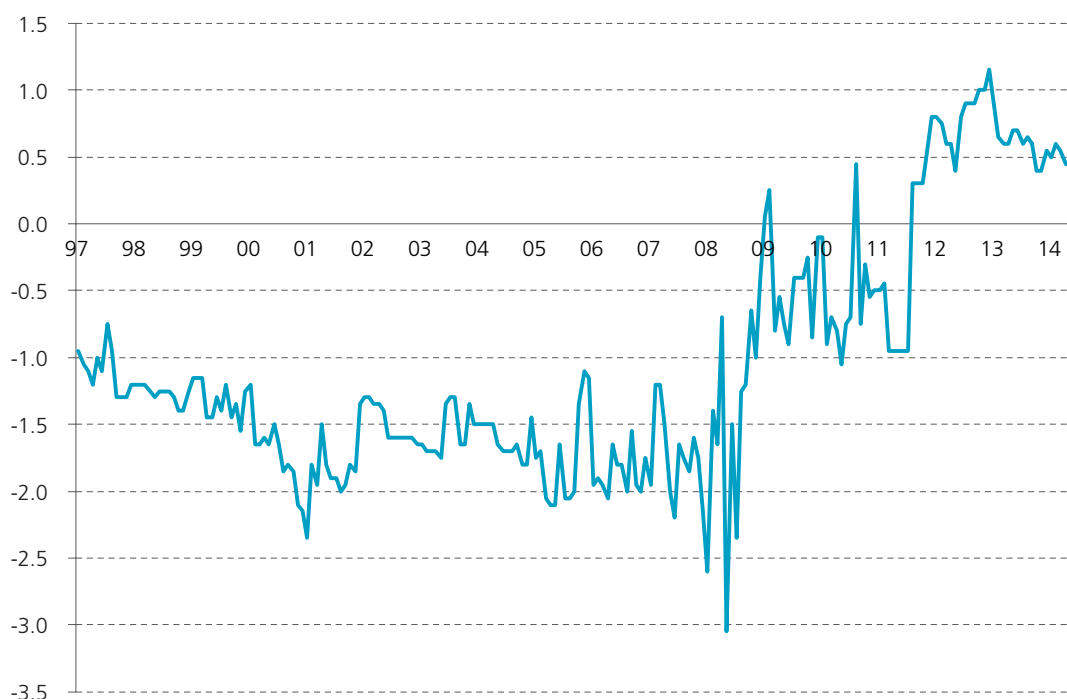
broadly in proportion to the growth of superannuation relative to the banking industry.

That said, we have observed that bank funding, post the global financial crisis (GFC), has evolved substantially with an increased focus on the ability for banks to maintain appropriate assets in a post-Basel III world to underpin liabilities. Given the ongoing asset and liability mismatch of banks, investors that have a longer-term horizon and can support bank funding requirements are of significant strategic importance. Australian superannuation funds are strongly aligned in this sense as they are supporting long-term investment outcomes (multi-decade retirement incomes) and their growing asset base is projected to move above that of the Australian banking system in the medium term.

Factors relevant to the ability and desire of superannuation funds to provide funding to banks revolve around the returns on offer and the risk of providing that funding.

Bank funding has typically been comprised of a combination of wholesale and retail funding. Wholesale funding has typically been dominated by offshore borrowing, while retail funding has increasingly come from retail term deposits. Post the GFC, banks have focused on increasing their exposure to retail term deposits due to the widely held perception that they represent a 'stickier' form of funding. This has seen retail term deposit rates move to a premium to match that available on wholesale term deposits. This is especially visible in 'special' term-deposit rates offered by banks to attract additional deposits post the GFC.

Figure 6: 90-day retail term deposit rate spread over RBA cash rate (%)



Source: Reserve Bank of Australia.

The above outcome is driven by the view that retail term deposits represent more stable or 'sticky' funding and hence banks are willing to pay an additional rate of interest over wholesale funding markets.

Buyers of wholesale term deposits (wholesale investors) are deemed to be less sticky than retail investors and are typically less attractive to banks. However, for many wholesale investors, particularly APRA-regulated superannuation funds, their underlying investors are primarily the same as those individuals holding retail term deposits.

This creates an uneven playing field for those members of APRA-regulated superannuation funds that cannot access retail term deposit rates. Some superannuation funds have sought to address this issue by

providing access to retail term deposits on their fund platforms. While this solution will likely support a relatively small number of members and size of assets to access retail term deposits, it will be a modest percentage of overall bank funding.

Given the similarity in underlying investors between retail investors directly in term deposits and super fund members holding assets including wholesale term deposits, a more level playing field would drive a preferred outcome.

By enabling a look-through mechanism for APRA-regulated superannuation funds to access retail term-deposit rates by identifying end clients, it is likely that super funds would increase the term of their most significant proportion of short-term funding to banks. Whilst this may have some impact on funding costs for banks, it would also be expected to grow the attractiveness of bank funding for APRA-regulated superannuation funds and allow banks to meaningfully tap into the growing pool of superannuation fund assets. This issue will become increasingly important as size of the superannuation sector in Australia continues to grow. Also, APRA-regulated superannuation funds will become increasingly attracted to long-term deposits or other paper as more members enter the retirement phase making yield attractive in terms of liability matching.

A key area of risk in providing funding to any entity is counterparty risk. Banks are no different. However, in Australia, counterparty risk for the banks has been largely discounted. This is driven by the perception of a government back-stop for an Australian bank if it gets into difficulty. This is underpinned by the depositor protection mechanisms afforded to retail depositors up to a maximum amount of \$250,000. For wholesale depositors, more significant protections were offered during the GFC, but the current depositor protection offers more limited benefit.

While it is reasonable to assume that the risk of a banking default in Australia is extremely low, superannuation fund trustees cannot ignore it. Being able to effectively price this risk and be compensated for it can support a trustee in assuming this risk. Additionally, the ability for investor 'look-through' would support the ability for the vast majority of super fund members (excluding a greater proportion of SMSFs) to benefit from the depositor protection afforded to depositors who are funding banks directly.

The possibility of greater risks to bank creditors was highlighted by the issues suffered by the Cyprus banking crisis in 2013. Recent commentary from the Financial Stability Board in particular^{iv} suggests a broadening consensus across regulators that creditors should be prepared for capital loss in the event of a bank becoming insolvent.

In summary

Given the growth of the superannuation system expected over coming decades, it is likely that the proportion of bank funding sourced from superannuation will also grow. However, in the current system, there are some constraints on this growth that should not be ignored. As a result, the two key points relevant for trustees of Australian superannuation funds are:

- they should be aware of their exposure to Australian banks across all forms of the capital 'stack' and that returns from that exposure should be risk adjusted, even if counterparty risk is perceived as very low
- the ability to facilitate an efficient 'look-through' mechanism for superannuants in pooled vehicles would assist with the returns available and also the risk as it relates to depositor protections and counterparty risk.

In managing these risks, we believe there would be significant benefit in monitoring the risks of the superannuation system holistically. Given the dollar value of the holdings that the superannuation system will have in individual banks across default funds, choice superannuation and SMSFs, significant exposures may emerge which need to be assessed in the context of financial system stability.

Chapter 4: Superannuation

Future trends

2-85

The Inquiry seeks further information on the following area:

What effects will the trends in the size and composition of superannuation have on the broader flow of funds in the economy over the next few decades, including on international capital flows to and from Australia?

Aggregate superannuation assets are projected to rise to around 120 per cent of GDP by 2025, 130 per cent by 2035 and to around 160 per cent of GDP by 2060. This will lead to a sustained increase in national savings (by around 1.5 per cent of GDP per year), reducing Australia's call on overseas capital.

Growth in superannuation assets is projected to be greater than the growth in the market capitalisation of companies listed on the Australian Securities Exchange (ASX). As a result, superannuation funds are likely to pursue alternative investments. Such investments in Australia are likely to include infrastructure, directly held property, venture capital and a range of other alternative investments. As well, there is likely to be substantial investment overseas. While much of this investment will be into shares in companies listed on stock exchanges in Europe and US, an increasing proportion of the increasing aggregate amount is likely to be invested in emerging markets, including in the Asia-Pacific region and South America.

There is likely to be an increased outflow of capital from Australia for investment, with an associated inflow of dividends and interest payments from those investments.

While the proportion of assets in SMSFs is likely to have peaked at around 30 per cent of overall superannuation assets, the proportion of assets in the retirement drawdown phase is likely to increase from the current 30 per cent or so to more than 40 per cent. Depending on the risk tolerances of future retirees and the nature of retirement income products promoted by funds and advisers, it is plausible that there will be pressures for funds to allocate more assets to bonds and other assets offering regular investment returns, which can include infrastructure and direct property. If there is an increased supply of corporate bonds issued in Australia, there are likely to be prospective purchasers in the form of superannuation funds.

While it is possible that SMSFs will not increase their share of assets relative to APRA-regulated funds, the amount of assets in nominal terms will grow markedly. This is likely to lead to increased flows of SMSF assets into bank deposits, Australian shares and direct property, each of which is a traditional destination of SMSF investment.

The corporate bond market

2-86

Observation

Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.

As outlined in ASFA's initial submission to the Inquiry, superannuation funds have invested a relatively low six to seven per cent of their asset portfolios in domestic corporate bonds over the past decade.

This reflects two factors. Firstly, that the defined contribution superannuation system in Australia has been in the earlier stages of development, and, as such, will hold a greater proportion of the total industry portfolio in growth assets, that is focus on equity investments. Secondly, that there is not a deep and liquid market in corporate bonds in Australia. Indeed, the share of total assets invested in domestic corporate bonds has been declining for several decades. Managed funds – including superannuation funds, life insurance offices, public unit trusts and cash management trusts – purchased 36 per cent of Australian corporate bonds in the 1970s. But by the 2000s, the share had fallen to just 11 per cent (RBA, 2012).

Australia has a small corporate bond market relative to other developed economies, influenced in part by government policies that favour equity investment. In addition, the corporate bond issuance is predominantly driven by financial institutions, which account for over two-thirds of all non-government debt outstanding. Non-financial corporates account for a minority of the corporate bond market, tending instead to issue in overseas markets. At the end of 2011, almost 90 per cent of the outstanding stock of non-financial corporate debt was issued overseas.

Thus, a low level of Australian superannuation fund investment in domestic corporate bonds may reflect:

- concentration risk (funds have significant exposures to bank equity)
- availability (non-financial issuers issue in offshore markets)
- foreign appetite for Australian bonds.

Domestic demands for corporate bonds

2-91

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Allow listed issuers (already subject to continuous disclosure requirements) to issue 'vanilla' bonds directly to retail investors without the need for a prospectus.
- Review the size and scale of corporate 'vanilla' bond offerings that can be made without prospectus where the offering is limited to 20 people in 12 months up to a value of \$2 million, or for offers of up to \$10 million with an offer information statement.

The Inquiry seeks further information on the following areas:

- As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives?
- Would the development of annuity-style retirement income investment products encourage the growth of fixed income markets?
- Could enhanced transparency of transactions improve liquidity in the over-the-counter Australian corporate bond market, including its attractiveness to retail investors? What commercial or regulatory impediments are there to the potential development of improved transparency in the over-the-counter corporate bond market?
- Could alternative credit ratings schemes develop in Australia and would this help improve the appetite for bonds, particularly those of growing medium-sized enterprises? Could alternative standards of creditworthiness develop in Australia? What are the barriers to such developments, and what policy adjustments would assist such developments?

It is difficult to determine with any certainty whether any of the structural changes to the system discussed above (that is the development of annuity-style retirement income investment products, enhanced transparency, alternative credit rating schemes and so on) would lead to the development of a deeper and more liquid corporate bond market.

Arguably, as the system matures and a significant portion of superannuation members and funds under management move from the accumulation phase to retirement phase, there are likely to be fundamental impacts on the structure of superannuation investments. One possible outcome could be a greater demand for fixed-income products.

For decades, there have been discussions around why there is not a deep and liquid corporate bond market. It has been argued that Australia's financial system has an imbalance in that Australia's banks are reliant on funding from offshore markets while superannuation funds seek investments offshore. A suggestion to address Australia's financial system imbalance is to encourage the development of a deep and liquid corporate bond market that would provide alternative avenues for companies to finance their debt needs.

Wallis argued that the domestic corporate bond market will grow only if it offers corporations the ability to borrow at more competitive interest rates than alternative sources. The Wallis Inquiry noted that the future of Australia's corporate debt market would depend on three factors:

- the number of companies able to achieve a sufficiently high credit rating to attract demand for their paper from investors

- the willingness of investors to hold a portion of lower-rated paper in their debt portfolios
- the intensity of competition from alternative sources of funds from both the banking sector and offshore debt markets.

So why hasn't it happened? One reason seems to be that, by and large, corporates are satisfied with access to international wholesale markets. And the yields at which they are able to obtain funds on the international market are not any greater than they would pay here in Australia. Perhaps then the issue is less one of demand from the superannuation market, but the willingness to supply on the corporate side? Certainly, there is no impediment to corporates issuing more into the domestic market. Superannuation funds can be expected to respond to increased issuance in the domestic market as attractive yields are offered.

That said, there are some constraints for superannuation funds, including SMSFs, investing significantly in corporate bonds, while the market remains small.

The first reason is one of diversification. The Australian economy consists of a large number of small companies, and a small number of large companies. This results in a relatively small number of companies offering corporate bonds to the market. The dominance of materials and financial companies provides an overall lack of diversification. The yield offered on Australian corporate bonds needs to compensate investors for this lack of diversification, or to pay them for the extra risk they are taking.

The second reason is that superannuation funds prefer the bonds to have a rating and the cost/benefit analysis of this does not stack up for the company. To achieve a credit rating, an Australian corporate must go through a lengthy and costly process. But absent these ratings, the appetite of investors is lower. Higher yields may attract SMSF investors to corporate bonds, provided the retail structure is in place, however, any demand will be dampened by the government guarantee available to SMSF investors on bank deposits.

While changes are underway to improve the ability of corporates to offer bonds directly to the retail sector, they will require mechanisms to communicate directly with retail investors. The time and resources required to communicate directly to retail investors may act as a disincentive for some corporates to utilise the reforms. It is also likely that retail investors will be attracted to invest in corporate bonds issued by companies that have an established brand in the market place. In most instances, this will mean that it will be household brands and large companies that will have the capability to issue to retail investors.

It is considered that the additional issuance in the Australian market to retail investors will be marginal compared to the overall size of wholesale markets. In practical terms, it is therefore not expected that these reforms will significantly increase the depth and liquidity of the domestic corporate bond market.

Efficiency

2-99

Observation

There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system.

Given the importance of superannuation to every Australian, it is critical that we ensure that the superannuation (and retirement) system is efficient and competitive. This debate is important and must be had.

Earlier in this submission (Section 1.3) we discussed the particular characteristics of the market – the demand side issues; the supply side issues, in particular fixed costs; and the ancillary benefits that superannuation provides. We also suggest that any discussion of costs and fees must be accompanied by a discussion of returns and benefits.

Analysing the costs associated with managing a superannuation fund is complex for a number of reasons:

- the superannuation policies, tax regimes, and related regulation have changed over the past decades, resulting in significant fixed costs of maintaining systems that adequately deal with the grandfathering of these redundant policies
- the quality of data provided to funds by employers has not been mandated, resulting in lost accounts and higher operational costs needed to ‘verify employees’
- business models are different and create different cost structures
- costs are not transparent across the industry and, at times, directly relating costs to the exact service to which they support is difficult.

We do know that fixed costs are higher as a result of the highly prescriptive regulatory regime, but also acknowledge that there are areas where greater operational efficiency can be achieved. SuperStream is the largest current initiative of the industry to improve efficiency as it focuses on data quality and the efficient movement of data across the industry. We are hopeful that the significant costs associated with SuperStream implementation will be reflected in lower costs of operating the system going forward. We have also highlighted in Chapter 7 areas where the regulatory burden could be reduced with the resultant reduction of costs and complexity.

While in the past there may have been little competition in some parts of the industry, there has always been strong competition in some sectors. Going forward, we do expect that there will be more competition as a result of a number of reforms, including decoupling the payment for financial advice from the sale of financial products. Some examples of competition in the Australian market are briefly discussed below:

- Fee-based competition has always been strong in the tender processes for default funds that have been undertaken by large employers. This has resulted in both retail and industry funds tailoring their offerings, including through reductions of fees from the standard rate, in order to obtain the business of an employer.
- Industry funds have competed for choice members through television and other advertising whose primary thrust is on the comparative fees of their offerings.
- Rating agencies have played a role in facilitating price competition by providing information and comparison tools for consumers on their websites.
- Retail superannuation funds have responded to such competition and to the changed remuneration arrangements for financial planners by developing their own directly distributed superannuation products, which typically have fees of less than 100 basis points, considerably below the up to 300

basis points that some personal retail products charged in the past. These retail superannuation products have typically been directly marketed to consumers, along to employers as default funds, and have rapidly grown market share.

- The MySuper application processes and the application process for a fund to be included as a default fund in awards also gives attention to fees, amongst other factors. The great bulk of MySuper products and practically all products that are being considered for inclusion as a default fund in awards have fees under 100 basis points.
- Public sector funds, especially those that are defined benefit, may not have direct competitors but their fees are paid in effect by the employer. These funds have also demonstrated their cost competitiveness to their employer sponsor through international benchmarking activities.
- More generally, Australia now has a reputation amongst international fund managers as a country where funds take the standard investment management fee as just a starting point in negotiations, rather than as a given amount in a transaction.

ASFA has prepared a research paper on international fee comparisons and it is provided in Appendix A. This demonstrates that fees for Australian superannuation funds are around the level in most other countries when like-for-like funds are compared. It is certainly true that DB funds, which are mostly invested in bonds and funded by one employer, have lower costs than most Australian superannuation funds, however, this is not a realistic comparison. In a range of developed and developing countries, fees for DC funds mostly invested in equities and open to multiple employers typically are in the range to 70 to 100 basis points per year. In a number of countries, including the US, Canada and Hong Kong, costs and fees are in excess of 100 basis points, sometimes substantially more.

Efficiency of the system

2-114

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements and review the effectiveness of the MySuper regime in due course.
- Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.
- Replace the three-day portability rule:
 - » with a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress
 - » by moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach.

The Australian superannuation system:

- is advanced in its product offerings
- has a robust regulatory framework, relative to alternative pension systems in the world
- provides additional benefits such as insurance, advice and so on.

These factors need to be taken into consideration when making comparisons with the costs associated with other systems. A view of superannuation costs that ignores these facts would result in a dangerous over-simplification and incorrect presumption of the cause of costs including inefficiency. Despite this, the superannuation system should always look at ways in which it can produce more efficient outcomes and reduce costs to recipients of superannuation, while not compromising the quality of the product.

The key role market forces play in driving natural efficiency in markets is not a concept foreign to superannuation and Rice Warner research has indicated that allowing the market to operate naturally has resulted in a reduction of superannuation fees overtime. Certainly increasing comparability of products is expected to positively contribute to competition and, over time, reductions in fees.

With respect to each of the policy options, we provide the following comments.

No change to current arrangements and review the effectiveness of the MySuper regime in due course

An appropriate timeframe being utilised to assess the MySuper regime effectiveness will allow the Inquiry to ascertain whether the target benefit of the Stronger Super reforms in reducing costs by 38 basis points has been achieved. As noted in the Interim Report, funds have only been able to offer MySuper from 1 July 2013, and further savings are expected in administration fees from the SuperStream components. There may also be additional competitive pressure from increasing mobility of superannuants, increasing balances and the ageing population.

There may be an opportunity cost incurred by the industry if MySuper is demonstrated to be ineffective when assessed in hindsight. The cost, however, is unquantifiable.

Choosing to hold fire on further changes at this point in time gives the industry and its members the opportunity to be saved from:

- inevitable additional regulatory costs (resulting, ironically, in higher fees) to recalibrate products in line with the amended requirements
- prevents further disengagement from members frustrated with constant change.

There are significant costs in implementing Stronger Super and it will take time for this cost burden to flow through (for example, costs of data reporting, establishment of an ORFR).

Focus should not just be on cost – there are long-term benefits that can be derived from the improved simplicity and comparability that MySuper will deliver.

There is also the possibility that technology advances, particularly in direct, non-intermediated, online distribution can further lower costs.

In conclusion, we submit that major reform should be given a sensible period of time to review whether it has succeeded. This is no exception.

Replace the three-day portability rule

Assessment of the use of illiquid investments and current liquidity constraints suggests that, in today's environment, there is no need to change the three-day portability rule. ASFA believes that the portability timeframe does not adversely affect trustees' ability to invest in the long term. Funds with significant scale are unlikely to have needed to alter their investment approach in order to comply with three-day portability rule. Some specific liquidity-related issues are discussed below. Outside liquidity issues, however, there are a number of operational efficiencies that could be achieved by some simple changes to legislation. For example, currently, if a fund pays out a full redemption and then subsequently receives an additional contribution from the employer, they are not permitted to use the same instruction to forward on the additional monies. This creates unnecessary costs and complexities, and does not contribute positively to the customer experience.

Given the cash flow from contributions in open products, we do not believe that the three-day portability timeframe increases the demand for liquidity such that it results in higher allocations to liquid assets than required or a reduction in after-fee returns to members.

It should be noted that, in the case 'choice' investment options and designated 'illiquid investments', the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) already allow a staged transfer of benefits from one fund to another. A staged transfer of funds for a member not exercising choice, and therefore in the default investment option/MySuper, which is subject to the three days, would not be appropriate.

A principles-based approach, without proper accountabilities for determining timeframes, may result in portability being subject to 'perceived' abuse in delayed rollovers.

In considering benefits, it is important to distinguish between choice and default members:

- in a choice environment, where a member chooses an option with an illiquid element – the SIS regulations permit the trustee to inform the member of the portability requirements, the reasons why the investment is illiquid and obtain written consent that the member understands and accepts that a period longer than 30 days is required because of the illiquid nature of the investment
- in a choice environment where a member chooses an investment option other than an illiquid investment – the SIS regulations state that the trustee is not required to rollover within three days if the trustee takes steps to redeem within three business days and the rollover is made within three business days after the trustee receives the proceeds of the redemption. The trustee must rollover within 30

- days, unless they have sought further information or there is an APRA-granted suspension in place
- for default members, who need more certainty and consistency around timeframe – the three-day rule applies.

The SIS Regulations provide discretion to the regulator to assist in times of stress, however, APRA has 30 days in which to consider the application and notify the trustee of its decision. Given the relief being sought is generally urgent and that the implications for members of granting relief are not profound, we submit that this period should be reduced.

Consideration could be given to providing APRA with the power to be able to grant across-the-board relief to all registrable superannuation entity (RSE) licensees, without the need for application on a case-by-case basis, should it be warranted in the circumstances.

2-115

The Inquiry seeks further information on the following area:

Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns?

As noted in the Interim Report, it is early days in the implementation of the MySuper reforms. The success of the MySuper reforms should be assessed in the medium to longer term; this may be as much as five to ten years. That said, we do need to monitor the progress of the reforms in meeting the objectives of the superannuation system.

In Section 1, we discussed the need for the clear policy objectives and for the performance of policy initiatives to be set against clear and measurable outcomes. This suggests an approach where we first ask whether the MySuper reforms are consistent with the overarching objectives of the superannuation system. An appropriately invested low-cost option for disengaged members should deliver better final retirement balances than options which might have higher fees (eating away at after fee returns) and limited diversification (reducing the probability of the best investment outcomes for members). That said, it will be important to track the efficacy of the MySuper reforms against clear, reasonable and measurable targets.

ASFA has previously challenged the assumptions behind the likely cost reductions that would flow from the introduction of MySuper.^v In the Interim Report, it was estimated that the fee reduction was likely to be in the order of 38 basis points. ASFA believes that this is an overstatement, although we do expect to see fees on MySuper products continue to decline as scale benefits are realised.

In covering off this issue, we need to both analyse the fee environment in Australia vis-à-vis other countries and assess whether the fees are as excessive as some commentators imply. We also need to look at the costs, to see whether these have potential to be reduced and the benefits passed through to consumers.

Our discussion on international fees is attached in Appendix A. It suggests that the Australian fees are not as high as suggested in the Interim Report, relative to other jurisdictions. We also note that, in looking at fees for Australian superannuation, the Grattan Institute has been overly simplistic, resulting in some misconceptions.

Recent research by the Grattan Institute found that: *“fees differ markedly. Many funds – mostly industry funds – charge fees at just below 1 per cent. The fees of retail funds range from around 1 to well over 2 per cent a year. Fees of individual products and investment options ... vary even more”*.

In ASFA’s view, there are a number of factors that may account for at least some of this fee differential, as well as the perception that the overall (‘average’) level of fees is high. For example:

- Many providers maintain legacy products that are closed to new members. These products are often costly to administer, but are maintained for a range of reasons – including a level of member apathy which stymies providers' attempts to move them to newer, open products, as well as punitive tax implications and regulatory impediments in some cases. In our view, an analysis that is confined only to those contemporary products that are open to new members is likely to reveal a much smaller disparity in fees than that suggested by the Grattan Institute research.
- It is also likely that the figure quoted in the Grattan Institute research for retail fund fees may include a significant component of distribution/advice costs. To the extent that this is so, it is likely that the members in question are 'choice' members rather than default/MySuper members, and should be excluded in order to determine a truly comparative cost figure for default members.

Costs

There are three main categories of costs that may be incurred by trustees of superannuation funds:

- operational/administration costs
- investment costs
- distribution/advice costs.

These vary significantly between types of providers and products.

Eliminating unnecessary costs, which result from inefficiencies from the system, will deliver a higher end benefit to members – assuming of course that these benefits are passed through. However, whether Australian super fund fees and costs are slightly lower or higher than their peers should be largely irrelevant in meeting the objectives of superannuation. Success is delivered when the members' final retirement outcome is consistent with their risk and return expectations and matches that of other superannuation systems for the same risk and return profile. Critical to the assessment of the success of MySuper will be the performance of funds on an after-fee basis. The members' retirement outcomes will depend on their net return. Net return is certainly positively impacted by lower fees and costs, but is critically dependent upon the performance of the investments. MySuper success should be measured against this benchmark.

The Grattan Institute is of the view that adoption of a passive investment approach will deliver improved net returns, compared to active management and diversification into more expensive illiquid assets. There is not, however, consensus on this view.

As noted by SuperRatings in February this year:

"MySuper products have largely achieved the Super System Review's goal of reducing total fees to 1.00% per annum, with the industry average now sitting at 1.02%, but what will be interesting is how they perform investment wise. There has been an unfortunate leaning towards passive investments purely to reduce fees. If that impacts future earnings, then the whole exercise of forcing MySuper into the industry will be not only negated, but detrimental to Australians' future retirement benefits.^{vi}"

Similarly, recent research from the Centre for International Finance and Regulation (CIFR) concludes that "whether MySuper leaves members better off is an open issue". In particular, CIFR noted that:

- Fees for not-for-profit funds have risen marginally, while retail providers have reduced. However: "Whether retail fund members are better off as a consequence of these fee reductions remains a moot point".
- Following the introduction of MySuper, not-for-profit funds have higher investment fees than actively managed retail funds, while retail funds charge higher administration fees.
- The fee reductions by retail providers should be evaluated in the context of product design changes including a notable shift to lifecycle options, increased use of passive management and more limited use of alternative assets. "Whether this product mix enhances prospects for adequate balances at

retirement is a moot point... Lifecycle strategies decrease the risk around the balance at retirement, but also decrease its expected value. They hence move the member down the risk/return spectrum.”

- “For the record, it is Chant West’s opinion that members in retail funds are worse off as a consequence of these changes. Chant West bases this view on two notions. First, that active management adds value when evaluated at wholesale investment management fees, noting that active managers have been comparatively successful in the Australian equity market. Second, Chant West believes that alternative assets are beneficial to members by virtue of the diversification that they bring.”

Scale

Questions have also been raised regarding the ‘benefits’ of scale. A variety of benefits of fund size have been identified by CIFR, including the capacity to support more functions and services, the ability to negotiate lower management fees, and cost efficiencies in administration. However, the CIFR also notes that it appears to be less clear that size necessarily leads to improved access to fund managers and to unlisted assets. The CIFR has also noted the view that being ‘too large’ can have disadvantages, including the capacity to successfully pursue active management.^{viii} There is also a view that there can, in fact, be diseconomies of scale – a point where the returns from increased scale diminish or even turn negative. However, it is not yet clear where that point lies and there is no evidence to suggest that it has been reached in the Australian market at this time.

We note that, while scale is relevant, it is not the only indicator of likely success. There are cases where smaller, appropriately resourced and skilled funds are able to demonstrate that they are able to provide optimal benefits to members. Similarly, funds with relatively small assets and/or members can achieve economies of scale through outsourcing operational and other functions to service providers and through combining with other trustees when acquiring services or in developing product or service offerings.

In our view, open competition within the marketplace as MySuper balances become more significant will lead to an increased focus on net returns, while the ‘annual scale test’ to be undertaken by trustees offering a MySuper product^{ix} is likely to encourage fund mergers and further sharpen the competitive pressures within the sector.

In addition to the introduction of MySuper products, there are other recent and pending reforms, which have the potential to deliver improvements in competition, if given the necessary time to bed down. These include SuperStream, FoFA and the publication of enhanced fund-level statistical data by APRA.

The Inquiry seeks further information on the following areas:

What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there other alternatives?

The issue of whether there should be a single national default fund was posed as part of the Super System Review. ASFA's response to this question is unchanged – we are strongly of the view that there should not be a single national default fund.^x

The 'Cooper Review' of the superannuation system recognised the existence of a 'disengaged' segment amongst Australia's superannuated population, and this ultimately led to the introduction of the default MySuper product offering. This development was somewhat at odds with initiatives implemented by previous governments and by providers, which sought to engage average Australians in their retirement planning and provide opportunity for them to make choices in relation to how their retirement savings are managed. Adoption of a single national default fund approach would, in ASFA's view, further undermine providers' efforts to engage members.

ASFA is particularly concerned with the suggestion that it might be appropriate to auction default fund rights primarily on the basis of fees. In our view, tendering for default fund business based on price alone would necessarily impact on the product design and features, and would impede a trustee's ability to provide a product that appropriately discharges their fiduciary duty to act in the best interests of members. ASFA considers this duty to be of paramount importance, especially when dealing with default (disengaged) members who have made no active decision to acquire that product.

Aside from the issue of the *appropriateness* of the tender model, ASFA considers that the prospect of a substantive reduction in fees (for a given asset allocation), resulting from a tender process, would be very limited as:

- most providers do not have any (or any substantial) profit margin that could be reduced in order to obtain default business
- any reduction in costs and fees resulting from a tender process is unlikely to be at the levels claimed by proponents, given that international fee comparisons show that MySuper products are already relatively competitive in terms of fee levels in international terms
- the MySuper authorisation process already involves an implicit tender process, where trustees put forward their cost competitive proposal. Many large employers also periodically review their default fund arrangements, and this also includes elements of a competitive tender process
- a focus on costs and fees, rather than net member benefit, is likely to lead to development of passively managed products with a heavy investment weighting toward bonds. This is not, in ASFA's view, an approach that will maximise long-term investment returns and deliver the most benefit for fund members.

In ASFA's view, it is unlikely that the default fund auction model adopted in Chile would deliver the same apparent levels of success if replicated in the Australian system as:

- Chile has only a relatively small number of funds, lending feasibility to a tender process. In contrast, Australia currently has just under 300 APRA-regulated funds^{xi}
- the Chilean funds do not offer the range and complexity of services provided by Australian funds, including insurance. Adoption of the Chilean model in Australia is likely to result in a significant reduction in the services and benefits offered to members
- a major driver behind the Chilean model was the need to reduce excessively high administration fees, which were inflated by large marketing cost components. The Productivity Commission has noted that between 1992 and 1998, the average marketing cost for the Chilean authorised pension funds ranged between 21 and 52 per cent of total expenses.^{xii} There is no evidence to suggest that marketing costs incurred by Australian default funds have approached these levels or are likely to do so

- caution should be exercised if seeking to attribute cost reductions in the Chilean system solely to the introduction of the default fund auction model. Rather, they can, in part, also be attributed to other recent reforms such as restricting the frequency with which individuals can switch between funds, regulation of the use of sales agents, along with a reduction in competitive forces due to industry consolidation, and the elimination of fixed fees charged for contributions^{xiv}.

In considering whether there are other alternative options that should be explored, ASFA again notes the comment in the Interim Report that it is “too early to assess the effectiveness of MySuper reforms in stimulating competition and improving after-fee returns for default members”.^{xv}

We are of the view that it is inappropriate to be considering further, major reforms to the default fund process at this point in time. An appropriate period needs to be allowed for the impacts of the MySuper and related reforms to bed down, and for an assessment to be made of their effectiveness in achieving better outcomes for default members.

The Inquiry seeks further information on the following areas:

Is the recent trend of greater vertical integration in the wealth management and superannuation sectors reducing competitive pressures and contributing to higher superannuation fees? Are there mechanisms to ensure the efficiency of vertical integration flow through to consumers?

ASFA notes the concern of the Inquiry Committee that the degree of cross-selling of services in a vertically integrated wealth management model may reduce competitive pressures and contribute to higher costs in the sector.

ASFA does not have a fixed view about the appropriateness of one type of structure over another. The sector is still developing and we would not wish to see an undue level of inflexibility or restrictions imposed on the business models that are able to be adopted by providers. We do, however, consider that the regulatory settings must be focused on ensuring that the trustee’s duty to act in the best interests of members is paramount in any structure involving the provision of superannuation products.

The Inquiry seeks further information on the following area:

Are there net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements?

ASFA is of the view trustees should consider their asset base in relation to the demographics of their membership. Ultimately, we consider the matter of appropriate asset allocation to be a trustee decision that should not be subject to prescription.

We note that the GFC led to a new appreciation of sequencing risk and its impact on superannuation fund members approaching retirement. To address this, there has been a move toward the introduction of lifecycle investment options that aim to reduce sequencing risk included within MySuper products.

ASFA supports trustees having the ability to utilise lifecycle options and is pleased that the regulatory provisions, in their final form, allowed for the design of these options to take into account factors other than simply members’ age. In our submission to the Cooper Review, we advocated against the *mandated* use of lifecycle options. We continue to hold that position. A number of trustees have chosen a lifecycle option as the MySuper offering within their funds. For example, 23 of the 120 authorised MySuper products, as at March 2014, include a lifecycle investment strategy.^{xvi} However, there are also indications

that while lifecycle options may reduce risk and, potentially, fees, they may also reduce expected returns.^{xvii} Consistent with oversight of all default strategies, ASFA considers it important that trustees oversee the effectiveness of lifecycle strategies for given cohorts over the medium term, particularly for members with lower balances.

Projections of retirement incomes on statements

ASFA strongly supports the provision of tailored retirement income projections to members on statements.

In our view, the provision of a benefit projection or retirement income estimate will contribute greatly to superannuation fund members better engaging with their retirement savings. In particular, we consider that it may prompt members to engage earlier and more thoroughly with their superannuation, including by seeking financial advice or using tools such as superannuation calculators.

Over recent years, ASFA has made a number of submissions to ASIC in relation to proposals to facilitate the provision of retirement income projections. In ASFA's view, it is critical that any such projections include the member's projected eligibility for the Age Pension. Around 70 per cent of retirees are currently in receipt of at least a partial Age Pension and – given the relative immaturity of Australia's superannuation system – it is expected that the Age Pension will continue to be an important part of the post-retirement income for many fund members. For these members, it is meaningless to consider the adequacy – or otherwise – of their income in retirement without regard to the Age Pension.

We note that ASIC considers the provision of a retirement income projection or forecast to constitute personal advice, as it takes into account the personal circumstances of a member. ASIC has provided regulatory guidance and relief^{xviii} from regulatory requirements around licensing, conduct and disclosure^{xix} provided the projection is based on prescribed assumptions and is given in a prescribed form. ASFA has concerns with the level of prescription in regards to projections. Rather than using prescribed investment earnings assumptions, it may be more useful to use the target returns set out in the product dashboard or some other forward looking assumption/model. Further, it may be useful to show a range in which expected performance will lie or to show more than one scenario. More flexibility is also required around when a projection can be provided – the focus on provision with member statements is too restrictive.

While this guidance and relief was intended to encourage and facilitate the provision of retirement projections, there has been a relatively low take-up rate among trustees. ASIC has recognised that trustees have felt limited in their ability to rely on the relief when providing retirement estimates to their members, particularly in relation to incorporating potential Age Pension eligibility. Proposed refinements to ASIC's regulatory guidance^{xx} have not been finalised at this time. As a result, there is a continuing lack of confidence within the industry regarding the provision of retirement projections.

Those trustees who have provided retirement income estimates to members, in reliance on the ASIC relief and/or the proposed refinements to it, have reported extremely positive outcomes.

For example, in 2013, one large APRA-regulated fund sent such estimates to 20,000 members with their statements in order to raise awareness that taking the lump sum was not the only option on retiring. The fund subsequently registered an increase in engagement from the control group, with 12 per cent raising their contributions, 10 per cent changing their investment options, and 14 per cent contacting the fund's advice team. Almost all of the members who received the estimates were of the view the fund should continue to provide them.

There are, however, suggestions that projections may have limited effectiveness in some circumstances. For example:

- where a member's superannuation holdings are split between accounts held with different providers, the projections generated by any of those providers will deliver an incomplete picture of the member's total (projected) retirement income
- for members with very small balances, and particularly those in younger age brackets, there is a

risk that a low projection may create the impression that their superannuation will not make a meaningful contribution toward their total retirement income, and thereby cause (or exacerbate) disengagement.

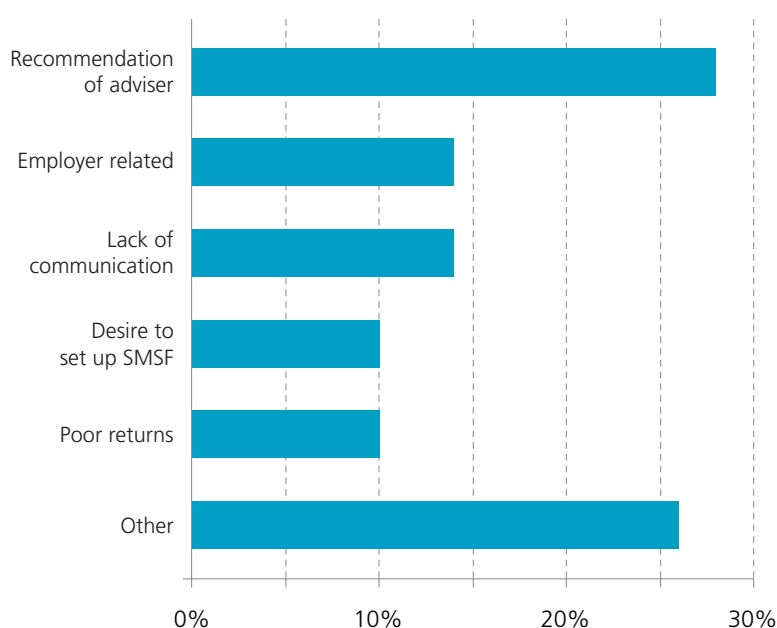
The Inquiry seeks further information on the following area:

Is there an undue focus on short-term returns by superannuation funds? If this is a significant issue, how might it be addressed?

For individual members, there appears to be little focus on short-term investment performance.

Disengaged members, by definition, are not looking at this data; and even amongst engaged members, switching between superannuation funds is not very common. In a survey of over 1,000 employed persons conducted for ASFA in 2011, the vast majority of respondents had not switched super funds in the last 12 months (96.7 per cent). Of the respondents who had changed super funds, more than a quarter did so based on a recommendation by their professional adviser while another 14 per cent did so on advice from an employer or change of employer default fund. Poor returns and a desire to set up their own SMSF ranked equal fourth. (The “other” category is made up of assorted factors including desire to consolidate accounts). 2011/12 was a poor year for investment returns; this reinforces the view that poor returns are not a large factor in a decision to change funds.

Figure 7: Results of survey on member switching



Source: ASFA (2011).

ASFA is not aware of any evidence of ‘short-termism’. And given that member outflows appear agnostic to return outcomes, any short term-focus of internal management or superannuation trustees must be for other reasons.

Peer-relative tables are keenly watched by industry participants. Only a few funds have elected to not participate in these surveys, stating that peer-relative statistics are not consistent with their objective of focusing on member outcomes.

The Interim Report suggests that ‘short-termism’ is reflected in the use of active managers. However, this is based on an assumption that it is not possible to consistently outperform a market index, leading to longer-term outperformance. There are many, including Chant West, which would challenge this premise. There are others who would describe market indices as fundamentally flawed and would promote the use of index agnostic managers – so-called ‘high tracking error’ managers to achieve better than market returns. Active managers with long-short capabilities may also reduce the volatility of a portfolio, which is almost always desirable. So the linkage of the use of ‘short-term’ focus with active management is perhaps over-simplistic.

In competition for corporate superannuation business, one of many aspects which the appointing trustee assesses is the performance of the fund against benchmarks and against peers. However, in discussions with various tender managers, it was generally identified that the emphasis was on medium and longer-term returns, rather than short-term returns, although these may be the subject of discussion, particularly if they appeared to add greater volatility than was desirable to the observed performance history.

ASFA does not believe this is a significant issue. That said, continuing to focus on long-term returns, and their conversion to an ultimate retirement income stream is a positive message to be providing members. It is also worth noting that the publication of MySuper return series will positively contribute to like-for-like comparisons over longer time periods in years to come.

The Inquiry seeks further information on the following areas:

To what extent is there a trend away from active asset management within asset classes in superannuation funds? Is this a positive or negative development for members?

In answering this question, it is important first to limit the applicability of ‘active’ versus ‘passive’. Passive management is only relevant for those asset classes where there is a generally accepted replicable market index. Examples include using the ASX300 as a proxy for the Australian share market or the Citigroup World Government Bond Index to represent the global government bond market. There is a significant, and growing, proportion of superannuation portfolios for which the concept of passive, is largely irrelevant. This includes asset classes such as private equity, direct property and direct infrastructure.

Of course, from an economic standpoint, there is great benefit in long-term investors such as superannuation funds, wanting to invest in these asset classes, which are not accessed via listed securities markets. Typically, large infrastructure assets are financed through direct financing with investors and/or trust vehicles. For the investor, these type of assets add diversification to portfolios and allow the capture of an illiquidity premium, which is consistent with the longer-term investment horizon.

That said, with the current asset allocations of superannuation funds, the greater proportion of most portfolios can be invested ‘passively’ and there is evidence that MySuper products have a greater exposure to passive management than other diversified superannuation products.

There are arguments both for and against passive management and the impact it has on member outcomes. In the main, these centre on:

- whether it is possible to achieve positive alpha over the long term from active management
- whether the size of the superannuation fund is too large for active management to be effective (for example, for a large fund such as AustralianSuper, capacity constraints may lead to using passive investment in equity portfolios in the short term. This is a further reason for large funds to bring some investment management in-house as AustralianSuper has done)
- whether the investment cost benefit from using passive management – which is substantially cheaper, especially for funds with significant scale – is passed through to members
- whether market indices are efficient and do not expose member to:

- » additional risk (for example, governments increasing their share of the market index by higher borrowing may result in a higher risk index for the passive investor), or
- » poor pricing (for example, all index followers buying equities at the same time resulting in a snow-balling effect on the price of large stock in the index).

ASFA believes that trustees are best placed to make the assessment of the appropriate investment for their members, and should be assessing these aspects of their investment portfolios, with the help of specialist advisors, if necessary. That the debate is being had, and that trustees of various superannuation funds are weighing up the costs and benefits for members, should be regarded as a positive development.

The Inquiry seeks further information on the following area:

How could funds price switching properly and take into account differences in liquidity between asset classes?

In responding to this question, we need first to assess whether funds are not currently pricing switching properly. Is there evidence that this is the case? Certainly over recent years, the increasing use of unitisation has supported appropriate practices of using buy-sell spreads to reflect the frictional costs of redemption and switches amongst options and asset classes.

ASFA has advocated that the trustees are responsible for determining whether to apply a transaction cost factor in their unit pricing through a buy/sell spread. There is no single right answer to this question – appropriate policy depends on factors such as the nature and size of the fund and the pattern of transactions in the fund. One positive benefit of a buy/sell spread is that it may discourage short-term trading in the same way that brokerage and other transaction costs would do for direct investments (for example, in shares), as well as reducing arbitrage opportunities between the more and less astute investor.

The FSC recommends the use of buy/sell spreads where there is material cost involved in the acquisition and/or disposal of fund assets and these costs are not reflected in the valuation of the assets. APRA and ASIC suggest that, where the fund incurs transaction costs, they should be passed on to the transacting members. They consider that the use of a single mid-price with no allowance for transaction costs is not consistent with good practice.

Trustees need to consider this issue on the basis of the principles of equity, internal coherence, transparency, consistency and verifiable accuracy.

- A transaction cost factor is a nominal amount that is added to, and/or subtracted from, the price determined by the underlying asset value of units in order to set the price at which units are bought and sold respectively (including through switching).
- Transaction costs incurred by the investment pool (as a result of individual purchase/ sale decisions) include brokerage costs, custodial transaction costs, stamp duty and other taxes associated with the purchase/sale of an individual security by the ultimate investment manager.

The purpose of any buy/sell spread is equity between members contributing entering, continuing and withdrawing from the fund or an investment option in the fund

When should it be used?

- A transaction cost factor should be applied if material costs are in fact involved in buying and selling of underlying assets, where those costs are not reflected in the valuation of fund assets.
- Where there are no identifiable actual or potential acquisition or disposal costs, no transaction cost provision is required (this might be the case for a cash investment option).

- It would be possible to make the application of a transaction cost factor dependent on the level of flows into and out of the fund or investment option (that is if system capability allows); however, this would create uncertainty for members, as well as a disclosure problem.
- The importance of applying a buy/sell spread is magnified by the size of cash flows. Even a relatively small transaction cost to the fund that is not passed on to transacting members can make a large difference in returns to existing members. This applies particularly in the case of a new fund or investment option or in a rapidly contracting fund.

One pricing option available to trustees wanting to move towards more frequent pricing is to determine 'hard' unit prices on a monthly (or perhaps weekly) basis, with more regular unit prices estimated on a 'soft pricing' basis, for example, through the use of index movements for the relevant asset class. Full daily (or even weekly) 'hard' pricing, based on current market prices and fully reconciled balances, is expensive and may not be cost effective for all funds, particularly if daily transactions for individual members are relatively small and switching is either not available on a daily (or weekly) basis, or is infrequently exercised.

Other reasons for determining 'hard' prices on a less frequent basis are:

- the capacity of the fund or its service providers to perform daily (or weekly) hard pricing
- the nature of the assets and the ease with which more frequent pricing information can be obtained (for example, international shares or illiquid assets such as hedge funds or direct property or unlisted property trusts).

Those funds that normally do daily hard pricing may not be able to do so for blended products containing international shares or illiquid assets. Often their daily 'hard' prices are a mix of today's price for Australian shares, cash and son on, and yesterday's price for international assets.

The Inquiry seeks further information on the following areas:

Could other arrangements be developed to facilitate asset transfers between funds when members switch? Do funds require additional mechanisms to manage liquidity beyond the need for liquidity for portability and member investment switching?

The cost frictions as members leave, or withdraw funds and then re-invest elsewhere, create transaction costs that can generally be regarded as a drag on performance and efficiency.

In managed funds, these frictions are sometimes managed well by larger funds management operations by matching buying and selling investors, thereby eliminating the buy/sell spread transaction cost. For example, State Street Global Advisors (SSgA) operate a process where they have specific days on which they try to execute as many incoming and outgoing transactions as possible. This minimises the costs to both the incoming and outgoing investors, and is also operationally efficient for SSgA.

Even allowing for the three-day portability requirement, it seems possible that a similar process could operate for superannuation funds, particularly those with roughly equal inflows from contributions and outflows from pension payments.

Applying the same process to the switching of members between funds is likely to be less practical. The reason for this is that the assets held in one fund are likely not to be the same as those in another, or not held in the same proportions. This precludes the swap of assets owned by one member from the terminated fund to the newly appointed fund. There may be instances where the account balance is large that this makes sense, however, we would regard instances where this opportunity was practical and cost effective as relatively uncommon.

Looking ahead, as funds grow in size, and if members become more mobile across superannuation funds, there may be some funds which see regular outflows and inflows against others. If this eventuates, then it would make sense to undertake some kind of clearing process, not dissimilar to the clearing of bank cheques or intra-bank transfers in the payments space.

At this stage, ASFA members are not observing liquidity constraints in their funds, and have not advocated for additional mechanisms to manage liquidity. This may arise as a more pressing issue as the superannuation system matures.

The Inquiry seeks further information on the following area:

Is the trust structure best placed to meet the needs of members in a cost-effective manner?

There are two aspects to this question:

- 1) 'best placed to meet the needs of members'; and
- 2) 'doing it in a cost effective manner'.

ASFA believes that the trust structure is best placed to meet the needs of members for a number of reasons:

- trusts are a traditional/classic arrangement for managing assets on behalf of others. Trustees legally hold superannuation funds monies on behalf of other people (that is members and beneficiaries)
- the trust structure highlights the fact that funds are holding 'other people's money' to be used for their (the member's) benefit – not for the benefit of promoters, or sectors of the economy or for political expedience/convenience
- the trust structure provides strong protection for members as it places a fundamental obligation on trustees to act loyally and in the interests of the beneficiaries of the trust
- trusts provide an appropriate separation between the trustee's own assets and the fund's assets – this protects members' funds from the trustee's personal creditors
- the trust structure is used in a variety of analogous situations – for example, charities, property trusts, unit trusts, housing trusts and so on where the structure works well. A further example of this is the fact that custody ordinarily operates under a bare trust structure
- even though trusts were not initially designed for superannuation, trust law has adapted to fit an evolving and changing superannuation industry
- there is a large body of law (legislative and also well-developed general law) around trusts which is well tested. A new system will not have the legal background/safeguards and may be open to legal uncertainty and challenges (and even potential misappropriation)
- rules of trust law are principles based, as opposed to prescription or a tick a box process that may be associated with a contract law approach. Trust law requires a trustee to turn their mind to the circumstances, and is guided by the over-arching equitable principles
- the trust structure, with the separation of ownership and assets, and the duty to act in the best interest of beneficiaries, has stood the industry in good stead during the GFC
- the trust structure provides maximum flexibility particularly in regards to dealing with end users and will be adaptable to changes that are likely to occur over the next 10, 15 to 20 years
- there are comparable trust structures for pension funds in the UK, Canada and Hong Kong.

It would appear that most industry participants and commentators agree that the trust structure is the most appropriate structure for superannuation funds, but is it cost effective relative to alternatives?

Alternate structures could include:

- a contractual structure similar to banking or insurance
- a corporate structure where 'members' become shareholders

- a statutory/government controlled fund
- the managed investment scheme (MIS) structure
- employer book reserve accounts (common in the US).

ASFA has concerns with each of these alternate structures and does not believe they will be more cost effective than the existing trust structure. Our concerns are:

- In a contractual or corporate structure, the 'members' rely on the balance sheet of the issuing institution for their protection. Superannuation trusts, on the other hand, ensure that the fund's (being the members') assets are specifically held on trust for the members and are segregated from the trustees' other assets (and liabilities). It should be noted that there have been numerous instances of banking and corporate failures – but no failures of major super funds (in Australia).
- A statutory/government controlled fund, while simple and prudentially certain, removes the element of competition to keep fees down and investment returns high as well as removing much of the flexibility of the current system, which allows members to structure their retirement savings in a way which suits their risk profile.
- The MIS structure does not provide an alternative to the trust structure as REs are in fact trustees of the schemes they manage.
- Employer book reserve accounts provide less security for members and provide employers with too much influence.

It should be noted that the government and regulators have seen fit to impose duties and obligations on trustees of super funds which go far beyond the duties and obligations of traditional trustees (a position that ASFA supports) – and it is these additional duties and obligations which impose substantial costs on funds – not the fact that they operate in a trust structure. To ensure the integrity of the retirement savings system, the government would have to impose these additional duties and obligations on the operators of any alternative model/structure.

It should also be noted that there would be substantial costs in replacing the current trust structure and any changes to the current ownership arrangements (trust structures are an ownership arrangement) may have negative tax/stamp duty implications – requiring further government remedy/intervention.

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Observation

If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.

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The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:

Restore the general prohibition on direct leverage of superannuation funds on a prospective basis.

ASFA supports the policy option of prohibiting direct leverage in superannuation.

The strong performance of Australia during the GFC and the role that superannuation funds were able to play in stabilising markets was noted in ASFA's first submission to the Inquiry. That key role was only possible through the generally unleveraged nature of the superannuation pool and its naturally longer investment horizon.

Superannuation investors are, by compulsion, longer-term investors. However, the flexibility of the current superannuation settings allows individuals to invest with a risk and return profile of their own choice. This includes the ability to borrow to invest in superannuation assets. This presents three problems to the financial system and the superannuation system.

1. Meeting fiscal sustainability

In looking to satisfy the fiscal sustainability objective of superannuation, the government is looking for a balance between tax revenue foregone and a reduction in future social security liabilities. In borrowing to invest in superannuation assets, the consumer is reaping a significant tax benefit, and it is not clear that this is matched by any equivalent reduction in liabilities for the government.

2. Meeting dignity in retirement objectives

Australians are given the flexibility to determine their own superannuation portfolio. It is intended that this portfolio will allow them to set aside money/invest in assets which, at retirement, will provide them with a reasonable standard of living. Trustees who are looking to make decisions on behalf of disengaged members, look to a diversified unleveraged portfolio to deliver this over the long term for investors. Indeed, trustees are explicitly prohibited from leveraging a superannuation fund under the *SIS Act*. The reason for this is that in an unleveraged portfolio you can experience significant losses, but provided you don't need the money for something else, you can ride out the volatility on the assumption that markets will eventually recover. However, in a leveraged portfolio, this option disappears as you may be forced to sell part or your entire portfolio to meet interest repayments and/or margin calls. This risk is highest when markets are overvalued, when your portfolio is not well diversified, when interest rates are low or when the institution you have borrowed from faces capital constraints.

In satisfying the 'dignity in retirement' objective of super, using leverage to provide additional returns is a high risk strategy, which may result in significant losses in superannuation accounts.

3. Overall financial stability

The superannuation system must be designed in a way that does not contribute to the risk of financial system instability. While the primary objectives of the superannuation system are not to provide stability in financial markets, it is important that the superannuation system does not allow significant exposures to particular risks which may work against the overall system's stability.

An increase in overall leverage in superannuation accounts in an environment where asset prices are high and interest rates low, has the potential to disrupt the economy if a sudden market adjustment were to occur. An example, which is quite relevant today, would be a correction in residential property prices alongside an increase in interest rates.

ASFA notes that many MISs, property trusts and similar have some form of leverage embedded in their structure. For example, many property vehicles have leverage, usually around 30 per cent, to provide liquidity across a portfolio of lumpy assets. ASFA does not regard this as direct leverage. Consistent with the current SIS legislation, this type of investment should be regarded as acceptable for superannuation investors, particularly as part of a diversified portfolio.

Stability of superannuation policy settings

2-118

Observation

Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.

The importance of a stable policy and regulatory environment is the key message in this second submission to the Inquiry. Our discussion on this has been included in Section 1. We believe that establishing clear objectives and incorporating these into the mission statements of APRA and ASIC will assist in achieving this.

The importance of stability to trust in the system was previously noted by the Charter Group, appointed to develop and recommend a Charter of Superannuation Adequacy and Sustainability and to develop and recommend an appropriate structure for a Council of Superannuation Custodians. The Charter Group devoted an entire chapter of its report to the issue of constant change and noted that the same issue had also been raised in the 1993 Fitzgerald Report.

As noted in Section 1 of this submission, ASFA supports the need for long-term thinking and certainty with respect to superannuation policy, which will in turn promote community confidence in superannuation. We agree that the principles of certainty, adequacy, fairness and sustainability are important in ensuring confidence and trust in the system.

Earlier, ASFA noted the twin social and fiscal objectives of the superannuation system. Clearly, public policy needs to achieve the balance between a) facilitating and encouraging people's saving and provision for their own retirement while b) ensuring that the quantum and distribution of the cost of the tax concessions is equitable. It is also be recognised that that there will always be those who do not have the means to fund their own retirement, or to fund it sufficiently, who will need the government to continue to provide a safety net, by means of the Age Pension, set at an appropriate level.

The concern is that the changes do not end up as a net positive for superannuation participants. Unless the reforms deliver a significant improvement in efficiency or more equitable sharing of the costs and benefits of the system, changes to the system are unlikely to achieve positive outcomes. Rather, the implementation of these increases both:

- the costs of managing superannuation funds, which is then passed on to the members
- the complexity of the system which jeopardises consumer trust.

Absent clear policy objectives, complexity quickly emerges in any system. This is particularly true where public policymakers and drafters of legislation have an incomplete appreciation of the practical difficulties of implementation. Poorly defined policy outcomes, together with a lack of understanding of the details of the existing regulatory regime will likely result in poorly drafted legislation. This can produce unintended consequences and can create more difficulties than it resolves.

The layering of multiple changes over time, and the grandfathering and sun-setting provisions sometimes necessary to ensure equity, result in a degree of complexity which makes it more difficult for members to understand and further erodes confidence in the system.

Accordingly, it is imperative that

- the objectives of superannuation are agreed
- a process is developed which ensures any changes are consistent with furthering and achieving the purpose, goals and objectives

- an approach be adopted that seeks to minimise change, especially ones which are adverse to members, in order to provide some certainty to members to enable them to make long-term decisions about their financial future
- those making policy decisions and drafting the legislation possess appropriate expertise with respect to superannuation; have an appreciation of how the industry works and that they consult appropriately to ensure that any potential implications and flow through effects, including costs, are identified. A significant improvement in the quality of the legislation would assist greatly in the efficient operation of the system
- there continues to be recognition that, as superannuation is a mandatory system into which most employees are compelled to contribute, it should not be treated as just another financial product. Superannuation has a unique legislative and regulatory structure and must be dealt with separately and appropriately – it should not be made to align with other financial products for the sole purpose of enabling regulators to streamline their activities. Superannuation warrants an approach specifically tailored to its policy goals and objectives.

The Inquiry seeks further information on the following area:

To what extent should the Inquiry be concerned about the high operating expenses of many SMSFs?

Available data on SMSF costs

The costs associated with SMSFs will vary significantly depending upon the size of the fund, individual decisions of the trustees and the extent of use of service providers, including accountants and SMSF administrators.

The ATO has published estimates of average SMSF operating expenses (as reported to the ATO), which indicate that average expenses increased each year from 2010 to 2012 (\$5,000, \$5,300 and \$5,600 respectively). This followed decreases in 2008 and 2009 (\$6,500 and \$5,100 respectively). SMSFs solely in the accumulation phase had estimated average operating expenses of over \$7,500 in 2012.

In 2012, SMSFs with \$50,000 or less in assets had an average operating expense ratio of 9.5 per cent. This compares to SMSFs with more than \$500,000 in assets that had an average of less than 1 per cent. As can be expected, the estimated operating expense ratio for SMSFs declines in direct proportion to increased size of the fund.

SMSFs often have services provided by an accountant or other service provider. There are indications that accounting firms usually charge in the order of \$2,000 to \$3,000 for the combined accounting/audit function. Where a specialist administrator is used, the separate audit fee is typically \$400 to \$600. A number of new providers of administration that make use of computerised systems typically charge a lower fee than a traditional accounting firm. This fee usually does not vary by size of fund but a handful of providers charge operating fees as a percentage of assets.

Where an accountant is the sole service provider, fees are typically around \$2,500 per year. This includes the cost of audit, tax lodgement and annual review. There are other costs such as updating trust deeds, ATO levy and bank charges. Together these probably average about \$300 per fund per annum. A further \$400 per year, on average, is charged for funds in the pension phase.

The level of fees charged for SMSF administration and associated activities can vary significantly between providers (despite the provision of similar services). Some service providers will provide a package of administration, investment and advice services.

Approved auditors play a major role in regulating SMSFs. In the year ended 30 June 2012, the average audit fee was \$556 and median audit fee \$457. The trend decreased each year from 2008 to 2012 for both average and median audit fees. Fees varied significantly depending on the services provided. The average audit fee for those who completed only the SMSF audit was \$530. Approved auditors reported as providing other services charged an average fee of \$874.

Generally, over the five years to 2012, SMSFs reported they were paying less for approved auditor fees. In the year ended 30 June 2012, 56 per cent of SMSFs paid less than \$500 in approved auditor fees, compared to 51 per cent in 2008. Only 2 per cent paid \$2,000 or more, compared to 4 per cent in 2008.

Trustees of SMSFs can 'shop around' to get the best deal in terms of services provided and cost. However, having an established relationship with an accountant or financial adviser, the competitive forces are likely to reduce.

Some trustees will also take direct responsibility for preparing records and accounts and/or investment

management of the fund. This can reduce the fees paid to service providers.

The regulatory and taxation returns provided by SMSFs to the ATO contain information on expenses which are deductible from the assessable income of SMSFs. Like APRA-regulated funds, there are other expenses, particularly in regard to investments that are either not deductible or are netted off from investment returns before they reach the superannuation fund.

SMSFs in the pension phase also will not have taxable income against which they can claim deductions, leading to lower reported expenses in the return to the ATO.

Any policy concern should be about whether an informed choice is being made by those establishing SMSFs and that SMSF trustees continue to assess the cost efficiency of their decisions. In this context, there is a need for appropriate licensing and enforcing of required behaviours for all advisers advising on or promoting SMSFs, including individuals and firms promoting setting up an SMSF in order to purchase a residential investment property.

Ultimately, it is, or should be, a matter for SMSF trustees and potential trustees to decide whether fees and costs are at an acceptable or appropriate level and to take any action if they consider costs are excessive. This includes not starting an SMSF or closing an SMSF and rolling over the account balances into an APRA-regulated fund or funds.

It is essential that SMSF trustees and potential trustees receive appropriate advice and information. In this context, accountants should be subject to the normal licensing provisions for those providing financial advice as soon as possible. The removal of the accountants' exemption will lead to increased obligations for accountants in regard to what advice they can provide and the circumstances in which they can provide it.

ASFA has indicated in submissions that:

- the accountants' licensing exemption that previously applied caused confusion around the extent to which the exemption applied
- the exemption had the potential to produce sub-optimal results for individuals
- ASFA supports the abolition of the exemption.

ASFA has also raised concerns that:

- the changes to licensing will not require an accountant to consider whether the client is better off moving from an existing superannuation product to an SMSF
- the transition period for obtaining a license is too long and, in the interests of consumers, should be reduced to 12 months from when the provisions were changed.

There also is a potential role for the ATO to provide more information on average and likely costs to those applying to set up an SMSF. A minimum balance requirement would be difficult to implement and enforce, and ASFA does not consider that such a requirement should be introduced. One reason is that an SMSF might start small but soon have its assets grow through contributions and rollovers.

However, ASFA considers that consideration be given to requiring the ATO to provide 'health warnings' to persons seeking to establish an SMSF with less than, say, \$400,000. Such an approach would require prospective trustees to indicate the amount of funds that it is intended to be used at the time of establishment of the SMSF or in a reasonable period thereafter.

The Inquiry seeks further information on the following area:

Should there be any limitations on the establishment of SMSFs?

ASFA does not consider that there should be any specific limitations on the establishment of SMSFs being imposed. However, there may be scope for the ATO to provide prospective trustees with more information about trustee duties and legal obligations. The extent of the material provided could be linked to factors such as any evidence of a professional adviser being involved (reducing the need for provision of some material), or past evidence of any general taxation law non-compliance or late submission of tax returns by a prospective trustee (increasing the need to provide material on compliance requirements for SMSFs). There could also be scope for the ATO to ask trustees a number of questions, again on a targeted basis. While there should not be a requirement to demonstrate competence as a trustee, such questions would at the very least identify for prospective trustees issues and matters they should be aware of to successfully operate an SMSF.

Chapter 5: Stability

Corporate governance

3-44

Observation

To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibilities and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions, substantial regulator focus on boards has confused the delineation between the role of the board and that of management.

As stated in the Interim Report, “[c]orporate governance prudential standards, set by APRA, are common for authorised deposit-taking institutions (ADIs) and insurers. These place requirements on the structure of the board and the independence of directors. The respective standards for superannuation do not have structure or independence requirements but do cover conflicts of interest”.^{xxii}

There are differences in the primary duties of governing bodies for different types of financial institutions – for instance, superannuation funds, insurers and ADIs. This reflects differences in the types of financial products they offer and the legal structures and duties imposed on them.

Superannuation funds

Regulated superannuation funds are based on a trust structure and operate under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and are also subject to the common law of trusts. As superannuation funds operate as a trust, trustee boards have a fiduciary obligation to act in the best interests of members and beneficiaries of the fund and not in their own interests or those of external parties. Trustee boards also have a general law duty to avoid placing themselves in a position where their duty to fund members conflicts with their personal interest (conflict of interest) or duty to someone else (conflict of duty).

New covenants in section 52 and 52A of the *SIS Act* require that superannuation trustee boards and directors must give priority to the duties owed to, and the interests of, beneficiaries over those of other persons, and must ensure that this duty of priority is met despite any conflict. In particular, section 52(2)(d) of the *SIS Act* requires trustee boards to:

- give priority to the duties to, and the interests of, beneficiaries over the duties to, and interests of, other persons
- ensure the duties of beneficiaries are met despite the conflict
- ensure the interests of beneficiaries are not adversely affected by the conflict
- comply with the prudential standards in relation to conflicts.

Similar covenants on individual directors apply under section 52A(2) to perform their duties and exercise their powers in the best interests of beneficiaries.

Shareholders of proprietary limited corporate trustees hold those shares in trust for members of the fund and their constitutions do not allow them to deal with those shares.

Insurers

Insurers operate under the *Life Insurance Act 1995* and the *Insurance Contracts Act 1984*. They are subject to a duty of good faith imposed by legislation and also under common law. Directors of life offices are required by law to place the interests of policy holders ahead of shareholders. Insurers are highly regulated entities with requirements to operate through statutory funds. These obligations are related to the nature of the risk products they offer.

ADIs

These are corporations authorised under the *Banking Act 1959* and include banks, building societies and credit unions. ADIs can offer a variety of products, including superannuation products, which must comply with the legislative and regulatory obligations applicable to that type of product. ADIs are subject to significant regulatory requirements which offer protection to consumers of their products.

ASFA's position is that the diversity of duty of care across different financial institutions is appropriate given the differences in the products they offer.

The role of boards and management

ASFA agrees with the description of the roles of the board and management set out on page 3-45 of the Interim Report:

- Ultimately, the board is accountable for the actions of the institution. Good corporate governance across all industries involves clear and distinct duties performed by the board and senior management.
- A board's obligations are: overseeing, directing and monitoring the performance of the company; approving and overseeing strategic policies and frameworks, including for risk management; and satisfying itself that such policies and frameworks are effective.
- Management is responsible for operational day-to-day activities and implementing strategic policies and frameworks.
- Generally, boards oversee what management implements.

Requirements on boards

The Interim Report "invites further information from stakeholders on where they specifically believe corporate governance requirements unduly place managerial responsibilities on boards. Consultation to date suggests that at least part of the issue appears to be uncertainty about APRA's expectations of how boards need to meet governance requirements".^{xxiii}

In ASFA's view, there appears to be mixed messages being sent by APRA in relation to its expectations around the obligations of boards. The approach adopted by APRA is not always consistent with the above descriptions of the roles of boards and management. Public statements by APRA's representatives and its dealings with directors indicate an expectation that directors must have detailed knowledge of the day-to-day administration of the fund. But, as outlined above, given the board role is strategic in nature and involves overseeing, directing and monitoring the performance of management, this is not an appropriate or constructive way to regulate boards.

In a recent survey undertaken by ASFA of directors, CEOs and senior executives of superannuation entities, the vast majority of respondents (89.5 per cent) felt that, from their recent dealings with APRA and messages coming from the regulator, APRA (inappropriately) expects managerial-level knowledge and responsibilities of board members. In particular, respondents expressed concern regarding APRA staff expecting board members to have detailed knowledge of functional matters that are the purview of management including, for example, IT access levels for fund staff, details of staff risk awareness training and controls associated with the implementation of an office wireless network.

There was also concern expressed regarding the nature/extent of the prudential requirements themselves resulting in managerial responsibilities being unduly placed on boards.

Requirements on boards

3-48

The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:

- No change to current arrangements.
- Review prudential requirements on boards to ensure they do not draw boards into operational matters.
- Regulators continue to clarify their expectations on the role of boards.

The Interim Report notes that submissions are critical that the current regulatory and supervisory system does not delineate appropriately between the role of boards and management.^{xxiv} ASFA supports this criticism and believes it is appropriate for changes to be made to the current requirements. As such, option 1 (no change to current arrangements) is not supported.

Specifically, ASFA believes there is scope to review the prudential requirements on boards to ensure they do not unnecessarily draw boards into operational matters. In particular, the level of granularity of the requirements in the APRA prudential standards should be reviewed to ensure that boards are not overwhelmed with procedural reports, which often result in boards struggling to consider strategic issues.

As outlined in our response to 3-44 reflecting the views of ASFA's members, the substantial regulator focus on boards has confused the delineation between the role of the board and that of management. The majority of respondents (81.8 per cent) of ASFA's recent CEO/director/senior management survey stated that APRA should provide guidance to clarify its expectations on the role of boards and distinguish these from its expectations of management.

In ASFA's view, the combination of the level of detail currently required by the prudential standards and APRA's resulting regulatory approach means that many boards are unwilling to delegate (what should be) managerial matters to management and feel instead that they have to be intimately across the detail on these matters. ASFA contends that this is incompatible the strategic nature of a board's role.

ASFA therefore supports both options for change above. The prudential requirements on boards should be reviewed to ensure they do not draw boards into operational matters. As well, there is scope for APRA to clarify its expectations on the role of boards. We note APRA's position that while correspondence is often addressed to boards with the intention of ensuring that they are aware of APRA's concerns and ensure that management addresses them; they are not for the board's direct action. If that is the case, ASFA supports the view that APRA should clarify its expectation of boards to dispel misconceptions. In our view, such a clarification would have a number of benefits for the industry including:

- Boards will be more inclined to relinquish themselves of the perception that they have to be involved in what are strictly managerial matters and instead leave boards free to focus on approving and overseeing strategic policies and frameworks, including for risk management, and satisfying themselves that such policies and frameworks are effective.
- If APRA's position on how boards need to meet their governance requirements is adequately clarified and documented, the industry can rely on it if, at any point in the future, APRA undertakes any supervisory activities or issues any statements or communication that do not respect the appropriate division between the responsibilities of the board and those of management.
- APRA supervisory staff would have a formal position to regulate against, which would likely increase the chances of greater consistency in the regulation by APRA of funds in different geographic locations (that is reducing the likelihood of differential treatment between funds in different states).

The Inquiry seeks further information on the following area:

Is it appropriate for directors in different parts of the financial system to have different duties? For example, differences between the duties of directors of banks and insurers and trustees of superannuation funds. Who should directors' primary duty be to?

ASFA believes it is appropriate for directors of different parts of the financial system to have different duties, based on the different nature of the financial products offered and the different consequences that can flow from a failure of one of these institutions.

Listed entities are subject to a range of ASX corporate governance standards. Some of these standards can be adapted for superannuation. However, while most superannuation fund trustees are corporations, many of these standards could not be adopted by trustees without modification. This is because the trustee's duty of care is owed to members of the fund and not to its shareholders (and appropriately so).

There also needs to be an understanding that different duties of trustees attract different liabilities. The increased risk that superannuation fund trustees face as a result of their primary obligation to members may require them to have greater safe harbours.

Chapter 6: Consumer outcomes

Current disclosure obligations

3-56

Observation

The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.

ASFA agrees that the current disclosure regime has historically produced complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.

We also agree that consumers should have access to products and services, and access to the information, advice and education necessary to make effective decisions about products and services that help them meet their financial needs.

ASFA recognises the need for a balanced and effective consumer protection framework and, for the most part, ASFA maintains that the current framework does not need substantial change. Instead, consumer outcomes may be improved through better or more effective supervision and the facilitation by ASIC of the use of new data analytics and technology to enable product issuers to build and distribute financial products in a more targeted way to better meet consumers' needs. This facilitative approach to the use of data and technology may be an appropriate alternative to further regulation. ASFA is particularly cognisant of the risk that further regulation in this space may reduce innovation and competition or result in some consumer needs being partially or wholly unmet. An example of an undesirable outcome of excessive regulation has seen the exit of certain segments of the wealth management advice market by banks in the United Kingdom.

Overly conservative legal advice has been a key driver behind disclosure documents becoming long and complex. The product issuer's fear of liability, the requirements of professional indemnity insurers and unfavourable or unhelpful Superannuation Complaints Tribunal (SCT) decisions have contributed to this. Any potential solution must strike a reasonable balance between the liabilities associated with product disclosure and maintaining appropriate consumer protections. Whether disclosure on its own provides enough consumer protection is addressed elsewhere in this submission.

3-62

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.

ASFA believes that the current regulatory approach to disclosure should be amended. No change to current arrangements mean consumers will remain disengaged and maintaining the status quo will probably lead to poor consumer outcomes. While there may be some costs in reviewing and determining the appropriate new level of disclosure, on the assumption that disclosure would become less burdensome and less 'legalistic', we would anticipate that overall costs would reduce.

- Improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.

ASFA supports the voluntary supplementation of the existing disclosure regime with mechanisms to enhance consumer understanding of product information. As the relevant regulator, use of these mechanisms would need to be facilitated by ASIC. Examples include:

- **layered disclosure** – place less reliance on mandated disclosure documents and move to make layers of additional voluntary disclosure available to consumers
- **better information presentation** – facilitate the presentation of information in formats that enable its delivery using mobile technology to make the information accessible at times and through mobile devices that are more convenient to consumers
- **risk profile disclosure** – improve consumers’ ability to understand risk by the presentation of information about risk in a standardised manner to allow products to be easily compared, so consumers can make more informed choices
- **online comparators and choice engines** – facilitate the provision of information by third-party providers through online tools and comparators. The growth of these services will be facilitated by better access to data, both about financial products and about consumers’ behaviour.

- Remove disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery.

ASFA supports removing disclosure requirements that have proven ineffective and the facilitation of new ways of providing information to consumers, including using technology and electronic delivery.

Our members have identified a number of areas of uncertainty in regard to the electronic delivery of documents and have provided the following comments:

- ASIC has expressed conservative views in respect of the delivery of various disclosures online. In RG 221 at RG 221.31, ASIC states that, generally, unless the law provides otherwise, or a client actively decides to receive financial services disclosures online, a provider is generally required to deliver paper disclosures to clients, that is “paper disclosure is the default method of delivering disclosure”.
- There are certain cases where the law clearly does not require consent for electronic delivery. For example, section 1017F allows transaction confirmation to be delivered via a standing facility if:
 - » the holder has agreed that the confirmation may be provided by means of the facility; or
 - » the holder has been informed about the facility and its availability and has not opted out.
- There are also provisions which ASIC suggest require consent. For example, where delivery is permitted to an electronic address ‘nominated’ by the client (for example, section 940C(1)(a)(ii)), ASIC states that ‘nominated’ means the electronic address must have been identified by the client for sending disclosures and that it is therefore necessary for the provider to make the client clearly aware that when the client provides their electronic address, disclosures will be delivered online.
- There are, however, other provisions which do not refer to an electronic address ‘nominated’ by the client, but which also do not provide a clear alternative (such as in section 1017F). In relation to some of these sections, it is arguable that consent is not required.
- For example, in relation to periodic statements required under section 1017D, the legislation says the statement may be given:
 - » in writing
 - » electronically
 - » in a way specified by the regulations. Under regulation 9.75.A, this includes “in any way agreed to by the holder”.

- There is no specific mention of consent or other requirements in relation to delivery of the documents electronically. This raises the question as to whether the ability to give a statement electronically in accordance with section 1017D(6) is an example of documents which, in ASIC's view, the law "provides otherwise" than paper delivery.
- If the legislators have in the regulations contemplated delivery of the documents in any method agreed to by the client (as per regulation 9.75.A), this would confirm that the other options do not require agreement or consent.
- It is also worth considering the effect of the *Electronic Transactions Act 1999* (Cth) (ETA). Under the ETA, where a law of the Commonwealth requires a person to give information in writing, that requirement is taken to have been met if the person gives the information by means of an electronic communication where:
 - » in all cases, at the time the information was required to be given, it was reasonable to expect that the information would be readily accessible so as to be usable for subsequent reference; and
 - » in cases where the recipient is not a Commonwealth entity or a person acting on behalf of the Commonwealth, the recipient consents to the information being given by way of electronic communication.
- The ETA defines consent as including "consent that can reasonably be inferred from the conduct of the person concerned".
- Therefore, it may be possible to either rely on the ETA (where the *Corporations Act* requires something to be done in writing) or use it to inform our understanding of what is reasonable in the electronic delivery of disclosure documents. For example, it may be that the application of the concept of consent used in the ETA could support a less conservative view of the nature of the consent required as suggested by ASIC in RG 221.

- Subject product issuers to a range of product design requirements, such as targeted regulation of product features and distribution requirements to promote provision of suitable products to consumers.

ASFA supports supplementing the current disclosure regime with the ASIC facilitation of additional voluntary disclosure over the adoption of more intrusive regulatory tools.

Strategic, targeted regulation of product features has the potential to stifle innovation and limit competition. If it were to be considered, it should be limited to circumstances where it could be demonstrated that a significant number of consumers are being caused (or could be caused) significant detriment. The same should apply to any move towards mandated product design.

In relation to superannuation, however, we believe this power is needed. Without it, it would not be possible to fulfil either a) the duty to act in the best interest of fund members; or b) the duty to ensure that member benefits are not eroded by excessive insurance premiums. This may have the effect of placing a similar obligation on product providers in the retail market, where superannuation and direct customers invest in the same product.

It is important to encourage and facilitate additional voluntary disclosure using data and technology and to facilitate the presentation of any mandated short-form disclosure in technology friendly and accessible formats to better educate consumers and enable them to make better decisions about the suitability of different products to meet their needs.

- Provide ASIC with additional powers such as:
 - » Product intervention powers to prescribe marketing terminology for complex or more risky products.

Powers to give the regulators any product intervention powers needs to be balanced against the potential to stifle innovation and impose additional cost burdens on the industry without necessarily delivering better outcomes for consumers.

These powers should be drafted as a regulatory tool to be used as a measure of last resort where it is likely that consumers will be misled.

There does need to be greater consumer testing and the development of interactive self-education and self-assessment tools for the marketing of financial products, and to better ensure that both consumers and their advisers are equipped to understand the suitability of products to meet their needs.

- A power to temporarily ban products where there is significant likelihood of detriment to consumers.

ASFA supports giving regulators some powers to ban products or product features as a last resort, where consumer detriment is likely and information asymmetry is present. The main concern is one of ensuring regulator accountability. If it were to be considered, it should be limited to circumstances where it could be demonstrated that a significant number of consumers are being caused (or could be caused) significant detriment.

Financial advice

3-63

Observation

Affordable, quality financial advice can bring significant benefits for consumers. Improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.

ASFA notes that consumers' preferences for financial advice have shifted significantly over recent decades, particularly in the use of and preferences around comprehensive advice. Advice from member superannuation funds suggests that customers today are much more aware of financial advice and therefore have stronger preferences on how they receive advice, what topics they wish to receive advice on, and how much they are willing to pay for this service.

ASFA generally agrees with these observations and believes that the provision of intrafund advice by superannuation funds is part of the solution of making affordable quality advice more accessible to Australians.

ASFA considers that intra-fund advice:

- provides members of super funds with affordable and accessible advice in regards to their superannuation
- is popular with superannuation fund members and provides better outcomes for them
- while simple in nature must be able to include some personal advice
- does not impose an excessive cost burden on the funds or unreasonable cross subsidisation between members.

This view is supported by research undertaken amongst the ASFA member base. In the last quarter of the 2012/2013 financial year, and the first quarter of the 2013/2014 financial year, ASFA conducted a survey of superannuation funds in regard to the provision of advice and related services.

The research found:

- Most superannuation funds provide advice to members. The provision of scaled advice is relatively common with around 75 per cent of the funds surveyed providing such advice.
- The bulk of the cost of scaled advice (87 per cent) is covered by general administration fees charged to members by funds or a combination of general administration fee and a specific fee for the service provided. At least 57 per cent (and possibly up to 87 per cent) of scaled advice is collectively charged for (that is, it is intra-fund advice)
- Members of super funds will not seek advice if it is expensive and complex. Most respondents (approximately 75 per cent) in a survey commissioned by ASIC indicated that they were unwilling to pay more than \$250 for advice. That survey also indicated that most demand for financial advice attached to superannuation is at the simple end of the advice spectrum and approximately one third of Australians prefer to receive simple advice as required.
- The provision of intra-fund advice is affordable for funds and is much cheaper than full personal advice. For example, for the industry funds surveyed, the average minimum fee for scaled advice, in the cases where a fee is charged, is \$220, while in the case of full personal advice, it is \$1,190.
- Other survey results indicated that financial planning costs are only a small part of fund administration costs. The median amount for administration expenses per fund member per annum is \$38.20. The financial planning component of this is only \$1.97.

These findings are supported by a Deloitte report (published as Appendix D of the final report on the Superannuation System Review), which found the estimated cost of providing intra-fund advice based on

reasonably high take up rates, would range from \$8 per member per annum (for funds with more than 800,000 members) to \$18 per member per annum (for funds with less than 4,000 members. State Super Financial Services has recently conducted research into client advice preferences as part of segmentation research, (CoreData April 2014) that shows there is a clear consumer preference for scaled advice, most particularly amongst members under 55 years of age. The following table shows that only 8 per cent of under 55 year olds would not consider using scaled advice.

Question: Assuming you could find an adviser you trusted, would you consider seeking scaled advice as an option for you?

	Under 55 years	55 years old and above	Total
Would not consider	8%	14%	12%
Might consider	67%	54%	58%
Strongly consider	12%	13%	13%
Not sure	13%	19%	17%
Total	80%	67%	71%

Source: State Super.

However, a preference for scaled advice does not necessarily mean that people don't want a face-to-face financial planning experience, or that they don't want to have an ongoing relationship with a planner. The scaled advice preference is more likely to be related to dealing with what the customer actually wants as well as providing flexibility and affordability.

This suggests that the current debate should not be about comprehensive versus scaled advice, but more about how the industry delivers advice on the client's terms. That means having flexible advice offers and differentiated pricing for clients that facilitate the full spectrum of advice required, from the simplest advice request to the most complex.

In summary:

- there is research that customers want access to simple, accessible and lower-cost advice
- both intra-fund advice and scaled personal advice provide options for customers
- these two forms of advice should be promoted more so people know what they are and how to access them.

Adviser competence

3-69

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.

ASFA believes that there would be benefit to reconsidering policy in order to improve the competency of the adviser industry. We see such improvement having the benefit of avoiding significant negative consequences such as clients losing money, reputational damage to the industry, loss of confidence in the industry and significant costs to the industry (potential fines, enforceable undertakings (EUs), compensation, increased professional indemnity [PI] insurance costs and so on).

- Raise minimum education and competency standards for personal advice (including particular standards for more complex products or structures, such as SMSFs) and introduce a national examination for financial advisers providing personal advice.

While there has been much discussion about raising the entry level standards into financial planning, the competency required to become RG 146 qualified has not changed and is still low.

ASIC has publically stated that “the current system for training and assessing advisers is inadequate and pitched at too low a level and that “the competency of advisers has a significant impact on the quality of advice provided to investors” (ASIC Senate Inquiry Submission paragraph 562).

“Until standards improve and financial planning becomes a profession, planners will continue to be seen in a poor light by the general public, media and with policymakers.”

ASFA supports higher educational standards and other measures designed to safeguard the trust of clients and raise the standards in the financial advice industry. This should include, for all new advisers providing full personal advice on tier one products, a requirement to be degree qualified (in a finance/business related discipline) and an appropriate transition time for existing advisers to meet higher qualifications (for example, advanced diploma in financial planning or a degree). A requirement to be degree qualified will put the advice industry in line with other professions such as accounting.

As we point out in item 3-74 (General Advice) for superannuation funds (and most financial institutions), the member engagement and advice spectrum has evolved and broadened over time from single issue factual enquiries to complex full personal advice. Once the government develops appropriate labels and regulatory frameworks to reflect the various levels of advice, it may be possible to tailor educational requirements to reflect the nature of the advice being provided. For example, if an adviser can only provide intra-fund advice, then possibly the educational requirements should more closely reflect the advice areas permitted under section 99F of SIS. In putting together this framework, the inclusion of an advice category that does not relate directly to products will also be important as many Australians are looking for financial advice that is unrelated to a specific product category.

Professionalism in the broader financial planning industry could also be further improved by not only raising minimum educational and ongoing competency requirements but also requiring all financial planners to be members of industry associations with mandatory professional codes of conduct.

We are not supportive of a national exam either instead of or in addition to higher educational standards. A national exam could possibly be used during a transition period where experienced (and possibly ageing) financial advisers for whom it is not practical to undertake further study could demonstrate their competency and remain in the industry [for a limited time].

Requiring a higher degree of training for advice providers has the potential to add costs to the industry in that more qualified advisers may want, and be able to demand, higher remuneration for their services. This could be ameliorated by the use of innovation and finding new ways to do things to reduce advice production costs, and with, possibly, a lessening of regulatory requirements as a balance to higher professional standards.

There would clearly be cost trade-offs associated with raising minimum education and competency standards for advisers but the industry really has no choice but to increase standards for the benefit of consumers and ensure the longer term future and viability of the advice industry.

The minimum education and competency standards for advisers should be reviewed as part of the upcoming Senate inquiry on professional standards.

- Introduce an enhanced public register of financial advisers (including employee advisers) which includes a record of each adviser's credentials and current status in the industry, managed either by Government or industry.

Notwithstanding the positive impact that the FoFA reforms are having on the financial planning industry, it is essential that those licensed to give financial advice are of good character, are appropriately qualified and trained, and can be tracked and that ASIC, the public and Australian Financial Services Licence (AFSL) holders have visibility at all times on these matters.

There is a risk that financial planners who do not adhere to appropriate standards of advice enter the industry, or move within it between AFSL holders, and for professional misconduct not to be taken fully into account due to lack of visibility.

ASFA supports a national, universal and consolidated register of all financial advisers (including employees) to be maintained by ASIC. This which would disclose the following:

- Name and date of birth
- Personal Registration number (Unique Identifier)
- Current licensee they are authorised through
- Work history (full work history)
- Education qualifications
- Membership of a professional body.

It may also be useful to record the nature of the engagement (employee/independent broker/tied or aligned) – perhaps through use of the labels 'restricted' or 'aligned', as in the UK.

A register will be most effective if it is mandatory that licensees report when an adviser's employment or representative status is cancelled for disciplinary reasons or other 'unconscionable conduct' reasons.

AFSL holders should be responsible for ensuring that all of their advisers are registered and that registration details are kept up to date (the updating requirements could be similar to the updating requirements in regards to Section 29QB of SIS).

A register will benefit consumers, AFSL holders and ASIC:

- consumers will benefit from the ability to refer to the register prior to appointing a financial planner and gaining a better understanding of their position within the industry
- AFSLs will benefit from the ability to more effectively reference check potential employees or authorised representatives against the register prior to putting them in front of their clients. This process can be very difficult at the moment
- increased visibility of advisers will assist ASIC's regulation of the advice industry
- allow policymakers to track numbers of financial planners in the industry. This is currently very difficult.

Further evidence of the benefits of such a register is the fact that international jurisdictions, such as the US, currently administer individual registration of financial advisers. Customers who are seeking to use the services of a US-registered investment adviser are able to view individual investment adviser representative records that include information about that individual's professional background and conduct, including current registrations, employment history, and disclosures about certain disciplinary events involving the individual.

In regards to the costs (to the government and the industry) associated with creating and maintaining a national register, we believe they should not be substantial. Further, given AFSLs already have obligations to notify and update other details, the additional regulatory burden on them to collect, report and update this new information wouldn't appear unduly onerous. Our members have indicated that the benefits from the creation of a national register would outweigh the costs to them.

ASFA would be concerned if there was additional costs from ASIC passed on through an increase in any industry levy.

- Enhance ASIC's power to include banning individuals from managing a financial services business.

ASFA supports enhancing ASIC's power to include banning individuals from managing a financial services business. Clearly people managing these businesses have a significant influence over the day-to-day activities, management arrangements and the general compliance and ethical culture that drives the organisation. Inappropriate, dishonest or incompetent people should not be allowed to manage a financial services business and ASIC should have the power to ban such individuals.

A banning power together with the creation of a national register of advisers will assist ASIC in locating and removing advisers and individuals who do not comply with legal requirements or who do not act in the best interests of clients.

The Inquiry seeks further information on the following areas:

- What opportunities exist for enhancing consumer access to low-cost, effective advice?

There is a clear demand for low-cost, effective advice. Where cost is a consideration, consumers have indicated their willingness to accept alternative models for advice delivery. The September 2012 Annual Advice & Limited Advice Report prepared by Investment Trends provides some useful statistics on consumers' preferences. In particular, it notes that:

- the traditional planning model, delivered face to face, is not the only option; only six per cent of the adult population intuitively prefer the traditional comprehensive advice model if cost is a considered factor
- another eight per cent would be happy to receive comprehensive advice over the phone if it were cheaper
- thirteen per cent would prefer to receive face-to-face modular advice (at a medium cost)
- twenty per cent would prefer low-cost modular advice (over the phone and online)
- the remaining half is unwilling to pay for advice
- overall, 41 per cent would prefer a different advice delivery method at a lower cost.
- even among existing planner clients,
 - » only one in five stated a preference for comprehensive advice delivered face to face (at a higher cost) and
 - » sixty per cent were open to receiving lower cost advice either through a different channel and/or within a defined scope.

Notwithstanding the demand for cheaper advice, personal advice is still predominantly delivered via a face-to-face business model where information can take weeks to capture before recommendations are finalised and presented to clients. The model is relatively high cost and perceived as only for those who are relatively wealthy or have high levels of superannuation savings. This model is not flexible for those who cannot travel to planner office locations and work non-standard hours.

An obvious solution to increase flexibility and lower the cost of advice, which has been suggested by many in the industry, is to provide advice online – either self-directed or using features such as co-browsing where a client can interact with a planner in real time online which removes the geographic barriers to receiving advice.

A further opportunity is the fact that sophisticated analytics (big data) has allowed customer information from a wide variety of sources to enable prediction and personalisation when and how the customer needs it with a high degree of accuracy. This information can be used to pre-qualify product suitability, help navigate a customer through digital and physical interactions, and improve the availability of relevant information.

- What opportunities are there for using technology to deliver advice services and what are the regulatory impediments, if any, to those being realised?

The benefits of digital technology are yet to be fully realised in the financial services sector. While advances in digital technology have been rapid in many industries, managed investments, life risk products and

superannuation are lagging behind this trend. They still operate predominantly as an intensively face-to-face and paper-based industry. A clear example of this is the Statement of Advice (SoA) requirements to give recommendations and disclosure in writing. Planners comply with this regulation by providing clients with a lengthy word document. This is not only potentially more costly for the planner, but it likely to be less convenient for individuals, negatively affecting their engagement with their superannuation.

In contrast, the banking industry has been able to make significant advances in digital technology which allow customers to transact using a variety of channels. The banking sector has been able to trade-off increased potential for fraud risk with lower operational costs and higher client convenience. This same step change has not happened in the managed fund, life risk and superannuation industries, possibly because of the high compliance requirements and the 'need to provide and SoA in writing' as mentioned above.

ASFA believes that the advances in digital technology used by the banking industry should be extended to super. In doing so, regulations will be required around paper-based signatures, which can be amended to allow online verification and signatures. This would enable financial planners to provide advice and immediately implement that advice by using a secure portal that could replace the traditional face-to-face consultation. This could drive member engagement, especially for individuals in remote areas, as they are offered a considerably more convenient way of interacting. ASFA notes that the new IQ card is a good development but regulations requiring a paper-based signature must be changed to make it possible to utilise new digital technological advances. This topic is canvassed more broadly in the section of the ASFA response to the Interim Report dealing with digital identity (see items 4-70 and 4-71).

Current regulatory barriers to the provision of online advice include:

- 'wet' signatures required on third-party access forms (and the non-standardisation). A potential solution would be to provide a standardised form, as required by the ATO or Centrelink, to give authority and make it digitally fillable using the my.gov login system
- AML/CTF verifications
- validating past contribution history from the ATO. A potential solution would be to require the ATO to update their reporting systems so that past super contributions can be viewed online by entering the clients' tax file number (using the my.gov login system)
- confirming current product fees and premiums as PDSs are not always reliable for specific client situations. A potential solution would be to require product issuers to disclose required information such as fees, premiums, automatic acceptance details, product features etc. on a dashboard in a similar manner to the MySuper dashboard
- disclaimers and statements of underlying assumptions, which create distrust and either dissuade customers from using the technology, or people disregard them altogether
- rigid requirements relating to the provision of a PDS prior to implementation of advice makes it difficult to provide and implement the advice in a single engagement. Improving reliance on 'cooling off' periods, for example, would be likely to improve conversion to implementation of advice
- security constraints relating to the delivery of financial advice via non-secure channels, such as email, require that advice providers have a secure and accessible repository for advice documents
- further, the length and complexity of the SoAs currently makes it difficult to ensure that it is read and understood. An alternative, and something closer to client expectations, would be instead a printout of the client's financial modelling and 'what if' scenarios (dated and with caveats)
- best interests obligations may make some providers nervous about agreeing scope with the online users. For example, advice might be provided around super contributions yet the client agrees not to cover debt. This forces providers to be comfortable limiting what digital tools can be offered and applying an effective triage system. Investigation and mitigation of legislative and regulatory impediments (formulated for a face to face and paper-based world) is warranted
- ASIC's view is that online calculators may provide personal financial product advice. This enlivens legislative provisions that, in turn, impact on conduct and disclosure provisions.

ASFA is not suggesting that the current paper-based information is not important or relevant, but that the

methods for accessing, presenting and receiving information are antiquated and not conducive to a digital solution, and hence delivering a lower cost, more flexible solution to the Australian public.

Notwithstanding these barriers, a number of ASFA members are currently creating extremely innovative online intra-fund advice solutions that provide high-quality, cost-effective advice and member engagement.

In looking at the effectiveness of these online tools, the sophistication and thought behind the tool must be considered. Based on the level of intellectual property and subject matter expertise that could be used to produce and underpin these tools, one could argue that more confidence could be placed on the outcome of the tool versus a single adviser's capability and point of view. The new intra-fund advice tools in the market are focused on retirement adequacy, with stochastic modelling and a demonstration of potential outcomes with input from expert investment consultants, testing by independent actuaries, vetting by compliance experts, and design which consider behavioural science. Consideration also has to be given as to how we are going to reach the younger generations and the mass market. These tools, which can be accessed and played with on phones and tablets, could be the answer.

A further benefit of digital solutions would be to lower the cost for the face-to-face financial advice models. Regardless of technology developments, research shows that many customers still value a personal relationship with their adviser, particularly those in the over-55 cohort.

- What are the potential costs or risks of this form of financial advice, and what measures could be taken to mitigate any risks?

In a digital context, these opportunities need to be approached carefully to ensure compliance with legislative and regulatory requirements, in particular that the relevant details of the customer's situation are adequately understood and that advice is suitable for their circumstances. We have identified the following risks associated with the using technology to deliver advice:

- Some websites and digital tools have limited control in checking the accuracy of information supplied and therefore rely on the customer to ensure that the information is accurate. A customer, who might otherwise not qualify for digital advice, might 'fudge' their own information to receive a recommendation or guess where they do not know the answer. This creates a risk that inappropriate advice may be implemented. Robust triage funnels are required to direct the customer to an accessible alternative (phone or face to face) where they fall outside the scope of the digital tool.
- Websites and digital tools have only limited time and capacity to adequately explain difficult concepts. This makes information placement, simplicity of messaging and warnings critical to the delivery of effective personal advice. The user experience should be supported with a variety of communication mediums such as images, text and video, yet these must supplement, not impede, the user experience.
- Some digital tools assume that customers have the same objectives. Where an adviser might be able to help a customer realise and articulate their objectives, a website or digital tool cannot empathise or coach. Technology enabled support such as online chat and video facilities can improve access to and delivery of support at a reduced cost but may add to the administrative burden of preparing and supporting advice. Hence the need for triage models which may direct the customer to an alternative advice path including phone-based support or seeing a qualified financial adviser.
- The use of digital technology in providing advice may encourage scaled or single-issue advice or product solutions where the person's actual needs are more complicated or demanding.
- The lag of privacy laws to technological advancements remains an ongoing risk. Even with the recent transition from the National Privacy Principles to the Australian Privacy Principles, which specifically recognised the expansion and volume of virtual and digital delivery and capture of information, there remains a risk that there will always be a growing gap or area of weakness around the current

regulations and controls not capturing the current state of technology. The introduction of a Privacy Commissioner is a positive step as they have the ability to be broadly market aware and can guide policy from the feedback of the financial services industry.

- The growing issue of fraud and the possibility of fake websites, which could appear to come from a legitimate advice provider, but are offered by providers outside of Australia's regulatory jurisdiction.

Two benefits of providing scaled advice and information through low-cost technology channels are:

- it is easier to create a record of disclosures and acceptances than in a face-to-face session, which requires the adviser to most often record the conversations manually; and
- advice quality (including inputs and assumptions) can be centrally controlled with the potential for human error being reduced.

The feedback from our members is that providing scaled advice (particularly now that it has been made clear under the recent FoFA reforms that clients and advisers can agree the scope of the advice) using technological means should be less risky and complicated than providing comprehensive advice (using technological means).

General advice

3-74

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options:

- No change to current arrangements.
- Rename general advice as 'sales' or 'product information' and mandate that the term 'advice' can only be used in relation to personal advice.

In response to the specific question being asked, ASFA supports renaming general advice as 'product information' – as this is essentially what it is and the term is more likely to be understood by the consumer. However, any change of name should not change the definition of general advice or its use.

This being said, the existing advice labels are not helpful for consumers and do not reflect the full spectrum of advice/engagement which currently exists. Presently, there are three broad labels for advice/engagement, being 'factual information', 'general advice' and 'personal advice' and two sub-labels, being 'scaled' and 'intra-fund advice'. For most superannuation funds (and other financial institutions), the spectrum of engagement is far broader than the regulatory labels would indicate.

The levels of engagement range from a single-issue factual enquiry (such as calling the call centre to find out account balance details), the provision of factual information, general product advice, intra-fund advice, scaled advice, simple full personal advice to complex full personal advice.

Clearly, the industry has evolved significantly over time and the regulatory framework has not reflected this evolution. It would now be appropriate to properly review the advice architecture and develop appropriate labels and regulatory frameworks to properly regulate the industry and also provide transparency to consumers so they understand the nature (and limitations) of the advice they are receiving.

Underinsurance

3-75

Observation

Technological developments have the potential to reduce insurance pooling. This will reduce premiums for some consumers; however others will face increased premiums, or be excluded from access to insurance. Underinsurance may occur for a number of reasons including personal choice, behavioural biases, affordability, and lack of adequate information or advice on the level of insurance needed.

While life insurance is based on the concept of pooling, it allows considerable flexibility as to whether customers choose to be part of a wider pooled arrangement or seek individual risk rating. This compares to health insurance where the core principle in Australia is community rating or pooling.

The trend toward individual risk rating is a societal one, where some people want to be rewarded for aspects like good health and exercise habits, as measured by technology. In time, this will inevitably see some people pay more for life insurance and some pay less as they are individually risk rated or rewarded. Arguably, this is not bad policy. People will still be able to find pooled structures if they want, however the cost of cover for less healthy lives insured might be higher.

3-80

The Inquiry seeks further information on the following areas:

Does Australia have a problem with underinsurance that warrants some form of policy response? Specifically:

- How does Australia compare internationally on adequacy of insurance coverage?
- Has the issue of underinsurance been increasing over time?
- What evidence and data are available to support a conclusion about our level of underinsurance?
- What evidence and data are available to assess whether more granular risk-based pricing will lead to exclusion or further underinsurance?

If warranted, what are possible approaches to lessen the existence of, or mitigate the impact of, underinsurance?

There are two aspects to the question as to whether Australia has a life underinsurance issue.

Firstly, while international comparisons provide direction and support for policy initiatives, they must be based on consistent parameters to be relevant. For insurance, international comparisons have limited use. International studies generally show Australia to have lower levels of life insurance, but fail to take into account the elements of investment in international life products that increase premium volumes. This makes any comparison invalid. In Australia, the life market has moved to a pure life risk component. The cost of cover is the pure cost of the risk making relative premiums lower.

Secondly, underinsurance in Australia can be measured by research and surveys. There are a number of studies, which are publicly available that point to high levels of underinsurance for death, income protection and critical illness. One such piece of research is the one commissioned by the Financial Services Council (FSC), conducted by KPMG, into the level of underinsurance of Australian lives.^{xxv}

A summary of the main findings of this research is shown in the table below.

	Death insurance	Disability insurance
The typical employed person requires...	\$570,000 of death insurance ¹	84% of income until retirement in the event of disability ²
The typical person only has insurance cover equivalent to ... per cent of their adequate insurance level	68%	37%
At an aggregate level, this means the level of underinsurance of employed Australians is approximately...	\$800 billion	\$304 billion
Age group of Australians most underinsured	18-29 year olds (48% underinsured) ³	45-64 year olds (77% underinsured) ⁴
Percentage of Australians without any insurance	19% of families do not have any death insurance	35% of people do not have any disability insurance
Social security benefits that could be saved each year if Australians were adequately insured	\$29 million per annum (after taking into account foregone tax revenue)	Minimum \$340 million in the first year (even before taking into account foregone tax revenue)

Source: FSC, KPMG.

Notes:

- ¹ Based on factors such as: settlement of mortgage on family home, income replacement needs of dependent and rent for non-home owners.
- ² Based on: 75% income replacement + 9% superannuation replacement.
- ³ Compared to 31% underinsured for 30-44 and 45-64 year olds.
- ⁴ All other age groups reasonably consistently underinsured by approximately 55%.

As the table above indicates, the FSC/KPMG research found that there was underinsurance at an aggregate level of just over \$1.1 trillion for death and disability. At an individual level, the typical person was found to only have 68 per cent of the death insurance they need. For disability, the story is even worse: the typical person only has 37 per cent of the disability insurance they need.

Similarly, recent research undertaken by TAL indicates that 20 per cent of people still have no life insurance and acknowledge this is not an adequate situation, which is very worrying. According to TAL Chief Customer Service and Operations Officer Penny Coates, “[e]ven more concerning is the fact that lower income earners make up a large percentage of those who are most underinsured, yet these are the very people who can least afford the financial pressure which comes with the death, illness or injury of a member of the household”.^{xxvi}

That said, there is research that shows that the level of underinsurance is steadily reducing as the market has evolved with more life cover provided through collective superannuation schemes and directly. One such piece of research has been conducted by TAL, with the development of its ‘Australian Financial Protection Index’. The Index is the result of polling of Australian consumers from late December 2012 to mid-2013, and provides a score out of 100 to measure the adequacy of people’s insurance cover – with zero representing no cover and 100 representing full cover (and adequacy). The 2013 national score was 24.2 out of 100, however this result increased by 38 per cent to 33.5 out of 100 in 2014. This represents a promising rise in protection scores, albeit from a low base.

ASFA's view is that underinsurance continues to be a big issue for Australia and is a drain on the public purse – Rice Warner's latest Underinsurance Research Report found that it cost the Federal Government over \$1.5 billion a year^{xxvii} in social support due to life and disability underinsurance.

There is no evidence that more granular risk-based pricing will lead to exclusion or further underinsurance. The evolution of the life market has made it more efficient and offers more consumer choice.

Competitive claims payout ratios for collective schemes will be close to 90 per cent of premiums paid, for advised products, it will be close to 50 per cent and fairly similar for most direct products. Collective scheme coverage is very efficient for consumers and most offer a right to apply for underwritten top-up cover over and above the default levels. This is a good and efficient model. We believe that by the end of 2014, group insurance will account for close 40 per cent of market premium volumes and, based on the higher claims payout ratios, they may account for close to 60 per cent of all claims paid. This trend is accelerating and also reflects many consumers preferring the placement of life insurance in their collective superannuation scheme rather than a stand-alone policy.

Further points to note:

- Certain portions of the population already choose to self-insure. This has been the case for many years and should be regarded as an individual's right.
- Some people with superior genetic profiling and health might be more inclined to self-insure or to ask for a significant discount. Life insurers cannot require genetic testing but do ask customers to disclose at the time of underwriting whether they have had a genetic test. This is to ensure a level playing field, although it is doubtful whether a person with an adverse test would disclose that.
- There are many major pooled structures available to customers. People with adverse health can, if appropriately employed and meet conditions of entry, have access to these structures or to products that have pre-existing conditions with stand down periods. These products will, over time, be more expensive because they will reflect poorer health risks generally.
- High-risk individuals should still be able to obtain access to cover, although generally there will not be community rating or cross subsidisation. ASFA contends that there is no compelling argument that this will lead to further underinsurance.
- There is an ongoing public policy debate on whether health insurance should continue to be community rated or whether risk rating should be allowed. Given that there is more relevance for ratings in the health sector, there is no compelling reason why community rating for life insurance should be mandatory across the market.

ASFA considers that the main approach to lessen underinsurance should be to continue to encourage the development of multi-channel offers and customer engagement. This has favourably accelerated market growth and evolution.

Life cover in superannuation is very valuable and should be allowed to continue. It is worth noting that fund members are used to the idea of having access to insurance cover through their super fund (and have been for some time). In fact, not only are members used to this idea, but they actually place significant value on their insurance cover within their fund. It is an easy way for members to obtain insurance cover, generally at a reasonable price, and very often with little or no underwriting (particularly where cover is obtained under a group policy).

The other important point to consider is that the provision of life insurance in superannuation has delivered much better levels of cover to most working people than seen ten years ago. Most of them would have cover now but in many cases not enough.

Without insurance being provided through superannuation, many Australians would not have any insurance cover at all. Rice Warner estimates that current life insurance cover is 64 per cent of the amount needed, with disability insurance much lower again. Without insurance in super, Australia's underinsurance problem would undoubtedly be exacerbated.

That said, a legitimate public policy question worthy of consideration is: does the cost of life insurance in collective superannuation consume too many retirement benefits? ASFA considers that this question is best addressed on a scheme-by-scheme basis. It should be noted that trustees of superannuation funds are required to have insurance strategies that deal with this issue.

In some cases, default levels of cover are being reduced and optional top up cover is available for those who choose to do so. As well, schemes generally have opt-out arrangements for those who do not want default cover.

In our view, this issue of appropriateness of cover will be managed well under the current frameworks and no policy changes are needed.

In summary, ASFA considers that, notwithstanding Australia's current underinsurance problem, a policy response is not warranted at this time. The life market has evolved rapidly in competitive terms and is now accessible via direct channels and via group superannuation. ASFA contends that it remains good public policy to allow life insurance to be offered inside superannuation. Without insurance in super, Australia's underinsurance problem would be a great deal worse.

Compensation arrangements

3-86

The Inquiry seeks further information on the following area:

Given the limitations of professional indemnity insurance, what options, if any, exist for addressing the issue of consumer loss?

Following a number of collapses in the financial sector causing substantial financial loss and damage to a large number of investors, compensation arrangements for consumers of financial services have been under scrutiny. The public policy response has been under review for some time. The timeline of events is as follows:

2009	The Parliamentary Joint Committee on Corporations and Financial Services (PJC-CFS) conducted an inquiry into financial products and services in Australia. The inquiry concluded that professional indemnity (PI) insurance was inadequate protection and the merit of a statutory scheme should be examined.
2010	The government engaged Richard St. John to undertake a review of compensation arrangements for consumers of financial services and the need for, and costs and benefits of, a statutory compensation scheme.
2011	The collapse of Trio Capital raised further issues with respect to the ability of consumers to recover compensation following the failure of a financial product due to fraud.
April 2012	Release of the Richard St. John report: Compensation arrangements for consumers of financial services. The report did not support the introduction of a statutory scheme, citing concerns around the relatively limited controls or regulations over licences, in particular in solvency requirements to meet claims from investors. St. John believed that a statutory compensation arrangement would not provide the right incentive to improve the protection of retail clients by the industry.
May 2012	Inquiry of the PJC-CFS into the collapse of Trio Capital recommended that further efforts be made to find ways to protect investors in the case of theft and fraud by a managed investment scheme. While the shortcomings of a statutory compensation scheme for consumers of financial services were acknowledged, the door was not shut on this as a possible solution.

In ASFA's view, the introduction of a limited statutory compensation scheme of last resort and improvements to requirements with respect to PI insurance could go some way to resolving the issue of compensation for consumers.

ASFA's position on the creation of a compensation scheme was thoroughly explained in ASFA's submission to the St. John review of compensation arrangements for consumers of financial services. The moral hazard of a compensation scheme is significant. To ameliorate this risk, ASFA's submission to the St. John inquiry proposed that: a "segregation" model is adopted, such that each sector only bears the risk of its own part of the industry; and that a sliding scale of compensation should be used. That submission is available on the ASFA website at: www.superannuation.asn.au/policy/submissions-2011 under the June 2011 heading.

On the issue of PI insurance, ASFA proposes that the audit function is linked to ensuring adequate PI coverage is in place. The appropriateness of cover is one of the key risks in relying on PI insurance to satisfy consumer claims. The problems are that either: there was no PI cover in place; the cover was inadequate; or there was “phoenix” activity on the part of the licensee. ASFA supports making the currency and adequacy of PI insurance a matter to which auditors should attest and that this be reported to ASIC annually.

However, this approach may not be effective if auditors find it difficult to quantify risk, resulting in:

- reluctance from auditors to make the assessment
- a conservative assessment which results in excess PI cover being bought
- audit fees rising to reflect their risk of getting the assessment wrong.

As such, it may be necessary for the legislation to be amended to be more precise and for ASIC to provide guidance as to what factors to take into consideration when determining adequacy.

Given the long tail of claims, and that PI insurance is generally on a claims-notified basis, the absence of a requirement to have adequate run off cover can have a material effect. We would recommend that ASIC require run-off cover to be in place for a period of at least three years.

Product rationalisation of 'legacy products'

3-87

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Government to renew consideration of 2009 proposals on product rationalisation of legacy products.

ASFA understands that the Inquiry will receive some cost analysis on legacy products through the Financial Services Council (FSC). As such, we have not looked to cover the cost aspect of product rationalisation – either ongoing costs or one off costs of rationalisation as part of the ASFA submission. Below, we make more general observations on the potential benefits and difficulties associated with product rationalisation.

There are clear benefits of product rationalisation to members, including lower costs (primarily due to achieving greater economies of scale), improved service standards, and enhanced and new features including online transactions.

A number of reviews of the superannuation industry have identified scale as key to promoting market efficiencies and, ultimately, better outcomes for members. In assessments of the increase in the scale of superannuation funds in Australia, the common approach is to look at headline funds under management (FUM). At this level, we have seen significant FUM consolidation across superannuation providers in Australia. (Refer Figures 3 and 4 above)

However, this approach does not consider the impact of legacy products and multiple product offerings within these large organisations. These are the result of time passing – products which have been closed to new business – but also the result of mergers, where existing product ranges remain in place, both open and closed, following the merger of two large organisations.

Currently, there is no broad policy or framework of measures to support the rationalisation of legacy superannuation products and funds. The measures available predominantly relate to certain tax relief on assets transferred under a fund merger, which involves the transfer of all fund members to another super fund. For example, there is no tax relief on assets transferred where members of a sub-plan or legacy product of the fund are transferred to a different super fund.

Importantly, historically product rationalisation has been primarily achieved through successor fund transfers. The superannuation regulations require the trustees of both the original and successor funds to agree that 'equivalent rights' are provided to the transferring members in the successor fund after transfer. As outlined in the Final Report of the Super System Review, the Cooper Report, this requirement results in product complexities and other undesirable features being perpetuated and as a result "legacy products are not rationalised." And, absent tax relief and other exemptions, the trustee may not be in a position to approve an amalgamation of funds, as they are not able to demonstrate equivalent rights.

The Final Report made a recommendation that the successor fund transfer test is one of 'no overall disadvantage' rather than one of 'equivalence'.

The 2009 Treasury paper on rationalisation of managed investment schemes (MISs) and life insurance products explicitly excluded superannuation products. The rationale for this was that the superannuation industry had already undergone a period of substantial consolidation following the introduction of the Registrable Superannuation Entity (RSE) licensing regime in 2004. It was also felt that the successor fund transfer process is generally appropriate for the superannuation industry due to the fiduciary duty imposed upon superannuation trustees. In addition, Treasury felt that legacy products were not as significant an

issue in superannuation compared to other industries due to the nature of the industry and the existing transfer provisions.

ASFA believes that we should be looking at a whole-of-industry framework, which ensures that sensible product rationalisation can occur without any detriment to the interest of investors – whether they are superannuation members, life policy holders, both of these simultaneously, as is often the case, or direct investors. Given the interconnectedness of the investors across different product types, it makes no sense to differentiate the rights of investors. Many superannuation members hold their superannuation savings through a statutory fund of a life company, making them also a life policy holder. Further, super funds invest significantly in MISs and have a vested interest in ensuring they are run as efficiently as possible.

In determining whether to rationalise investment products, the primary determinant must be the interests of the member, policy holder or investor. In order for this to become practically efficient, the framework must address the issues of:

- “no overall disadvantage” as per the recommendation in the Cooper Report
- permanent CGT relief that is not linked to an MySuper or an ADA transfer
- ensuring that investors are not detrimentally impacted by any other tax/super treatment
- the deemed disposal of assets denies members the benefit of the imputation credits under the 45-day rule
- the permanent loss of any “tax-free component” of their account.

ASFA would support this approach when developing a policy and framework for product rationalisation across the financial services industry. We recommend that a broad framework for product rationalisation needs to be developed in consultation with the industry to ensure that this can occur in a considered and efficient way in the best interests of investors. We note that resolving this issue within superannuation may be easier than in other parts of the financial services industry. While we support a holistic approach, we would not be supportive of an approach that delays the development of a solution for superannuation.

Chapter 7: Regulatory architecture

Regulatory burden

3-97

The Inquiry seeks further information on the following areas:

- Is there evidence to support conclusions that the regulatory burden is relatively high in Australia when considered against comparable jurisdictions?
- Are there examples where it can be demonstrated that the costs of regulation affecting the financial system are outweighing the benefits?
- Are there examples where a more tailored approach could be taken to regulation; for example, for smaller ADIs?
- Are there regulatory outcomes that could be improved, without adding to the complexity or volume of existing rules?
- Could data collection processes be streamlined?
- If new data is required, is there existing data reporting that could be dropped?
- Instead of collecting new data, could more be made of existing data, including making more of it publicly available?

While it can be difficult to quantify costs and/or benefits in most circumstances, there are a number of examples where the benefits from particular regulation affecting the superannuation system would not appear to be justified by the costs.

Examples of this include:

APRA Prudential Standard 231 – Material outsourcing agreements	The reporting obligations for the offshoring of investment management agreements are excessive. The requirement to liaise with APRA and/or to have both internal and external audit and review of compliance with outsourcing processes, has added significant costs for funds. The costs are not just monetary – the time-critical nature of investment arrangements can often see opportunities lost as well. The benefits of this process are unclear.
APRA Prudential Standard 114 – Operational Risk Financial Requirement (ORFR) operational processes	There is an expectation that every operational risk loss is charged to the ORFR reserve, regardless of the origin, cause of the loss or materiality, and that any reimbursement of the loss by third parties can only be made to replenish the ORFR reserve. This approach necessitates the establishment of a costly and complex record keeping infrastructure around ORFR. It also means that a trustee can only make good an operational risk loss once the administrator has calculated the loss for each member. There should be scope for an administrator to directly make good an operational loss to members rather than compelling an elaborate “use and replenishment” approach. It is unclear what the benefits of a “use and replenish” approach are.
APRA – Superannuation Industry (Supervision) Act 1993, Section 29VA	APRA’s interpretation of the requirement that all members be charged the same fee is that this prohibits employers paying some or all of administration fee for some employees. To comply with APRA’s interpretation, trustees have to debit fees from member’s and receive additional employer contributions into the account. This necessitates unnecessary processes and procedures; and is not visible to members while producing the same net outcome as if the employer had paid the fees directly, as they used to do.

Trans-Tasman transfers	There is a need for people resident in New Zealand to complete statutory declarations which are compliant with Australian law – in particular the statutory declaration needs to be witnessed by an appropriate person, which generally means somebody who is Australian qualified. This is unduly onerous and is not reciprocated in the corresponding New Zealand regulatory framework which allows people resident in Australia to complete a statutory declaration, which complies with either New Zealand or Australian law.
Contribution – work tests	Members over age 65 must satisfy work tests in order to be able to make superannuation contributions. These are costly and inefficient to administer, onerous for members and ineffective in achieving the policy outcome. The ability to contribute should be solely a function of a member's age, not of their employment status. Costs for trustees include having processes and procedures in place, training, compliance verification and reporting.
Product dashboards in periodic statements	The requirement to include product dashboards, which can represent a considerable number of additional pages, in periodic statements is inconsistent with the shift to electronic communications. The additional systems, production and postage costs to include dashboards in periodic statements is significant. Furthermore, inclusion of a dashboard in an exit statement, as opposed to an annual statement, is nonsensical. Temporary relief has been granted by ASIC regarding this measure and should, in ASFA's view, be made permanent.
Accrued Default Amount (ADA)	<p>Notification – tailoring of notification to members. This disclosure is in lieu of a <i>Corporations Act</i> "Significant Event Notice" (SEN). SENs are "generic" notices sent to members with respect to a decision of the trustee (such as to wind-up the fund and transfer the members to another fund, or to increase the fees payable by members) over which the member has no control. The intention of a SEN is to disclose to a member what will occur if the member does not take some action – such action is usually, but not always, to instruct the trustee to roll-over their benefit to another fund. SENs are sent to all affected members of the fund. Unlike SENs, ADA notification necessitates individual tailoring of notifications regarding:</p> <ul style="list-style-type: none"> the amount that will be transferred – in most cases, a member's ADA will be their total account balance. Accordingly, there is nothing meaningful to be gained by disclosing the dollar amount to be transferred – it is unlikely this would influence the member's decision whether to transfer out of the fund to allow the transfer to take place. Furthermore, the actual dollar amount to be attributed or transferred will fluctuate due to investment earnings, contributions, investment switches and rollovers/withdrawals. Tailoring disclosure in this way will have a significant impact on costs, with little discernible benefit. Disclosure only needs to cover the fact that the total amount of the member's account balance will be transferred, rather than the exact dollar value. any change to a fee or charge disclosed in dollars – fees for MySuper products are permitted by the fee rules to be in the form of a percentage or a dollar amount plus a percentage. If dollar disclosure is insisted upon, this will necessitate funds having to implement a program to calculate the dollar change in fees for each member, based on an estimated account balance 90 days before

	<p>the transfer or attribution. A better approach may be to permit disclosure for a “representative member”.</p> <ul style="list-style-type: none"> any change to the member’s insured benefits – this poses similar issues as for fees (see above). Specifically, meeting the requirement would require programming of the MySuper product’s insured benefits into the transferring fund’s administration system. Again, a better approach may be to permit disclosure for a “representative member”.
Portfolio Holdings Disclosure (PHD)	<p>The original PHD disclosure proposal is too granular – the proposed extent of “look through” creates undue complexity. The resultant volume of data would not be useful to members and would be costly for funds to produce. Furthermore, there should be greater integration and consistency between PHD and asset-related data collected by APRA. As this is not yet law and is the subject of further consultation, scope exists to ensure that the approach adopted in the final regulatory requirements achieve an appropriate balance between transparency and compliance burden.</p>
Website document publication	<p>This necessitates the production and publication of a summary of SENs where publication of suitably redacted copies of the notices themselves would be sufficient and more comprehensive.</p>
SuperStream – recognition of existing capabilities	<p>There remains significant issues for resolution including the capacity to cater for existing electronic portals (bridging systems). Although some progress had been made in reducing the burden and allowing existing solutions to be used on an ongoing basis, this has been negated by the recent release of the SuperStream – pass through of employee details draft regulations. The explanatory statement for these draft regulations states that:</p> <ul style="list-style-type: none"> ‘a default fund offering a transitional ‘portal’ solution that does not currently have the capacity to ensure the delivery of all of a default employer’s contributions (including that relating to other superannuation funds), will be required to: <ul style="list-style-type: none"> » develop such a service; or » outsource the delivery of such a service to a third-party provider; or » facilitate and encourage use of data clearing via their nominated gateway provider with direct payments by the employer to target funds.
Consistency of published information	<p>The application of the legislative obligation that published information must be calculated in accordance with APRA data reporting standards has been given broad application and there are a number of implications and unintended consequences. As the operation of this provision has been suspended, pending further consultation, there is scope to ensure that it is applied in a measured way.</p>
Concept of “interdependency”	<p>The recognition of persons in “interdependency relationships” as “dependants” for superannuation purposes and “death benefit dependants” for tax purposes pre-dated wider reforms to treat persons in same-sex relationships as “spouses” and therefore as “dependents.” In light of the subsequent same-sex amendments, and the fact that potential beneficiaries were often able to make a claim to be entitled to a death benefit on the basis of financial dependency, it is unclear whether there is any continuing need for “interdependency” as a freestanding</p>

	<p>concept. Its retention creates a compliance burden, as it significantly complicates the process of claim-staking for death benefits by fund trustees, is confusing to potential beneficiaries, and has the potential to protract the Superannuation Complaints Tribunal's consideration of complaints in relation to disputed death benefit distributions.</p>
<p>'Lost member' and 'unclaimed money' definitions</p>	<p>The definition of 'lost member' for Australian Tax Office (ATO) reporting purposes has been amended numerous times in a piecemeal fashion, with each amendment introducing unnecessary complexity and internal inconsistency. For example, the sub-categories of 'returned mail' and 'inactive' lost members have been blurred through the recent introduction of an activity test into the 'returned mail' sub-category, while the test for the 'inactive' lost member sub-category requires a person to have been a member of a fund for longer than two years, but no activity within the last five years. In addition to unnecessarily complicating the six-monthly lost member reporting process for fund trustees, these definitions are difficult to clearly communicate to members. A further layer of complexity is encountered when the definition of 'lost member' is imported into the concept of 'lost member account' for unclaimed money purposes. The concepts of 'small lost member account' and 'inactive account of an unidentifiable member' cross refer to the 'lost member' definition but involve numerous other criteria which require substantial time and effort for fund trustees to work through on a member-by-member basis. It is extremely difficult for members to understand when their account balance is likely to be classified as a 'lost member account' and transferred to the ATO as unclaimed money. This is especially of concern given the proposed increases in the threshold for transfer of small lost member accounts and the potential for members to lose insurance cover when their balances are compulsorily transferred. The concepts of 'lost member' for reporting and unclaimed money purposes need to be comprehensively reviewed and simplified.</p>
<p>Proactive payment of unclaimed monies by the ATO</p>	<p>As noted above, balances of 'lost member accounts' under a threshold amount are transferred to the ATO as unclaimed monies. The amount of unclaimed money transferred is expected to increase significantly as a result of pending legislation that will increase the threshold. While the ATO can identify a superannuation account for the unclaimed money that it holds, there is currently no legislative power enabling the ATO proactively to repatriate unclaimed monies. Instead, members must initiate a claim with the ATO to have the unclaimed monies paid into a specified superannuation account.</p>
<p>Choice form obligations in cases of successor fund transfers</p>	<p>When two superannuation funds merge, Superannuation Guarantee law requires employers whose default fund is the transfer fund to reissue choice forms to employees, despite the fact that the employees will have been informed by the fund about the merger. This could be easily resolved with by amendment to legislation.</p>

APRA data reporting	<p>The current process for trustees to lodge their mandatory data returns with APRA has considerable scope for improvement. For example:</p> <ul style="list-style-type: none"> • APRA's system 'D2A' 'Direct to APRA' is not web based and does not facilitate uploading of data, necessitating considerable manual data entry • the timing of ad hoc changes to D2A should be scheduled well before period end • data which is less relevant for prudential supervision could be reported annually as opposed to quarterly • data that has also been reported to ASIC could be obtained directly from the ASIC database not reported by funds • reporting on data that is typically not stored by funds could be eliminated • duplicative and redundant (zero) reporting could be removed • for a number of data fields, greater allowance could be made for estimation as opposed to absolute precision • parameters for tolerance, error and warning thresholds could be re-established so as to minimise the number of follow up questions received and reduce the need for re-reporting. <p>It is important to ensure that the data is being provided to APRA is necessary for consumer information or regulatory oversight to deliver a better outcome for the community.</p>
ATO reporting	<p>The ATO has indicated an intention to combine its current member contribution, lost member and unclaimed money reporting into a single 'omnibus' report. ASFA is supportive of this proposal.</p>

Regulatory perimeters

3-99

Observation

The regulatory perimeters could be re-examined in a number of areas to ensure each is targeted appropriately and can capture emerging risks.

Prudential regulation of superannuation

3-103

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Align regulation of APRA-regulated superannuation trustees and funds with responsible entities and registered management investment schemes.

Regardless of the structure of the investment – discretionary superannuation or platform – the financial system should be ensuring that the entity managing the money is doing so in a sound manner, consistent with the product disclosure statement (PDS) and in the best interests of the investors.

A decision to align the regulation of APRA-regulated superannuation trustees and funds with responsible entities (REs) and registered managed investment schemes (MISs) must be consistent with the objectives of superannuation and the duty of care owed to consumers within the superannuation and retirement income systems, and that owed to consumers outside the superannuation framework. If an assessment is that the same duty of care is owed to each, then a case for alignment may be made. This would require changes to the obligations of the superannuation trustee in the *SIS Act*. Consideration would also need to be given to the use of these products within the retirement income system, and what duty of care is owed to investors using them to provide income in retirement.

The current regulatory framework for the oversight of MISs (Chapter 5C of the *Corporations Act*) was developed when there were relatively few SMSFs, choice options on master trust menus and wrap platforms. As a result, the proportion of superannuation money held within MISs was small. The reverse is true today. As at end-December 2013, 78 per cent of all consolidated assets in managed funds were within the superannuation system.

The issue of how RE obligations are regulated may need to be considered given a) the amount of superannuation monies now invested in MISs, as well as b) the amount of retirement monies which will be invested in the future. While the *Corporations Act* clearly sets out the need for the directors of an MIS to protect the interests of investors, the regulatory framework is not as comprehensive as in the equivalent APRA-regulated superannuation trust.

It is important to ensure that we review and adjust regulatory settings to ensure that there is the right level of oversight of those entities that manage money on behalf of Australians. The trust and confidence in this space is critical to the future success of the Australian financial system as a whole, not just the superannuation system. To achieve this, the regulators must have the ability to “follow the investment trail” through different structures, entities and jurisdictions.

The Inquiry seeks views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Impose AFSL requirements for providers of fund administration and technology service of sufficient scale.
- Apply market integrity rules for licensed securities dealers that provide investor services substantially similar to market participants of a licensed financial market.
- Introduce a mechanism to allow a heightened level of regulatory intensity to be applied where risk arises outside the conduct perimeter.

The application of AFSL requirements may need review given the changing nature of agents and service providers across the system and the increase in SMSFs. We note, however, that administrators do not currently have AFSLs to cover their customer contact business. This should be addressed.

ASFA believes that these policy considerations should be considered holistically to ensure that emerging risks are being identified and managed. This will become especially important with the maturity of the superannuation system as many Australians will be relying on pension payments delivered by administrators for their day-to-day living expenses. It will be unacceptable if these are put at risk.

Independence and accountability (of regulators)

Observation

Australia generally has strong, well-regarded regulators but some areas of possible improvement have been identified to increase independence and accountability.

ASFA agrees that the international reputation of our regulators is very good. The relative performance of financial institutions during, and subsequent to, the GFC did much to cement the view that the Australian system is well regulated. However, it is important that complacency does not set in to the regulatory settings. It is also important that the regulators are assessed against their ability to respond rapidly and flexibly as environment factors shift. The speed with which industries now change and are exposed to new risks – especially given the vast changes in technology – requires the regulators to lift their game to a new level.

One particular improvement that ASFA would support is post-event analysis. Over recent years, there has been little evidence of ex-post assessments of ‘failures’ or other events which have caused disruption in the financial services industry. We see great benefit in learning from mistakes. A full analysis by the regulators of what could have been done to anticipate, minimise or prevent the particular event occurring would help prevent future problems. The industry would welcome a conversation with regulators on how failure can be prevented. We recommend that, as a matter of practice, the industry and the regulators workshop emerging regulatory risks and signs of provider failure.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Move ASIC and APRA to a more autonomous budget and funding process.

Lord Hampton's key principles of effective regulation include the tenet that regulators should be accountable for the efficiency and effectiveness of their activities, while remaining independent in the decisions they take. ASFA sees the regulator's lack of autonomy in setting and managing their budget and funding process as limiting the ability of the regulator to be truly accountable. Further, we believe that accountability requires that the budget and funding processes should be more transparent.

Currently, millions of dollars in levies are paid by pooled superannuation members to fund the regulatory process. However, there is no transparency of how the funds are applied or assessment of whether there has been value for money. ASFA believes that this represents a significant shortfall in holding the regulatory process to account. This comment does not only apply to APRA, but to all regulators that benefit from the levies paid by pooled superannuation members.

As noted earlier in this submission, and in our first submission, there is now significant diversity in the ways in which Australians invest in superannuation, both within pooled funds, through choice and default options, and within the SMSF sector. We must assess the appropriate levy process at the same time as we reassess the regulatory perimeters. This needs to take into account how levies are best applied in a superannuation system that both allows significant choice, yet is highly prescriptive about the way in which default options are offered to disengaged members. In ASFA's view, levies should be paid by all regulated industries, thereby capturing the full spectrum of products offered. This is not currently the case.

This could be facilitated by a comprehensive review of the regulatory environment. This review should look at:

- the way in which the current levies are used in the regulation process. The absence of transparency results in some scepticism amongst superannuation participants that their levies are indeed being used for the purpose of superannuation regulation. Naturally enough, without transparency, some worry that the levies are used to cross-subsidise other players in the market, who are not subject to the regulatory cost regime. Transparency around the formulas used to calculate the levy amount and the detail of budgets that are funded by the levies is important to achieve a good relationship between the regulators and the industry
- the remit of regulatory oversight across each industry to ensure that the scope is consistently defined and applied. We need to ensure that the scope of the regulator is neither too broad nor too vague
- the appropriate management and governance structures for regulators given the difference between different sectors and the global nature of some
- the quality and quantity of interaction with regulated industries
- identifying and agreeing the measures of success, the feedback mechanisms and the consequences of underperformance.

We note the potential benefit of introducing greater business management practices within the regulators. The current emphasis of the regulators is on policy deliberation, as evidenced by the organisation structure. Consideration might be given to the appointment of a chief executive officer or commissioner (member) who is responsible for budgets, funding, staffing and so on.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Conduct periodic, legislated independent reviews of the performance and capability of regulators.
- Clarify the metrics for assessing regulatory performance.
- Enhance the role of Statements of Expectations and Statements of Intent.
- Replace the efficiency dividend with tailored budget accountability mechanisms, such as regular audits and reviews to assess the regulators' potential for savings.
- Improve the oversight processes of regulators.

ASFA is firmly of the view that the current arrangements are due for review and realignment. We support all of the policy options above, other than 'no change'.

At the risk of repetition, the periodic reviews must satisfy best practice requirements of accountability, through clear objectives and measures of success against which performance is monitored. The periodic reviews must include clear analysis of successes and failures, analysis of the way in which complaints have been addressed, timelines and quality of work, communication with the industry, measures of innovation. Specific measures that would be desirable include:

- the percentage of time spent on different sectors of the industry and the risk assessment supporting this
- quality of surveillance and 'shadow shopping'
- quality of consumer testing
- measures of transparency
- meaningful and regular interaction with the industry.

Observation

During the GFC and beyond, Australia's regulatory coordination mechanisms have been strong, although there may be room to enhance transparency.

ASFA notes that the performance of the regulatory sector during the GFC has resulted in the view that Australia's regulatory co-ordination mechanisms have been strong. However, there has been no transparency over how that process worked during the GFC, no transparency around any ex-post analysis of the learning from that experience. ASFA suggests that there is currently no transparency, so there is much room for this to be enhanced.

Execution of mandate

3-121

Observation

Regulators' mandates and powers are generally well defined and clear; however, more could be done to emphasise competition matters. In addition, ASIC has a broad mandate, and the civil and administrative penalties available to it are comparatively low in relation to comparable peers internationally.

An international comparison of international regulation practices shows that ASIC has less scope to penalise their regulated industry than global peers.

While ASFA has no particular concern with increasing the ability of ASIC or indeed APRA to penalise individual institutions who are not behaving appropriately, we believe that this needs to be done in the context of the outcome that it will deliver. Specifically, ASFA has the following questions:

- Is the absence of high penalties clearly linked to the failures in the system?
- Will customers be adversely impacted by any change to increase penalties?
- How is the moral hazard managed?

The efficacy of higher penalties vis-à-vis other forms of disincentives has not been well explored or assessed. It is not clear that higher penalties would have prevented any of the failures that we have seen in the financial services industry over the recent past. In the case of Storm Financial, it is unclear whether increased penalties would have made an appreciable difference. The licensee is facing considerable costs as a result of:

- the direct compensation paid to affected customers
- indirect costs of determining the compensation payable
- reputational damage which may persist for some time.

It is also not clear that Trio would have been prevented by higher penalties. Trio Capital was a case of premeditated fraud and theft manifested on a massive scale. In cases like this where a crime is being committed, it is difficult to argue that the existence of penalties would have acted as a deterrent.

The pass through of fines also raises some questions of equity for investors. If a listed company is fined, then it seems not unreasonable that shareholders bear the cost of the inappropriate conduct. In a managed investment scheme, however, are fines payable by the investment management company, which may have very little capital of its own? Or are they passed through to the investors? It is important that the end customer does not ultimately bear the cost.

Finally, with budgets tight, there is a moral hazard that agencies have a fine 'target' which they use to fund their activities. This results in a counterintuitive outcome that the regulator needs the industry to behave inappropriately to some degree to enable it to operate efficiently, whereas the best case outcome from an economic perspective is an incentive to minimise poor conduct at all times.

We must be satisfied that these three issues are addressed before increasing the penalty powers of regulators.

Talent management

3-126

Observation

To be able to perform their roles effectively in accordance with their legislative mandate, regulators need to be able to attract and retain suitably skilled and experienced staff.

ASFA agrees that talent management is a growing problem within the regulatory community and that this is a fundamental flaw in the system. However, ASFA does not believe that salaries are responsible for this problem. There does appear to be a real reluctance, particularly at ASIC, to hire industry practitioners. Anecdotally, ASFA is aware of many examples where high-quality industry practitioners have not even been short-listed for ASIC roles. Given the challenges ahead, it is critically important to review the current management resources against those needed for the future, as well as assessing the recruitment practices within the organisation to assess whether they are meeting objectives.

It is also important that the regulators are given the little flexibility to manage, and remove, underperformers.

3-128

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Strengthen competition considerations through mechanisms other than amending regulators' mandates.
- Refine the scope and breadth of ASIC's mandate.
- Review the penalty regime in the Corporations Act.
- Review mechanisms to attract and retain staff, including terms and conditions.

ASFA is broadly supportive of all the policy options above, other than that of 'no change'.

However, we note that:

- there may be a fundamental conflict with ASIC and APRA looking at competition. ASFA suggests that this should be done by the separate agency
- the increase of choice within superannuation means there are issues with the regulatory scope of ASIC: Who looks after SMSF consumer issues? Who looks after post-retirement disclosure, does ASIC or APRA have responsibility for 'following the money', particularly for global investments?
- the scope of ASIC's mandate is very broad and there may be an issue as to whether the resources are appropriately matched with the mandate.

The Inquiry seeks further information on the following areas:

- Are changes needed to strengthen and/or refocus ASIC?
- Is the current enforcement regime adequate? Does ASIC have adequate powers?
- Are there alternative mechanisms for promoting better consideration of competition within financial sector regulation?

The recent Senate Inquiry has raised a number of issues with the performance of ASIC. As noted above, ASIC has experienced some challenges as a result of poor clarity around key objectives and remit, combined with the absence of discipline that an ongoing review/ accountability process delivers.

Key issues are:

- ASIC's scope is too broad over too many industries
- current enforcement processes rely on the effective follow through by the Department of Public Prosecution (DPP)
- poor transparency and inadequate understanding of industry structures and relationships
- limited national consistency, regulatory capture, poor communication, 'fishing' expeditions, poor timeliness, an excess of overseas travel without accountability of purpose.

3.2 Emerging trends

Chapter 8: Retirement income

The retirement income system

4-8

Observation

The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.

ASFA is strongly supportive of more options being available to individuals to meet the varying risk management and longevity needs of retirement. The great bulk of superannuation accounts in the retirement phase are account-based income streams. While these meet the needs of many retirees, the circumstances of other retirees mean that their risk management needs are not well met. In particular, account-based income streams do not necessarily deal well with the financial consequences of longevity or investment return variability.

In Section 2 of this submission, we discuss how we meet the challenge of developing the right policy design for retirement income in Australia.

4-25

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an ageing population:

- Maintain the status quo with improved provision of financial advice and removal of impediments to product development.

ASFA's views on these issues are covered above in Section 2.4. It is ASFA's view that this is the very least that is required. Both improved financial advice and removal of impediments to product development are important for supporting more options for retiring Australians.

The purchase of retirement income products is generally heavily influenced by the provision of financial advice. This supports the need for policies that ensure that the advice provided is high quality and that the adviser is well educated on a range of financial products and options. This is becoming more important with increases in:

- the number of fund members
- the average size of account balances
- life expectancy.

Advisers must have the requisite skills to deal with the varying needs of retirees and these skills must evolve at the same speed as developments in retirement income products.

Earlier in this submission, ASFA supported a policy of higher educational standards and other measures designed to safeguard the trust of clients and raise the standards in the financial advice industry.

In our first submission to the Inquiry, we advocated the removal of current impediments to achieve a

broader range of retirement income products. Existing impediments mean that the current retirement income products on offer are largely limited to account-based income streams, term annuities and life annuities. Some financial advisers are less familiar with life annuities and this may mean that they are not as widely considered as an option in advice provided to retirees. On the demand side, it may also be the case that the customer does not want to use annuities to generate their income stream, for a variety of reasons, including the desire to leave a bequest.

ASFA considers it imperative that the regulatory approach to approving these products is principle based rather than product specific. The example of deferred lifetime annuities (DLAs) and how they are currently treated in superannuation regulations and for taxation purposes highlights the nature of impediments to new products being provided.

Australia is not alone in the need for regulatory and taxation reform for such products. For instance, recent changes have been made in the United States of America to accommodate the provision of deferred lifetime annuities through the structure of 401(k) retirement savings accounts.

- Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.

As indicated in Section 2.4 above, the provision of incentives to encourage retirees to purchase products dealing with longevity and associated risks would be desirable, but ASFA appreciates that any decision to introduce such incentives would be subject to Budget priorities and constraints.

When there was a full and then a partial Age Pension asset test exemption for certain lifetime or very long-term duration income streams, purchases of annuities were very much higher in number and aggregate dollar value. Once the partial exemption was discontinued for the purchase of new products, the take-up of such products dropped very substantially.

However, clearly there would be a need to balance the cost of any means test concession against the public policy outcomes such as enhanced private incomes at advanced ages with lower Age Pension expenditures. At the very least, there is a case for special means test treatment for the Age Pension of deferred lifetime annuities and like products, which acknowledges the special characteristics of such longevity products such as no access to capital at all and even no access to income for a lengthy period. Exempting such products from inclusion in the asset or income test during the deferral period would provide neutrality of treatment relative to other retirement products. That said, appropriate controls would be needed, so as to avoid estate planning and other strategies such as arrangements within SMSFs that do not provide any genuine pooling of risks.

- Introduce a default option for how individuals take their retirement benefits.

As indicated in Section 2.4 above, ASFA considers that trustees should have the ability to default members to a retirement income stream but there should not be a requirement to do so. Trustees should exercise their fiduciary duty to consider longevity, market risk and inflation risk in designing post-retirement arrangements in much the same way they need to consider investment risk and insurance needs throughout the accumulation stage.

There also would be a need to deal with a range of practical issues. Current legal impediments in regard to when and how disclosure is made and member consent obtained need to be dealt with. Funds also

would need to have reliable processes to determine when fund members have retired as cessation of contributions is not necessarily evidence of retirement even when a person is over preservation age. Indeed, retirement is increasingly becoming a fluid concept, with many people returning to the work force on a part, or even full-time basis, after a break in employment. Details of a bank account for payment of income stream benefits also would be needed, or an equivalent destination for the payment of benefits put in place. There also would be a need to have in place arrangements to allow an individual to opt out from a product that they have been defaulted into without adverse consequences to the member.

As well, the overriding goal should be that fund members have the knowledge and advice at the time of retirement to make the best choice for them. Such choices might include access to a MyPension or other standard retirement income product, but it should be up to the trustee to determine which products are offered and how they are offered. Funds offering a MySuper accumulation product should not be required to offer a MyPension product as the trustee may have other arrangements in place involving, for instance, informed choice by members supported by financial advice.

- Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).

As indicated in Section 2.4 above, ASFA does not support the mandating of particular retirement income products. Product design and arrangements for offering them to members should be the responsibility of trustees who take into account the characteristics of the fund membership and exercise their fiduciary responsibilities. Equally, members should not be required to purchase particular retirement products. Rather, fund members should be informed of, and have access to, more, and better, retirement solutions. This can include default arrangements where the fund member can opt not to take-up the default option or to switch to another product (or to a lump sum benefit) at some later point.

One or even several retirement products will not necessarily be suitable for all fund members given their differing needs and varying financial and other circumstances.

Retirement income products

4-25

Observation

There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.

ASFA strongly agrees with this observation. ASFA has previously published material that sets out what these impediments are and what some possible solutions are.

Barriers to product development

4-31

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.

ASFA does not support such an option.

- Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-tests.

A principle-based approach should be taken as otherwise innovation would be stifled and there would not be equitable treatment of different products. In order to achieve this, substantial redrafting of SIS regulations and other legislative provisions might be required as the current regulatory arrangements tend to be very product specific.

Where relatively minor changes to SIS regulations would be sufficient to support the offering of products such as DLAs then the removal of current impediments to DLAs and like products should not be delayed by substantial redrafting of SIS to be more principles based in this area.

There is a clear case for the substantial redrafting of the SIS regulations given that they have progressively become complex and prescriptive, and include provisions that have largely or wholly had their effect expire.

- For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and Age Pension means-tests treatment of retirement income products.

Currently, product providers need to seek approval or clarification from APRA, ATO and Centrelink as to how a proposed new product will be treated. At times, there can be inconsistencies between the

regulators in how they view a product, with differing treatments for, say, tax and Centrelink purposes. There should be a 'one-stop shop' involving all regulators when approval for new products and clarification of tax and social security treatment is being sought.

More specifically, there should be a clear statement of policy intent in terms of having an appropriately flexible retirement income choice to guide regulators. As such, it may be appropriate to set up a forum or body, which represents all of relevant regulators, along with the policy departments. This would allow regulatory issues to be considered in a wider context, rather than through the lens of each regulator and government department. As far as reasonably practicable, this should provide a one-stop shop for considering innovative retirement income options, and ensure a consistent approach.

Such an approach would be consistent with the intention of the government to eliminate any unnecessary red tape for businesses. It would also mean that new products and options could be offered to consumers. Costs would be reduced through use of a one-stop shop approval process, leading to more competitive pricing for consumers. It would also facilitate the entrance of new providers of longevity products.

- Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.

The issuing of long dated and/or indexed bonds has been recommended or proposed by a number of commentators on the Australian retirement system. For instance, the Henry Tax Review's Recommendation 21, amongst other things, proposed that the government should support the development of a longevity insurance market within the private sector including through issuing long-term securities, but only where this is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance.

Currently, the Australian Government issues both standard and indexed Treasury bonds with maturity dates out to 2033 for standard bonds and to 2035 for indexed bonds. Maturity dates currently appear to be set more with an eye to facilitating the funding of the requirements of the Australian Government than to supporting directly income streams in retirement.

Maturity dates and types of bonds issued should be set in a way which, while meeting the funding needs of the government, also facilitate the support of income stream products that offer longevity and inflation protection for retirees.

The Inquiry seeks further information on the following areas:

- Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?

Group self-annuitisation arrangements involve many design, disclosure and equity issues. They have been discussed in extensive academic literature, are being considered in some countries but are yet to have any significant market impact. 'Defined ambition' (DA) plans also have been canvassed as options in some countries.

A DA plan is essentially a hybrid plan that has characteristics of both a traditional defined benefit (DB) plan and a defined contribution (DC) plan. Similar to DB plans, DA plans accrue benefits according to years of service and salary. The primary difference between the two is that when a DA plan's assets or longevity changes, the benefits are revised downward in poor times and conversely can be revised upward in good times. For example, if life expectancy increases, the plan can increase the retirement age and make adjustments to retirees' benefits. Similarly, when a negative financial shock hits the plan, the benefits can be reduced.

Where self-annuitisation arrangements and/or defined ambition arrangements sharing investment risk are being considered, it is normally as a replacement for a DB scheme rather than as a retirement solution flowing out of a DC regime. Such arrangements essentially need a large and relatively stable group of participants in order to provide predictable outcomes for those who form part of the group. Their sale or distribution on an individual basis would involve many issues, including whether individuals would be allowed to commute such arrangements and, if so, on what terms a commutation or transfer of benefit could be made.

If such products were offered in Australia, it would be crucial that potential purchasers received meaningful disclosure about what reliance on the specific mortality experience of the members of the group arrangement implies for future access to benefits and the amount of benefits that might be provided.

There also would be challenges in setting appropriate entry and exit prices for members of such products as there is no entity standing behind such arrangements providing a guarantee of benefits.

In summary, such products would need to be well regulated from both prudential and disclosure perspectives. It should be left to fund trustees to decide whether offering such arrangements was consistent with their fiduciary duties to fund members.

- If part of retirees' superannuation benefits were to default into an income stream product, which product(s) would be appropriate?

As previously indicated, this should be a decision for the fund trustee in each case, having regard to the demographic and financial characteristics of the fund membership, and the advice and other services being provided to fund members.

- Will the private sector be able to manage longevity risk if there is a large increase in the use of longevity-protected products? How could this be achieved?

The private sector should be able to manage longevity risk, even if there is a large increase in the use of longevity-protected products. Capital is available to back longevity products, provided that it is possible to appropriately price such products and that regulatory requirements are not unnecessarily onerous. There also will be the possible use of reinsurance arrangements, harnessing the capital and capabilities of overseas reinsurers. The potential supply of longevity products is more about the pricing and regulation of longevity insurance than any inherent capacity issue.

- Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?

For a government to be justified in increasing its provision of longevity insurance, there would be need to be evidence of market failure in terms of the private sector provision of such insurance. There is no reason to believe that, given appropriate policy settings, the private sector would not be able to provide longevity insurance. There is no evidence of market failure, more failure of regulatory and tax provision which currently inhibit the offering of such products.

As well, the government is already a very large provider of longevity insurance in the form of the Age Pension and through defined benefit pensions to public servants, and further expansion of those liabilities would not be consistent with sound financial management. It would also potentially raise significant inter-generational equity issues, with future workers potentially bearing the cost of longevity insurance for current workers.

- What are some appropriate ways to assess and compare retirement income products? Is 'income efficiency' a useful measure?

'Income efficiency', as defined in the Interim Report, is only one measure of the relative performance of a retirement income product and should not be the only measure used. It is a very narrow metric, which only compares the amount paid in with the expected amount to be paid out.

A number of other characteristics of a retirement income product also generally will be relevant to potential purchasers of such a product. A more balanced and appropriate approach would be for fund members to be provided with meaningful and comprehensive information and advice about retirement products, including through online calculators and by the use of product dashboards in product disclosure materials.

Chapter 9: Technology

Regulation in a digital environment

4-41

Observation

Technological innovation is a major driver of efficiency in the financial system and can benefit consumers. Government and regulators need to balance these benefits against the risks, as they seek to manage the flexibility of regulatory frameworks and the regulatory perimeter. Government is also well-positioned to facilitate innovation through coordinated action, regulatory flexibility and forward-looking mechanisms.

As observed by the Inquiry, technological innovation is a major driver of efficiency in the financial system and those efficiencies can benefit consumers.

Both the government and regulators have a role to play in facilitating technological innovation, be it through providing flexibility in the regulatory frameworks or providing leadership and supporting coordinated action by industry segments. However, in doing so, care needs to be taken to ensure that, where practical, any new requirements are principles-based and not prescriptive regulation that mandates specific technical requirements/standards. This is particularly the case where the regulated interactions are B2B (business to business) or B2C (business to consumer).

One key area in which technological innovation could be supported by the government is in ensuring there are minimum security standards for all participants in the financial services sector. This could be facilitated through the introduction of a commercial certification regime. Should the market fail to deliver an appropriate authentication method, the government could consider mandating the use of AUSKey by all participants in the sector.

Technology neutrality

4-44

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Amend regulation that specifies using certain technologies with the aim of becoming technology neutral. Amendments should enable electronic service delivery to become the default; however, they should include opt-out provisions to manage access needs for segments of the community.
- Adopt a principle of technology neutrality, for future regulation recognising the need for technology-specific regulation on an exceptions basis. Where technology-specific regulation is required, seek to be technology neutral within that class of technologies.

Technology neutrality has many faces. At one level, it is the ability of an entity to determine how an activity is undertaken. For example, should payments only be made electronically or should cheque and cash payments be permissible?

At another level, for any given technology, should there be restrictions on which specific solution can be adopted? For example, for electronic payments, should electronic funds transfer (EFT) be mandated or should an entity have the right to specify that only BPay is acceptable? Similarly, in electronic transactions, should only the data requirements be specified or is it also acceptable to specify the programs that are to be used to format and transport the data?

Similarly, in implementing a solution, should all entities be using big blue boxes or is the hardware/firmware of any supplier permitted?

ASFA argues that there is no 'right' answer. Essentially, the preferred position will depend on a number of factors including the ultimate goal being pursued, the nature of the matter being regulated, the relative sophistication of the parties and the particular part of the process being regulated.

It is worth noting here that innovation is controlled by the marketplace, not governments. Facilitating technology neutrality allows true innovation to occur. It enables the core principles to be held while the delivery methods/frameworks evolve. For example, while the banking systems new Real Time Settlement facility for payments within or between banks does not meet the legislated requirement for SuperStream payments to be made by EFT or using BPAY, it does meet the policy objective of electronic payments.

With respect to the proposal for no change to current arrangements, this would be welcomed by some segments in the superannuation industry given the current changes being implemented and the need to allow these changes to bed down so that benefits of the change can be measured. However, that is, at best, an argument for a pause. It is not an argument for "no change". The search should continue for improvements that can be made. However, any changes proposed should come from an implementation position of technology neutrality where that is achievable given the nature of the industry and the task being addressed.

With respect to the proposal to amend existing regulation that is not technology neutral, ASFA considers that there is such a need and it should be given priority.

ASFA would support a move to regulatory settings that enable the electronic service delivery of notices and information to become the default, providing they contain opt-out provisions for those people who do not have access to, or are unable to use, the technology.

The benefits flowing from such a change include processing efficiencies, more timely communication of key information, cost savings and the environmental benefits of being able to move away from paper-based communications.

ASFA considers that for B2B and B2C transactions, principles-based standards should be the default. However, if policy suggests that technology-specific regulation is required, such a proposition should be subject to wide community consultation prior to a final determination being made and the reasoning for the final decision should be published.

Where regulators have the power to deliver a technology neutral outcome, inconsistency in how an individual regulator applies that power can impact on cost. The following is but one example of current regulatory inconsistency regarding electronic disclosure and the cost impact of mandating technology specific requirements.

Example 1: *Corporations Act* disclosure requirements

ASIC Regulatory Guide RG 221 states at 221.3 that, while the *Corporations Act* expressly permits the online delivery of financial services disclosures, ASIC understands that some providers have been discouraged from doing so because of uncertainty about what specific practices the law allows. The Regulatory Guide goes on to state that it takes a technologically neutral approach to financial services disclosure and does not mandate the delivery of financial services disclosures online. However, there are a number of obstacles in the current regulatory financial disclosure environment which impede the wider use of electronic disclosure. These are:

1. Obtaining of consent

What is consent?

There is a requirement to obtain consent from the member prior to issuing electronic disclosure. However, in the common situation where, in accordance with the operation of the *Superannuation Guarantee (Administration) Act 1992* (SG Act), employees failing to exercise choice are enrolled by the employer in the employer default fund, the absence of a member-initiated application process requires a separate process to obtain the necessary consent.

As ASIC has stated that consent must be express and not implied, funds cannot assume that because a member or their employer has provided an email address that they would like to receive all of their disclosure via electronic means. That is, in the absence of express consent, funds cannot access the ASIC relief regarding electronic disclosure. While this chapter is based on the premise that ASIC is correct in its view on consent, note should be taken of the material in Chapter 6, which challenges the ASIC position.

The table below sets out ASIC's approaches whereby consent is required for some electronic disclosure but not for others. While the reasons behind this inconsistent approach are risk based, consideration needs to be given to whether the disadvantages of continuing to use paper based disclosure outweighs these risks.

Disclosure	Regulatory requirement <i>Corporations Act</i> and Regulations	Member consent required before issuing electronic disclosure?
Financial service guides	S. 940C, Reg. 7.7.01	Yes. Consent must be express and obtained prior to delivery, otherwise paper delivery.
Statement of Advice	S. 940C Reg 7.7.01	Yes. Consent must be express and obtained prior to delivery, otherwise paper delivery.

Product disclosure statements	S. 1015C and Regs. 7.9.02A and 7.9.02B S1016A	Yes. Consent must be express and obtained prior to delivery, otherwise paper delivery.
Financial service guides	s940C, Reg. 7.7.01	
Annual reports	s 1017DA(3) Regs. 7.9.75A(3), 7.9.75B and 7.9.75BA	No, provided the annual report is made available on the website with a free opt out for paper, if requested. This option must be communicated to <i>all</i> members.
Periodic statements	s1017D(6)(b) and regs 7.9.75A(2) and 7.9.75B	Yes. Consent must be express and obtained prior to delivery, otherwise paper delivery.
Ongoing disclosure of material changes and significant events	s1017B(3)(b) and (c) and regs 7.9.75A(1)(a) and 7.9.75B(1)(a)	Yes. Consent must be express and obtained prior to delivery, otherwise paper delivery. Note: New regulations now require all significant event notices to be up on a fund's website without a member's consent. However the requirement to notify members individually still applies, even though this material is generic.
Confirmation of transactions	S 1017F(6)(a)(ii) Reg 7.9.63I	No. Note: If the provider chooses a standing facility, it can provide disclosure electronically through that standing facility without obtaining consent. However, members must first be advised of the existence of the standing facility prior and given the opportunity to advise that they do not wish to receive confirmations this way.

ASFA considers that, in the superannuation context, consideration needs to be given to the difficulty of obtaining consent due to the unique features of the superannuation industry and, in particular, the choice of fund rules in the SG Act, which effectively mandate the process under which many existing members are enrolled. Consent issues in superannuation include the following:

(a) *Obtaining consent – new members*

Under the operation of the SG Act, employers are required to provide new employees with a choice of fund form advising them, in writing, of the fund to which their SG contributions will be paid, should the member fail to nominate an alternate fund. As there is no requirement for the employee to return the choice form, there is no opportunity to obtain written consent regarding electronic communication.

Thus, new employees who fail to nominate a chosen fund are enrolled in the employer default fund by the employer and there is no member consent to electronic communication.

The experience of funds which attempt to obtain the necessary consent from these employer-enrolled members is that, despite extensive and expensive letter writing and electronic campaigns, fewer than 20 per cent provide the necessary consent.

Noting again the concerns raised in Chapter 6 regarding ASIC's views on the need for express

consent, ASFA recommends that the legislation provide that an employer can provide email addresses obtained by them from the employee and that, if necessary, legislation be changed such that the fund can use the email address as the default mechanism for delivery of general information notices. The provision could operate in a similar manner as applies for the provision and use of TFNs under Part 25A of the *Superannuation Industry (Supervision) Act*.

As an alternative, consideration could be given to enabling the ATO, as part of its SuperTick service, to provide a taxpayer's email address (where held) to a superannuation fund for the specific purpose of facilitating the electronic delivery of mandated disclosure material.

(b) *Obtaining consent – existing members*

Existing members in large employer-sponsored funds also have joined via the default funds process and, as they were enrolled by their employers, there is no opportunity to obtain prior consent. There is also no opportunity for these members to have joined via the new electronic portal technology. Thus, for these members, there is no alternative but to provide paper disclosure unless they have responded to a campaign to go paperless which, as discussed above, is expensive, usually has a low response rate and is thus not a cost effective method.

There is evidence from surveys of members that many 'paper-based' communications are not opened by them. Readership of a communication is driven more by engagement levels than the medium of that communication. It is arguable that newer forms of communication media have the potential to increase readership through an increased ability to engage.

(c) *Obtaining consent – writing to members*

For large funds, though it is feasible to write to their members seeking consent to electronic disclosure, for those funds with in excess of one million members, this is a costly exercise. These initial costs are exacerbated as experience shows multiple paper-based follow-up mailings are also required.

ASFA recommends that, for existing members who are moved to a MySuper product, consideration should be given to amending the prior consent requirement. This is due to the enhanced trustee duties with respect to such members, which both recognise and address such members' lack of engagement with their superannuation.

2. *Inconsistency in legislation and the regulatory relief governing electronic disclosure provided by ASIC*

ASFA acknowledges that ASIC has attempted to facilitate the use of online disclosure by discussing the delivery mechanisms allowable and by giving relief to facilitate the delivery of product disclosure statements (PDSs) and financial service guides (FSGs) through electronic hyperlinks.

There is also an opt-out provision if electronic disclosure is offered (subject to prior consent) to assist those members without ready access to the internet or who do not feel comfortable using it. However, the current reach of electronic devices into the general community is such that there are limited numbers of members without the access or inclination to use electronic devices.

In comparison, ASIC has not given relief for Statements of Advice (SoAs) to be delivered via hyperlinks. In reaching this position, ASIC has drawn a distinction between private and public disclosure. Its belief is that clients would be exposed to security risks such as phishing where SoAs are delivered as hyperlinks.

ASFA, in seeking regulatory reform, would argue that, when the differing disclosure consent requirements in the above table are considered, the risks and differences between the approaches are not clear.

As a minimum, ASFA would argue that a distinction should be made on the basis of whether the information is generic (such as a PDS or an FSG) or individual/personal (such as an SoA or the member's annual statement) with the electronic default applying to generic information.

However, we would argue that it is possible to go further (and still address the security risks). The ability to act on a communication in an individual way could be limited to secure electronic means (for example, a PIN-protected website) or via paper.

What is electronic disclosure in the superannuation area?

A super fund's normal regulatory disclosure documents include periodic statements, PDSs, significant event notices, annual reports, standing facility for confirmation of transactions and FSGs.

Currently, consent from the member is required for all electronic disclosure, apart from annual reports and standing facilities (both of which have notification provisions and opt outs).

The delivery methods of electronic disclosure include:

- member emails
- member emails with hyperlinks to the fund's website
- the fund's website.

The first two points listed above require members' email addresses that must have already been given to the trustee (for example, through the application process).

As noted earlier, many members have not had the opportunity to provide their email address to the fund as they are enrolled by their employer.

For these members, and absent subsequent notification of an email address, website disclosure would appear to be the only practical disclosure that would be able to be used. ASFA recommends legislative change to facilitate such an outcome.

What are the potential cost savings of moving to electronic disclosure in the superannuation area?

The following approximate costs have been provided by an ASFA member fund with 1.5 million members. It sets out the current cost of specific member communications and the comparative cost should regulatory change permit and facilitate the disclosure to be electronic by default.

Disclosure item	Cost of paper delivery	Cost of electronic delivery
Financial service guides	No figures available	No figures available
Statement of Advice	\$1,680,000	\$75,000 if emails used
Product disclosure statements	\$1,680,000	\$75,000 – emails
Annual reports	Nil (statutory relief – website)	Nil (statutory relief – website)
Periodic statements	\$2,444,000 million per annum	\$302,644.80 per annum – emails
Ongoing disclosure of material changes and significant events	\$1,225,000 per mailing per event	\$75,000 per mailing per event – emails
Confirmation of transactions	\$1,350,000	\$90,000 – emails

3. **Different laws adopt differing approaches**

In addition to the difficulty of obtaining consent, there is the difficulty of some regulators adopting a technology neutral approach and others not. ASFA considers that, to promote efficiency, the government should adopt a whole-of-government approach to technology neutrality and require that approach to be followed by all regulators. As a minimum, ASFA argues for a consistent approach by regulators of financial services providers.

It is further recommended that, as a starting point, the government consider reviewing the provisions of the *Electronic Transactions Act 1999*, *Electronic Transactions Regulations 2000*, *National Consumer Credit Protection Act 2009*, *Corporations Act* and *Privacy Act*, to facilitate a move to a default position of electronic disclosure.

The government has a key role to play in facilitating innovation through co-ordinated action, regulatory flexibility and forward-looking mechanisms.

4. **Recognising that the opt-out should operate as the safe harbour, as opposed to using paper-based disclosure as a default**

In its regulatory approach, ASIC has put the risk back to the providers in terms of ensuring that any technological solution does not expose their clients to undue risk of scams and fraud.

ASFA considers that such risks are manageable through the adoption of appropriate opt-out processes. However, such an option cannot be pursued without first legislating for default electronic disclosure.

With respect to the final option – to adopt a principle of technology neutrality but where technology-specific regulation is required, seek to be technology neutral within that class of technologies. The following is an example of when such a principle is both appropriate and necessary.

Example 2: superannuation contributions and rollover benefits

While technology neutrality has much to commend it, there will exist circumstances where such an approach will not deliver an optimal outcome. One example of where achieving an optimal outcome required avoiding technology neutrality is the payment of superannuation contributions and the rolling over of superannuation benefits.

The implementation of the SuperStream Data Standards for rollovers and contributions and payments processing is an example where a degree of absence of technology neutrality is both desirable and necessary if the outcome is to be achieved. The implementation of the data standards was primarily aimed at overcoming the difficulty faced by Australia's 650,000 employers flowing from the decision to permit employees to nominate the fund into which their superannuation contributions were to be paid.

It also provided an opportunity to address the complicated tax and business rules associated with superannuation. The task of connecting over 600,000 funds and 650,000 employers necessitated the mandating of a technology solution that on some levels was not technology neutral and at other levels limited the range of technologies that could be used.

At the payment level, the capacity to accept EFT payments is mandated with respect to funds while the option is open for employers and funds to use BPay. Cheque cash payments are not approved methods of paying superannuation rollover benefits or employer superannuation contributions.

On the data side, the mandated method of preparing data is using the open standard XBRL and the mandated method of transporting data is using the Applicability Statement 4 (AS4) Profile of the ebXML Messaging Services (ebMS) 3.0 open source standard.

Avoiding technology neutrality in the context of paying superannuation contributions is seen as necessary for the efficient operation of the system due to the enormity of the task of connecting such a large number of players with vastly differing capabilities. A further advantage is that avoiding technology neutrality enables a large range of entities to compete on a range of levels in providing solutions to employers and funds. However, on the negative side, it needs to be recognised that, in individual cases, the impact may be negative in the situation where efficient existing processes are replaced by costly-to-implement standardised processes.

4-45

The Inquiry seeks further information on the following area:

- What specific regulatory and legislative requirements should be prioritised for amendment in relation to technology neutrality?

As set out in the previous section, ASFA has identified as a priority area for legislative change with respect to technology neutrality, the financial services disclosure requirements in the *Corporations Act* and Regulations.

ASFA recommends that:

- a technology-neutral approach be adopted for financial services disclosure
- the default be electronic disclosure with opt-out for all types of generic disclosure. This would ensure consistency across the superannuation industry
- research be undertaken to develop methods of facilitating default electronic disclosure and electronic methods of contacting employees
- a distinction be drawn on default electronic communication between generic information and individual/personal information, with the default only applying to generic information and potentially individual disclosure (with appropriate risk protection).

Facilitating innovation

4-51

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- Establish a central mechanism or body for monitoring and advising Government on technology and innovation. Consider, for example, a public-private sector collaborative body or changing the mandate of an existing body to include technology and innovation.
- Establish a whole-of-government technology strategy to enable innovation.

The Inquiry seeks further information on the following areas:

Are there specific areas in which Government or regulators need to facilitate innovation through regulation or coordinated action? For example, by facilitating the development of central utilities?

Superannuation is an area of heavy and pervasive government regulation. There are strict rules as to how superannuation trustees must manage funds, who can be members, what monies can be received and how members may access their benefits. There are also extensive reporting obligations imposed with respect to information provided to members and to the regulators.

Separately, there is an obligation on every Australian employer to contribute to superannuation funds for the benefit of their employees.

Another key feature of the superannuation industry is the number of service providers utilised to support operations.

Superannuation is an industry with a large number of participants with a diverse range of capabilities. But yet, fundamentally, those entities are undertaking a limited number of repetitive interactions: contributions, rollovers, investments, insurance and reporting.

The governance of the superannuation payments system needs to be addressed due to the following:

- the diverse range of participants
- the need for payment and data transfer efficiency
- the large number of transactions
- the move into 'drawdown'.

There is a need to move away from bespoke solutions to an economy-wide solution that will deliver benefits that would not otherwise be achieved.

Accordingly, ASFA recommends that the government facilitate a 'statutory self-regulatory' approach to the development and governance of superannuation industry standards and infrastructure through the establishment of an industry-based body operating under a legislative mandate.

We note the progress made to date with the government directing the ATO to involve itself in the management of the SuperStream Transaction Network. In playing such a role and in its provision of the tax file number checking services, SuperTick and EmployerTick, and the Fund Validation Service (FVS) (used for confirming a superannuation fund's electronic address and bank account details), the ATO is firmly 'in-line' in the B2B transaction process for superannuation contributions and rollovers. Given that the ATO is also the setter of the data standards, it has become the pivot point for ongoing change control and change management of contribution and rollover processes. However, this position may not be sustainable and, as such, it is timely to revisit a governance body.

Given the centrality of the SuperStream Transaction Network, its operational integration with ATO services and that the network's operation is based on ATO mandated standards, ASFA considers that there will be a need for the ongoing direct involvement of the government in the network's governance arrangements.

ASFA recommends that the government revisit its decision to pass control of the governance arrangements for the SuperStream Transaction Network to an industry established body from mid-2016.

Despite the advances made by the introduction of the rollover and the contribution and payment data standards for superannuation, inefficiencies that could be solved by the smart application of technology still persist. Superannuation interactions with the following key client groups present opportunities for the smart application on an industry-wide basis of technology solutions to common problems and processes that would reduce the costs to all participants:

- superannuation fund members themselves
- providers of insurance services to funds and their members^{xxviii}
- providers of investment and custodial services to funds.

What is required is a common framework to underpin these common transactions.

For exchanges of data with government agencies such as APRA and the ATO, the data format and transfer method are both mandated, producing efficiencies and therefore economic benefits to the recipient government agency.

ASFA considers that there are sound public policy grounds for requiring the superannuation industry to develop and implement data standards for other common industry transactions so that similar economic benefits can accrue. Achieving this would necessitate the establishment of a body with the capacity to identify appropriate transactions, develop and maintain the data standards while also being able to mandate their use.

Considerable work has been, and continues to be, undertaken by ASFA in determining the necessary features of such a framework within which such work could be undertaken.

The work considers the question: "what should the regulatory and structural framework of an industry data and payment standards and infrastructure governance body be?" As part of the process, the following issues (among other things) are being considered:

- Historical analysis: What has and hasn't worked so far and why?
- Is there an identifiable starting point?
- Scope of role: What should the body do? A standards-setter or should it have a wider mandate?
- Nature of the body: What legal status or legislative backing should it have?
- What ownership structure should it have?
- Powers: What coercive or enforcement powers should it have (if any)?
- Would a self-regulatory model work?
- Is a co-regulatory model needed?
- Could a pure statutory model work?
- Composition: Who should be represented on such a body?
- Accountability: To whom should the body be accountable?
- Funding: How would the body be funded?
- Comparable models: What models have worked here and overseas?

The initial focus of the work was not on the underlying work of the body but rather the optimal form of the body; structure, powers and governance. What would a credible and effective industry-based body that can discharge its mandate to the satisfaction of wider stakeholders, including government, actually look like?

The broad conclusions from the work to date are:

- A purely self-regulatory model will not work for superannuation as the industry is too heterogeneous, unused to cooperation, and involves wider stakeholders such as employers.
- The government is already embedded in this space through the role played by the ATO in developing and maintaining the data standards for rollovers and for contributions payments and data and its governance role with respect to the SuperStream Transaction Network.
- Australia needs a 'statutory self-regulatory' approach to the development and governance of superannuation industry standards and infrastructure where an industry-based body operates under a legislative mandate.
- As the superannuation payments network is a payments sub-system that is not systemically relevant from a financial stability perspective, it should not be connected to the RBA's payments system responsibilities.

In considering what an appropriate model might look like, consideration was given to the suitability of mirroring existing regulatory structures such as the Australian Accounting Standards Board (AASB) and the ASIC Markets Disciplinary Panel.

The conclusion reached to date is that an appropriate approach would be to create a new statutory body like the AASB, connected to APRA and funded out of the APRA supervisory levy. Like the AASB, standards made by the new body would, ultimately, have the force of law, although they would be similarly disallowable by Parliament as legislative instruments.

Importantly, the development framework for any further mandated data standards should follow the current SuperStream path and ensure such standards are appropriately based on the latest version of widely used open source standards, thus facilitating the integration of new technologies.

However, as noted above, the superannuation industry relies heavily on third parties for the delivery of services, thus complicating the development and implementation of technology solutions to superannuation processes.

Resolving this issue will require a mechanism to include those other voices. The challenge for such a superannuation industry focused model will thus lie in ensuring when new standards are developed that may impact the broader community, that the requirements of those other voices are acknowledged. That is, the challenge is to ensure the development of data standards is not dictated, or driven by one industry sector, or by a few players within a sector but rather with a view to the broader needs of all impacted sectors, a clear understanding of the business problem being addressed, and based on clearly defined public policy objectives.

The government has a role to play to facilitate and direct change based on clear public policy objectives, especially where there is evidence that the sectors themselves are unable to unite and coordinate to deliver the desired public policy outcomes.

The further challenge for government is to ensure that the adoption of new technologies is not inhibited and that their adoption is facilitated where that is required.

We note that, in the case of the banking industry, the Australian Payments Clearing Association (APCA) provides the capacity for its members to cooperate on the development of technological solutions and then require entities wishing to engage with APCA members to agree to adopt those technologies and also comply with specific conditions of participation. Such an arrangement is supported on the basis that banking is a public good and it is in the public interest to have an efficient banking sector.

Similar arguments may be made for a similar body for the development, implementation and maintenance of standards for a superannuation system into which government mandated contributions must be paid.

Digital identity

4-70

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

Develop a national strategy for promoting trusted digital identities, in consultation with financial institutions and other stakeholders.

4-71

The Inquiry seeks further information on the following areas:

- In developing a national strategy, what should be the respective roles, responsibilities and expectations of Australian public and private sector organisations in creating, accepting and maintaining the digital identities used by Australians?
- Is there a need for Government to enhance identity authentication by facilitating interoperability standards in areas such as biometrics, enabling better access to Government information or improvements to the Documentation Verification Service?
- The financial system's shift to an increasingly online environment heightens cyber security risks and the need to improve digital identity solutions. The government has the ability to facilitate industry coordination and innovation in these areas.

The report goes on to observe that the rise of e-commerce, combined with widespread internet connectivity, increasingly exposes financial institutions to more cyber crime.

While cyber attacks may cause service outages and lead to the failure of core operating systems, individuals are more concerned about the personal impact of increased fraud and unauthorised access to sensitive data.

The government, on the other hand, appears to be more concerned with organised crime's use of increasingly sophisticated techniques, particularly in money laundering and identity crime, to facilitate tax avoidance and other illegal activities.

To counter such threats, in 2006, the government introduced identity verification requirements for anti-money laundering and counter terrorism financing (AML/CTF) purposes. However, the requirement did not come with prescribed mechanisms. The development of 'safe harbour' identification processes was left to the entities tasked with meeting AML/CTF requirements in relation to delivering specific services to clients.

The market responded with innovation and a new generation of online identity verification solutions emerged which led to the current competitive market with its variety of identity solutions.

Superannuation's need for better identification processes

As technological changes largely removed the need for people to deal face to face, this increasing move to electronic transactions, and particularly to the electronic and remote initiation of transactions, has led to an increasing risk of cyber-crime. While the superannuation industry will be happy to see the end of contributions and benefit payment cheques being diverted and or stolen from letter boxes, it is concerned that the increasing use of technology poses its own challenges.

In establishing the SuperStream transaction network, particular attention has been paid to requiring the encryption of data as it moves from gateway to gateway to prevent the interception and alteration of data. Connections between originating parties and the gateway network, and the gateway network and end points have login code and password protection.

However, where transactions are passed through a chain of players, the overall security strength must be measured by the strength of the weakest link in the chain.

Identity theft is a growing concern in the superannuation industry due to the increasing size of member account balances. The problem is exacerbated due to the new member enrolment process for those being enrolled by an employer into the employer default fund.

For these members, a fund receives no member-completed documentation. While new arrangements under SuperStream include using the ATO's SuperTick service to validate the member details against the ATO's records of taxpayers, the process still relies on the person being who they say they are.

Creating trust over the internet is fundamental for transaction services provided by the superannuation industry such as the payment and rolling over of benefits.

In the task of identifying clients, superannuation funds are in a unique position as they have a legislated capacity to leverage the member's TFN within their identification processes. By combining the ATO output with private-sector solutions, the superannuation sector is well placed to meet its needs and many superannuation funds have adopted and integrated these solutions.

That superannuation funds have, until the recent introduction of the ATO's SuperTick Service, relied so heavily on physical documents prior to paying or rolling over superannuation benefits, reflects the difficulty of establishing the required level of trust.

That the ATO is confident in its ability to initiate rollover transactions on behalf of a taxpayer is reflective of their ability to establish the necessary degree of trust through independent, knowledge-based authentication interactions with taxpayers.

More broadly, while the providers of identity services continue to drive new innovation to improve 'match and pass' rates and recent innovations have seen the introduction of knowledge-based authentication of identity, the need for and desirability of a single identity token has not diminished.

Discussion on an Australian digital identity token has been underway for many years, led by a number of departments (Attorney Generals Department, Prime Minister and Cabinet, Department of Communications and now the Department of Finance). Progress is therefore not only slow, it has proven to be something the superannuation industry cannot rely on to resolve its issues with proof of identity. Funds must continue to invest in new technology that streamlines processes if they are to manage risks and reduce cost. The expectation of a substantial improvement to identity checking must be tempered by the challenging pace of achievements to date.

The following is an example of the slow pace of implementation of government-sponsored projects:

Authenticity of a Government issued document: a nine-year journey

2005	The document verification service (DVS) allows for the authentication of government issued documents. Its use is restricted to government agencies.
2007	The DVS is included as a key plank in COAG's National Identity Security Strategy.
2010	The Auditor-General criticised lack of progress with uptake.
2011	Media reports emerged of a government plan to open access to the DVS by November of that year.

2012	Government publicly committed to private sector access to the DVS.
2014	In May, DVS access starts; but access is restricted to entities which have a Commonwealth legislated identity obligation. Cost is \$5,500 to apply, \$55,000 to connect and up to \$1.40 per document checked.

The DVS would be significantly improved if the restrictive access provisions were eased and birth and marriage certificates added (this latter issue requires digitisation of various state registries of births, deaths and marriages holdings).

myGov as a solution?

At 4-66, the Interim Report states that the myGov digital service provides a potential basis for a government-issued digital identity and that myGov provides Australians with secure single sign-on access to various government services, including Medicare, Centrelink, electronic health records and tax records, including a digital mailbox to receive government correspondence.

It would seem logical, therefore, that this identity should be extended for a wider purposes.

However, before taking this step, there are some issues that need to be recognised and addressed:

- From a privacy perspective, expanded use of myGov runs the risk of being seen by the public as an online Australia card, as implementation requires the mandating of a single source of identity credentials, with the credential controlled and issued by government.
Although Australians will accept a biometric (fingerprint) to open their phone – and with it a Paypal application, we question whether there would be such widespread acceptance if it were a government-issued credential.
- The creation and widespread adoption of a government identity credential would inhibit private-sector driven innovation and improvements. For many years, the 100-point identity test has anchored Australian identity in government-issued documents, even though, until very recently, there was no means of verifying the authenticity of those documents. It appeared as if following a process and collecting the necessary 100-points of identity was more important than achieving the actual objective of verifying the identity of the individual.
- Having competition encourages both innovation and competition on price and value. Relying solely on a myGov credential would remove these market pressures, perhaps to the detriment of all.
- At present, there does not appear to be a market failure in the creation of identity checking solutions. Private sector providers have been meeting market needs and competition exists on price, match rates and processes.

However, basing a process/problem solution on a centralised database may also have its drawbacks as is illustrated by the following:

The register of lost superannuation members and unclaimed superannuation monies

For many years, there has been concern expressed by government at the large number of superannuation fund members recorded on the ATO managed Lost Members Register, representing many billions of dollars in superannuation savings.

Several consultations have been held on solutions and the ATO has been tasked with addressing the issue through the use of the TFN and the associated ATO-held address. While this has been of some use, for many superannuation funds, the more powerful solution has been found to rest with the use of address from a credit file.

The difference in effectiveness lies in the frequency with which address databases are updated. In general, taxpayers only update their address annually – when lodging their tax return. However, ongoing consumer

interactions by individuals sees addresses held by credit providers updated more readily. Some in the industry say a credit file is six times more likely to provide an updated address than using that held by the ATO against a TFN.

The lesson is that, although a single centralised identity checking solution may have advantages, it may also have its drawbacks.

Recent developments

More recently, the Commonwealth Government has begun to introduce a new identity framework to facilitate the provision of identity services to government by third-party identity service providers who have been accredited by the Australian Government Information Management Office. Accreditation is based generally on security, management of data, personnel and so on, but with the specific requirements varying depending on the *level of assurance* a provider is prepared to give with respect to the correctness of the identity. As is to be expected, the higher the level, the more certain the level of assurance, and the more rigorous the standards required of the provider. At the time of writing, only one provider has been accredited in what was an 18-24 month process.

We note that more work is being done with the Department of Finance updating their public key infrastructure framework. This document – the third edition – provides a framework of policies, standards and procedures governing digital identity certificates.

However, even if adopted by government, this framework would only apply to Commonwealth agencies as there has been no commitment from state governments to embed the standard for a national uniform approach to identity.

While ASFA encourages the government attempt to facilitate better use of government-held data for such innovations as knowledge-based authentication (KBA)^{xix}, the reality is the very slow pace of government change on identity means the industry will continue to work with private providers of identity solutions for the foreseeable future. The new requirements for the accreditation and draft framework for governance of identity may well add better rigour, integrity and assurance, but at this very early stage, those untested benefits appear to be some years away.

The government has a clear role to play in facilitating the connection between information sources and the public's needs so as to enable accurate, secure and authenticated transactions to occur in the digital world.

By enabling a connected digital environment for identity, the government would be supporting and facilitating an industry-wide reduction in red tape, cost and potential risk within the broad economy and in particular the financial and wealth sectors.

ASFA considers that the government could best support these benefits by ensuring all federal and state records are digitally enabled (removing paper) and by enabling cost effective access by institutions and service providers to connect transactions/processes and people to these records.

ASFA recommends that, for an immediate impact, government should support the following actions:

- allowing broader access to the DVS
- ensuring key state records such as birth certificates are digitised and available for use in the DVS.

Appendix A

International comparison of expenses and fees for defined contribution pensions

Executive summary

International comparison of fees

- Much of the recent debate and discussion about the level of superannuation fund fees in Australia has relied on partial and mostly non-comparable data for funds in other countries.
- There are significant structural differences between private pension systems that impact on the administrative and operating costs of funds.
- There will be markedly different cost structures between: a private pensions system which is dominated by single employer-sponsored defined benefit (DB) fund, mostly invested in bonds and fixed interest; and a system, such as Australia, which has multi-employer sponsored defined contribution (DC) funds with a high proportion of assets in equities and unlisted investments.

Differences between funds in Australia and those overseas

- The costs of insurance administration, contribution processing and the provision of advice in Australian superannuation funds total in excess of 10 basis points of assets on average. (100 basis points is equivalent to 1 per cent; 10 basis points is equivalent to 0.10 per cent.) These expenses are not typical in many other countries.
- Taxation and prudential regulation compliance costs are also relatively high in Australia compared to other countries.

The level of fee-based competition in Australia

There is evidence of fee-based competition in the superannuation sector. While in the past there may have been little competition in some parts of the sector, there has always been strong competition in some areas. Going forward, there will be more competition as a result of a number of reforms, including decoupling the payment for financial advice from the distribution of financial products.

Pension and superannuation fund fees in other countries for DC funds

- The lowest fees charged to members in DC schemes overseas are typically 0.8 to 1.0 per cent of account balance but, in other cases, are often well in excess of 1 per cent of assets.
- Care is needed in making comparisons, as in a number of countries, there is a mix of fees related to both contributions and account balances, and in most other countries, there is a lower allocation to equities and alternative assets than in Australia.
- In the United Kingdom in 2013 the average annual management charge (AMC) for trust-based schemes was 0.75 per cent of the fund per year and for contract-based schemes it was 0.84 per cent.
- In the United States of America (US), fees for smaller employer 401(k) plans are around 1.5 per cent of assets with fees for large plans around or just over 1 per cent.
- In New Zealand, the fees for KiwiSaver accounts typically are equivalent to one per cent or more of assets when there is substantial asset allocation to equities.
- In Ireland, total fees charged for defined contribution funds are one per cent or more of assets.

- In Canada, the fees for Registered Retirement Saving Plans, which form a major proportion of the pensions market in Canada, and which are DC, generally exceed one per cent of assets by a substantial margin and can be in excess of two per cent of assets.
- In Chile, fund expenses as a percentage of assets have been estimated by the regulator as being a little over 0.6 per cent of assets. In Chile, fund fees are expressed and charged as a percentage of contributions and there is no direct measure available of fees as a percentage of assets. ASFA estimates that fund fees in Chile as a percentage of assets under management are somewhat in excess of 0.6 per cent of assets. A further complication is that fees in Chile are set as a percentage of salary (in effect linking them to current contributions, rather than account balance). This makes direct comparisons with other national systems difficult.
- In a variety of other European and South American countries, fees for DC funds are generally in excess of one per cent of assets and sometimes in excess of two per cent.

Overall conclusion

The overall conclusion to be drawn is that superannuation fund fees in Australia are not out of line with fees for DC funds in other countries, especially if allowance is made for specific differences in the average asset mix and services provided by funds. Superannuation fund fees also will be likely to decline in Australia as average account balances increase (lessening the impact of fixed dollar administration fees) and as current and future measures to improve efficiency and reduce unnecessary red tape take effect.

Why the current interest in superannuation fund fees and expenses?

In recent months, there has been considerable public debate about the level of fees and charges that impact on the superannuation entitlements of individuals. This is understandable. The price of financial services is of considerable consequence for fund members. Superannuation will be, for most people, their most important financial asset after their home.

Administrative and investment fees and charges are also of considerable interest to policymakers because they can have a significant impact on eventual retirement income. Fees can reduce eventual retirement savings by between 10 per cent and 25 per cent, compared to a purely notional basis of no fees, depending on the fee level concerned. On the other hand, there are some that argue that higher fees can be a reward for better performance in regard to investment earnings and that some level of fees are necessary to operate a superannuation account on behalf of an individual. It is not possible to manage a superannuation or pension system based solely on the labour and services of volunteers.

International comparisons that have been made recently and their limitations

Much of the recent debate around the relative and even absolute cost of Australia's retirement savings system has relied solely on data from the Organisation for Economic Cooperation and Development (OECD). This included submissions to the Financial System Inquiry from the Treasury and the Reserve Bank, and the Grattan Institute's recent paper on the cost of our superannuation system.

However, these discussions are limited by the incompleteness and inconsistency of the OECD data. This data is derived from national sources, which differ in the extent to which they record all the costs of the relevant domestic pension (superannuation) system. Placing the country-specific data in one table does not make them comparable.

As well, there are significant structural differences between the various private pension systems that impact on administrative and operating costs of funds. For instance, a private pensions system that is dominated by a single-employer sponsored DB fund, mostly invested in bonds and fixed interest, will have a markedly different cost structure compared to a system which is defined by multi-employer sponsored DC funds with a high proportion of assets in equities and unlisted investments.

Costs also are generally higher when private pension products are purchased on an individual basis, often associated with the provision of personal financial advice with the costs of the latter included in the pension product costs.

Adding to the complexity, many pension systems have elements of various types of funds. Meaningful international comparisons can only be made by looking at the cost of similarly structured pension funds.

Differences between Australian superannuation funds and most pension funds in other countries

Legislative and taxation arrangements vary greatly between countries, and these can have a significant impact on operating costs. Australia's taxation treatment of superannuation is relatively complicated compared to many other countries where pension funds generally are not taxed on employer contributions or investment earnings. As well, the level of prudential supervision with associated licensing and prudential controls and documentation is relatively high in Australia.

The benefits provided vary, with some systems restricted to pension payments, while others have a lump-sum focus and/or a strong insurance-company-backed component.

Australia has very extensive insurance arrangements for fund members, ranging in events covered from death to total and permanent disability to temporary incapacity. These involve significant underwriting and claim processing costs. The costs of insurance claims processing alone are around 10 per cent of administration costs for funds, contributing around three to four basis points on average to the aggregate costs of superannuation funds.

Processing of contributions adds another three to four basis points to costs, given that funds in Australia have to process contributions from multiple employers with some funds handling contributions from hundreds of thousands of employers. Going forward, SuperStream will substantially reduce those costs but that is yet to be reflected in cost and fee structures.

There also are a variety of services provided to members of Australian funds that are not always and sometimes only rarely provided to members of pension funds in other countries. In some cases, these services are included in the fund's costs, whereas in other instances, an additional fee is payable that is independent of the reported costs of the fund and the general fee charged to the member.

The provision of financial advice to fund members is a case in point. In Australia, a significant proportion of the cost of the provision of financial advice is paid through superannuation fund administration. This can amount to up to five basis points on average. In countries where most assets are in DB funds, there may be little or no financial advice provided to fund members given that the benefit design is fixed and there are few, if any, options available to fund members to alter their contributions or the investment mix backing their benefit.

The costs of insurance administration, contribution processing and provision of advice total in excess of 10 basis points of assets on average.

As well, even without taking such expenses into account, there is no overseas equivalent to Australian DC funds with multiple employers contributing and with the bulk of assets in equities rather than bonds, which have expenses and fees in the order of 30 basis points.

This is consistent with evidence relating to mutual funds around the world. These mutual funds are more akin to DC superannuation accounts than single employer DB pension schemes.

According to Morningstar reports published in 2011 and 2013, managed funds in Australia are not expensive by world standards. Australia fares very well in these reports with respect to fees and expenses. According to Morningstar, Australian equity, allocation, and fixed-income funds are some of the least expensive globally, with only the much larger United States funds charging consistently lower total expense ratios.

www.corporate.morningstar.com/us/documents/ResearchPapers/GlobalFundInvestorExperience2011.pdf
www.corporate.morningstar.com/US/asp/subject.aspx?xmlfile=374.xml&filter=3081

The level of fee competition in Australia

There is evidence of fee-based competition in the superannuation sector. While in the past there may have been little competition in some parts of the sector, there has always been strong competition in some areas. Going forward, there will be more competition as a result of a number of reforms, including decoupling the payment for financial advice from the distribution of financial products.

Fee-based competition has always been strong in the tender processes for default funds that have been undertaken by large employers. This has resulted in both retail and industry funds tailoring their offerings, including through reductions of fees from the standard rate, in order to obtain the business of an employer.

Industry funds have also competed for choice members through television and other advertising that has had a primary focus on the comparative fees of their offerings.

Rating agencies have also played a role in facilitating price competition by providing information and comparison tools for consumers on their websites.

Retail superannuation funds have responded to such competition and to the changed remuneration arrangements for financial planners by developing their own directly distributed superannuation products, which typically have fees of less than 100 basis points, considerably below the up to 300 basis points that some personal retail products charged in the past. These retail superannuation products have typically been directly marketed to consumers, as well as to employers

as default funds, and have rapidly grown market share.

The MySuper authorisation processes gives attention to fees, among other factors. Similarly, new trustee duties require a specific focus on the financial interests of the beneficiaries of the fund who hold the MySuper product, and in particular returns to those beneficiaries (after the deduction of fees, costs and taxes).

The great bulk of MySuper products and practically all products that are being considered for inclusion as a default fund in awards have fees under 100 basis points.

Public sector funds, especially those that are DB, may not have direct competitors but their fees are paid in effect by the employer. These funds have also demonstrated their cost competitiveness to their employer sponsor through international benchmarking activities.

More generally, Australia now has a reputation among international fund managers as a country where funds take the standard investment management fee as just a starting point in negotiations, rather than as a given amount in a transaction.

The remainder of the paper provides far more detailed evidence than provided in the summary OECD table on the cost level of private pension or superannuation products. Particular emphasis is given to cost levels for pension products broadly equivalent to the mostly DC funds operating in Australia.

Pension and superannuation fund cost levels in specific countries

United Kingdom

In February 2014, the United Kingdom's (UK's) Department for Work and Pensions published a survey of the costs and quality of service in UK DC pension schemes.

The survey found that the average annual management charge (AMC) for trust-based schemes was 0.75 per cent of the fund per year. This had not changed significantly compared to 2011, when the AMC was reported as 0.71 per cent overall. Among contract-based schemes, the average AMC had fallen slightly from 0.95 per cent in 2011 to 0.84 per cent in 2013.

Trust-based schemes are similar in legal structure to superannuation funds operating in Australia. Contract-based schemes involve a contractual promise from a financial institution such as an insurance company or a bank.

The key determinants of the level of the AMC were:

- **size of the scheme:** members of smaller schemes (12 to 99 members) paid a higher than average AMC in both trust-based and contract-based schemes than members of larger schemes (1,000 members or more)
- **commission:** where a commission-based adviser was used, this led to an average increase in the AMC paid by members of trust-based schemes of 0.4 percentage points; and in contract-based schemes of just under 0.2 percentage points
- **contributions:** higher contributions led to a lower AMC being paid by members
- **scheme age:** older schemes tended to charge more.

Employers in the UK also typically pay substantial amounts to various professional and other advisers in regard to the operation of the pension arrangements relating to their employees. The survey indicates that in contract-based schemes, fees for advice also depended on the size of the scheme. The largest schemes paid less than half the average per member than the smallest (£60 and £150 respectively). Overall, the fees paid were lower in contract-based schemes: the average spent per member was £140 compared to £180 for trust-based schemes.

On a £30,000 account balance, an average spend of £150 per employee by an employer amounts to an additional 50 basis points to the costs paid for directly by the fund member.

<https://www.gov.uk/government/publications/defined-contribution-pension-schemes-landscape-and-charges-survey-2013>

United States of America

The average total plan cost and average investment expenses for 401(k) retirement plans fell slightly in 2012, according to the 13th edition of the *401k Averages Book*, an annual overview of plan benchmarks.

The study indicates that, in 2012, the average total plan cost – including administrative and record-keeping fees – for a small 401(k) plan (50 participants/\$2,500,000 assets) declined marginally from 1.47 per cent to 1.46 per cent. These fees are calculated as a percentage of assets under management in the plan. Small plan average investment expenses – the expense ratios charge by mutual funds for assets held within the plan – went from 1.38 per cent to 1.37 per cent.

Over the same period, the average total plan cost for a large retirement plan (1,000 participants/\$50,000,000 assets) declined from 1.08 per cent to 1.03 per cent; while large plan average investment expenses declined from 1.05 per cent to 1.00 per cent.

www.shrm.org/hrdisciplines/benefits/articles/pages/401k-feeseclined.aspx#sthash.JRPC7Hhm.dpuf

New Zealand

According to Canstar data for Kiwisaver products, in 2013, typical fees for such products ranged from a two part fee of around \$50 per member and 0.5 per cent of assets for a lower priced product with only 20 per cent allocation to growth assets, to around \$50 a year and at least 0.7 per cent of assets and often 1 per cent or more of assets for products with 80 per cent exposure to growth assets.

Kiwisaver funds have very low costs related to contribution processing. Employers deduct KiwiSaver contributions from salary or wages and send the relevant amount, along with Pay As You Go tax amounts, to Inland Revenue (the New Zealand equivalent of the ATO) by the 20th of the following month. Inland Revenue then distribute the contributions to the relevant funds.

www.canstar.co.nz/kiwisaver

Ireland

DC insured pension schemes represent a significant proportion of Irish pension schemes by membership numbers. Under a DC insured pension scheme, the trustees engage a life insurance company or group of companies to provide administration and investment management services.

Research has identified annual management charges for such schemes in 2012 of between 0.3 per cent and 1.5 per cent per annum for balanced managed funds for all scheme sizes. The findings suggest increased scale allows the achievement of lower annual management charges as the average charge reduces with membership size. Schemes with membership of less than 50 members reported an average annual management charge of 1 per cent per annum versus an average charge of 0.6 per cent for schemes with more than 500 members.

Employers also typically, as in the UK, pay additional fees to various advisers in regard to the pension schemes. The sponsoring employer may cover the cost of specific elements such as audit fees (a regulatory requirement where a pension scheme membership is greater than 100 members), policy fees and/or the costs associated with professional independent trustees. In other circumstances, the sponsoring employer will bear the cost of appointing professional advisers to the pension scheme, who will provide advice and support services to the pension scheme, such as trustee advice, member presentations and member one-to-one meetings/personal advice.

In addition to disclosed pension charges, DC insured pension schemes are also impacted by implicit (or non disclosed) investment costs borne by the underlying investment fund through which the pension is invested.

www.welfare.ie/en/Pages/Report-on-Pension-Charges-in-Ireland-2012.aspx

Denmark

The OECD summary table indicates that pension funds in Denmark have an average cost of 0.094 per cent of assets. Even if correct for the funds it covers, this figure excludes pension insurance contracts, which comprise more than 60 per cent of pension assets in Denmark. The fees for the seven commercial pension providers in Denmark range from 1.2 per cent to 1.7 per cent of assets.

Canada

The reported operating expenses of pension funds in Canada are 0.34 per cent of assets in the OECD summary. However, even if this figure is correct for the funds it covers, it does not represent the whole industry, as it excludes personal and group DC arrangements. These account for almost half the assets in the Canadian pension system, and they involve much higher costs and fees.

According to Canadian pension expert, Keith Ambachtsheer, the cost of participating in a Group Registered Retirement Saving Plan (RRSP) in Canada can easily exceed one per cent of assets per annum, while individuals investing their RRSP assets through retail mutual funds often pay two per cent per annum or more.

In this context, one major provider of RRSPs measure success as expenses falling to 1.75 per cent from the current level of 2.45 per cent in a similar mutual fund.

www.cdhowe.org/pdf/e-brief_172.pdf

[groupsavings.manulife.com/groupretirement/CPOv2.nsf/LookupFiles/DownloadableFileFutureStepSmallBusfeeimpactflyer/\\$File/FutureStepSmallBusfeeimpactflyer.pdf](http://groupsavings.manulife.com/groupretirement/CPOv2.nsf/LookupFiles/DownloadableFileFutureStepSmallBusfeeimpactflyer/$File/FutureStepSmallBusfeeimpactflyer.pdf)

Research from the International Organisation of Pension Supervisors

Dr Edgar Robles has undertaken studies (published in 2012 and 2014 by the International Organisation of Pension Supervisors (IOPS) and the OECD), which compare DC pension fund fees in a large number of countries around the world.

These comparisons are not easy to undertake given the range of fees structures that are applied around the world. For instance, some systems rely mainly on fees linked to salary or contributions; many also charge a mix of fees related to contributions, assets in the account, and withdrawals.

This research indicates that Chile is not quite the poster child for fee reductions that some commentators have claimed. The research indicates that average fund expenses in Chile are equivalent to 0.6 per cent of assets. Fees charged would be somewhat higher than that percentage given that fund providers have a significant profit margin. Given that fees are related to the salary of the contributor (and hence effectively to contributions rather than account balance), it is difficult to directly compare fees in Chile with pension and superannuation fund fees in other countries. Pension funds in Chile have significant exposure to equities of various types but the level on average is just of over 50 per cent compared to over 70 per cent on average in Australia.

This IOPS research focuses on DC schemes. While there are still differences in scheme characteristics, including allocation of assets to equities, the data are more comparable than the summary data used in the Grattan Institute report on fund fees.

Some of the main results in regard to average fees are:

- **Albania** – average fees of 2.4 per cent of assets
- **Bulgaria** – 4.97 per cent of contributions and 1 per cent of assets
- **Croatia** – 8 per cent of contributions and 2 per cent of assets
- **Czech Republic** – 0.6 per cent of assets
- **Estonia** – 1.49 per cent of assets
- **Greece** – 0.9 per cent of assets
- **Hong Kong** – 1.7 per cent of assets
- **Israel** – 3.8 per cent of contributions and 0.33 per cent of assets

- **Latvia** – 2 per cent of assets
- **Mexico** – 1.38 per cent of assets
- **Poland** – 3.5 per cent of contributions and 0.46 per cent of assets
- **South Korea** – 0.7 per cent of assets
- **Turkey** – 2 per cent of assets.

www.oecd.org/site/iops/Working%20Paper%202020%20Update%20on%20OPS%20Work%20on%20Fees%20and%20Charges%20.pdf
www.spensiones.cl/portall/institucional/578/articles-8609_recurso_3.pdf

Summary

The overall conclusion to be drawn is that superannuation fund fees in Australia are not out of line with fees for DC funds in other countries, especially if allowance is made for specific differences in the average asset mix and services provided by funds. Superannuation fund fees also will be likely to decline in Australia as average account balances increase (lessening the impact of fixed dollar administration fees) and as current and future measures to improve efficiency and reduce unnecessary red tape take effect.



Insurance Administration Expenses

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This draft report is provisional for discussion purposes only, and does not constitute consulting advice on which to base decisions. No liability to any party will be accepted for the consequence of relying on its contents.

1. Executive Summary

1.1 Introduction

Rice Warner has been commissioned by the Association of Superannuation Funds of Australia (ASFA) to assess the costs of providing insurance benefits within superannuation.

The recent Financial System Inquiry (FSI) interim report questioned the cost of the superannuation system and drew its criticism heavily from the Grattan Institute research paper on fees which compared the Australian system to a number of international systems.

The Australian system is unique and has several characteristics which need to be considered when comparing it to other jurisdictions. Some of the differences occur in:

- asset allocation
- system design (defined contribution vs. defined benefits)
- member investment choice
- intra-fund advice
- provision of life insurance benefits.

This report discusses the last of these points. It examines both the benefits of including insurance in superannuation and the additional costs that are incurred by doing so.

1.2 Benefits of insurance within super

There are a number of benefits of providing insurance to Australians through superannuation, including:

- Life insurance coverage in voluntary systems is not high, resulting in many people having inadequate cover – that is, there is an underinsurance gap. Insurance within super reduces the size of the underinsurance gap.
- Rice Warner estimates that there is a reduction in social security cost to the government of about **\$403m** p.a.
- Default insurance within superannuation provides a basic level of cover to those who would otherwise have no insurance. Insurance within superannuation funds represents the majority of total life insurance sums insured in the market:
 - 71% of total death benefit sums insured
 - 88% of total TPD sums insured, and
 - 59% of total income protection monthly benefits.
- Insurance tends to be cheaper within superannuation, reflecting:
 - tax efficiency
 - absence of high cost distribution (and commissions to insurance advisers)
 - simple product design
 - wholesale contracts which provide economies of scale.

1.3 Costs of administering insurance within super

Insurance within superannuation has numerous benefits for individuals, the government and society. However, the costs of providing the benefits are not recognised when making comparisons of expenses internationally.

We estimate that insurance administration costs make up 19% of total fund base administration expenses, being about \$200m a year. Most of these costs are for claims and underwriting administration.

There are a number of other related expense items which add costs for funds but are not quantifiable as they are generally not segregated from other expenses. These include:

- consulting/legal/tax advice (around insurance)
- record establishment
- record updating
- reporting
- communication/disclosure
- compliance.

1.4 Conclusion

Insurance is an integral part of the superannuation industry of Australia and contributes largely to reducing the underinsurance gap. Including insurance within superannuation funds does add an additional administration expense to funds. It is important to recognise these expenses when benchmarking the Australian system against international peers.

This report was prepared and peer reviewed for ASFA by the following consultants.

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22 August 2014

2. Benefits of insurance within super

2.1 Background

It is often stated that life insurance is sold rather than bought. Few Australians allocate an allowance for it in their personal budgets. This explains why a relatively low percentage of Australians purchase life insurance through traditional retail channels compared with the number of Australians purchasing insurance to protect their cars and homes.

This apathy towards obtaining adequate cover for death and disability risks largely contributes towards the current underinsurance gap resulting in an increased burden on the government in the form of social security payments for families who lose a breadwinner or individuals who become disabled.

Insurance within superannuation is now a dominant part of the life insurance market in Australia. It results in more Australians having cover and contributes substantially to reducing the size of the underinsurance gap.

2.2 Market share of group insurance

Insurance within superannuation makes up a large portion of the current life insurance market. In terms of annual premium revenue, insurance in superannuation represents:

- 48% of total premiums for death benefits ('Term')
- 75% of total premiums for TPD benefits, and
- 35% of total premiums for income protection.

Note that Trauma cover is prohibited by legislation from being paid from a superannuation balance as it does not meet a condition of release.

Table 1. In-force business at 30 June 2013 – annual premium income

Market segment	Term		TPD		Trauma		Income protection		Total
	(\$million)	(%)	(\$million)	(%)	(\$million)	(%)	(\$million)	(%)	(\$million)
Superannuation									
Corporate Funds	51	1	45	2	n/a	n/a	50	2	146
Adviser superannuation	1,310	22	435	22	n/a	n/a	184	6	1,930
Industry Funds	895	15	565	28	n/a	n/a	570	17	2,030
Public Sector Funds	296	5	187	9	n/a	n/a	179	5	662
Employer Master Trusts	333	5	291	14	n/a	n/a	174	5	798
Total Super	2,885	48	1,523	75	0	0	1,157	35	5,566
Ordinary									
Corporate Standalone	75	1	48	2	1	0	372	11	495
Adviser non-superannuation	1,937	32	378	19	985	93	1,681	51	4,981
Direct	1,178	19	70	3	69	7	81	2	1,397
Total Ordinary	3,190	52	496	24	1,055	100	2,134	64	6,873
Total market	6,075	100	2,018	100	1,055	100	3,291	100	12,439

2.3 Current levels of cover within superannuation

Total sums insured for each sector of the market are shown in Table 2. Superannuation sums insured represent a greater proportion of total cover than superannuation premiums. This reflects the fact that premium rates within superannuation tend to be lower than those in retail.

- 71% of total death sums insured ('Term')
- 88% of total TPD sums insured, and
- 59% of total income protection monthly benefits.

Table 2. In-force business at 30 June 2013 - sums insured/ monthly benefits

Market segment	Term		TPD		Trauma		Income protection		Total	
	(\$ million)	(%)	(\$ million)	(%)	(\$ million)	(%)	(\$ million)	(%)	(\$ million)	(%)
Superannuation										
Corporate Funds	66,165	1	57,507	2	n/a	n/a	463	2	77,286	1
Adviser superannuation	795,881	18	328,692	12	n/a	n/a	827	4	815,725	16
Industry Funds	1,572,907	35	1,313,597	49	n/a	n/a	7,137	35	1,744,188	33
Public Sector Funds	406,563	9	357,524	13	n/a	n/a	1,911	9	452,415	9
Employer Master Trusts	369,663	8	319,930	12	n/a	n/a	1,944	9	416,324	8
Total wholesale	3,211,179	71	2,377,250	88	0	0	12,282	59	3,505,938	67
Ordinary										
Corporate Standalone	92,319	2	55,831	2	355	0	3,981	19	188,210	4
Adviser non-superannuation	719,172	16	214,981	8	196,970	93	4,129	20	1,015,235	19
Direct	486,476	11	43,471	2	15,247	7	203	1	506,592	10
Total retail	1,297,967	29	314,283	12	212,572	100	8,313	40	1,710,037	33
Total market	4,509,146	100	2,691,534	100	212,572	100	20,594	100	5,215,976	100

Insurance within superannuation accounts for the majority of life insurance cover measured by sums insured/monthly benefits for Death, TPD and income protection.

Average levels of cover by Market Segment are given in Table 3.

Table 3. In-force business at 30 June 2013 - average sums insured or monthly benefits per policy

Market segment	Term		TPD		Trauma		Income protection	
	(\$)	(%)	(\$)	(%)	(\$)	(%)	(\$)	(%)
Superannuation								
Corporate Funds	219,330	89	220,678	91	n/a	n/a	4,297	133
Adviser superannuation	472,067	191	497,301	204	n/a	n/a	4,553	140
Industry Funds	211,734	86	207,941	85	n/a	n/a	2,043	63
Public Sector Funds	217,849	88	223,394	92	n/a	n/a	3,514	108

Market segment	Term		TPD		Trauma		Income protection	
	(\$)	(%)	(\$)	(%)	(\$)	(%)	(\$)	(%)
Superannuation								
Employer Master Trusts	212,508	86	224,989	92	n/a	n/a	4,300	133
Total wholesale	246,593	100	231,677	95	n/a	n/a	2,570	79
Ordinary								
Corporate Standalone	328,995	133	331,017	136	55,404	23	4,827	149
Adviser non-superannuation	413,998	168	480,559	197	246,214	104	6,108	188
Direct	149,755	61	239,608	98	172,218	73	2,757	85
Total retail	246,481	100	394,129	162	237,529	100	5,280	163
Total market	246,559		243,389		237,529		3,242	

Note: The percentages in Table 3 are the average sum insured (or monthly benefit) for the particular market segment, as a percentage of the average for the market overall.

Table 3 demonstrates that cover tends to be higher in non-superannuation policies (excluding direct). This reflects the fact that most of these policies are sold by financial advisers who deal with those on higher incomes. The benefits are also targeted to the insured person's needs.

2.4 Underinsurance

2.4.1 Life underinsurance gap

Rice Warner regularly measures the level of underinsurance as part of its *Underinsurance in Australia Report*. The estimated mean and median size of the life underinsurance gap is given in Table 4.

Table 4. Underinsurance (\$ billion)

	Basic	Income replacement	TPD	Income protection cover
	life cover	life cover	cover	per annum
Mean underinsurance				
Insurance need	4,341	6,715	12,526	808
Current insurance	4,130	4,130	2,751	237
Underinsurance	210	2,584	9,775	571
Current insurance as percentage of need	95%	62%	22%	29%
Median underinsurance				
Insurance need	4,341	6,715	12,526	808
Current insurance	2,788	2,788	1,733	129
Underinsurance	1,553	3,927	10,793	679
Current insurance as percentage of need	64%	42%	14%	16%

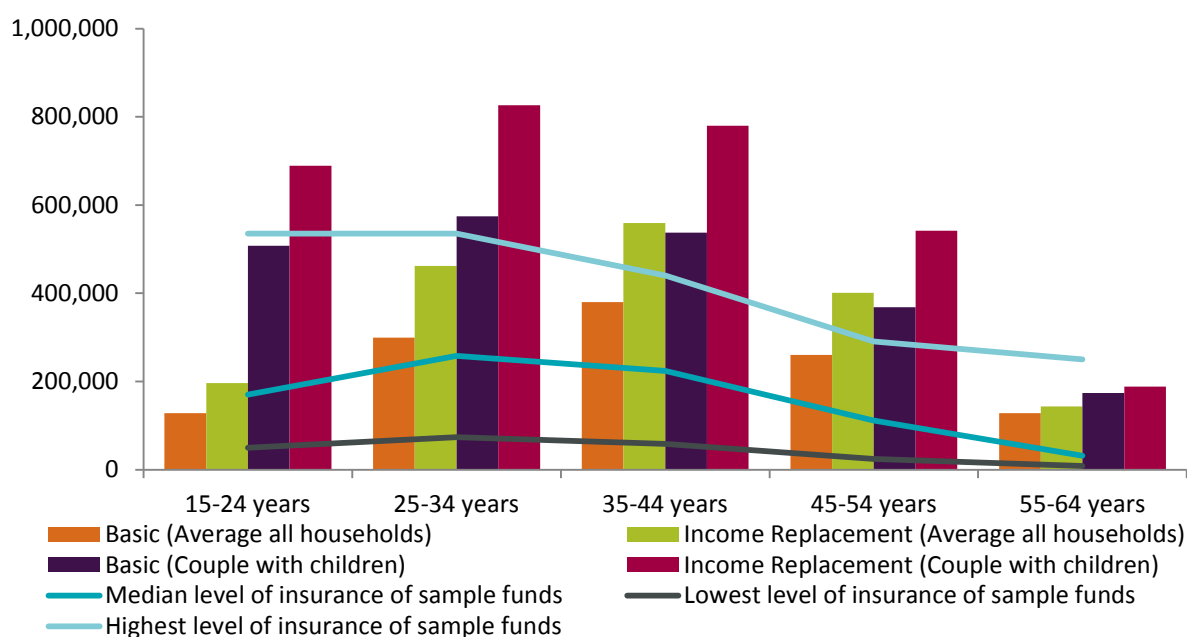
The underinsurance gap is large, but would be much larger if cover was not provided through superannuation funds.

2.4.2 Comparison with insurance needs

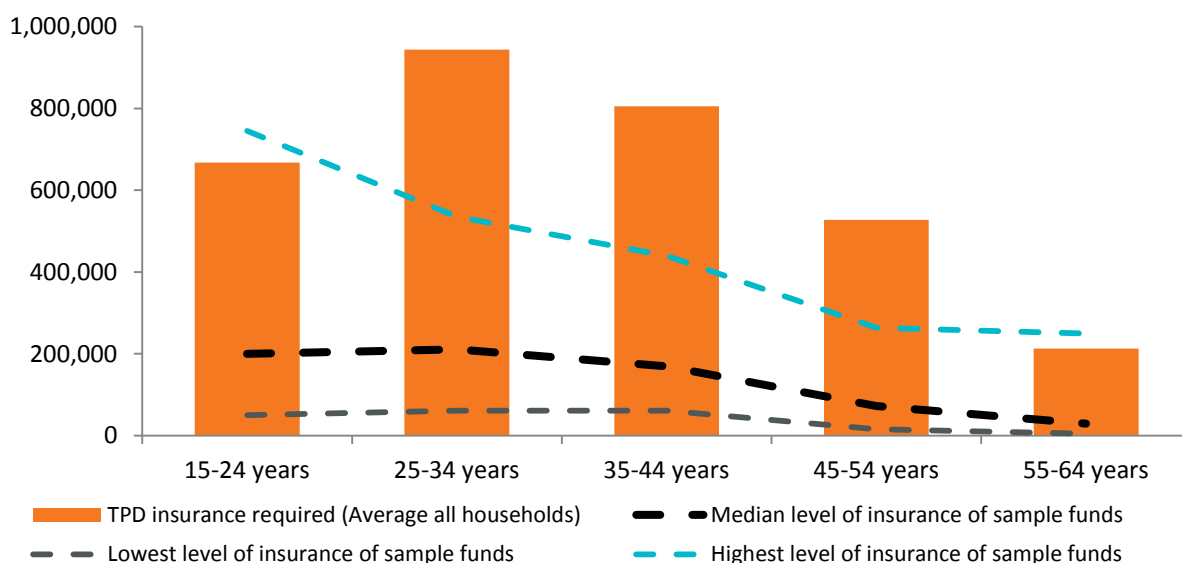
Graph 1, Graph 2 and Graph 3 illustrate the insurance required by age for a family with children and for the average of all households, compared to the median default insurance cover of a sample of superannuation funds.

The graphs also contain the range of the sums insured; being the funds in our sample with the highest and lowest default insurance cover levels.

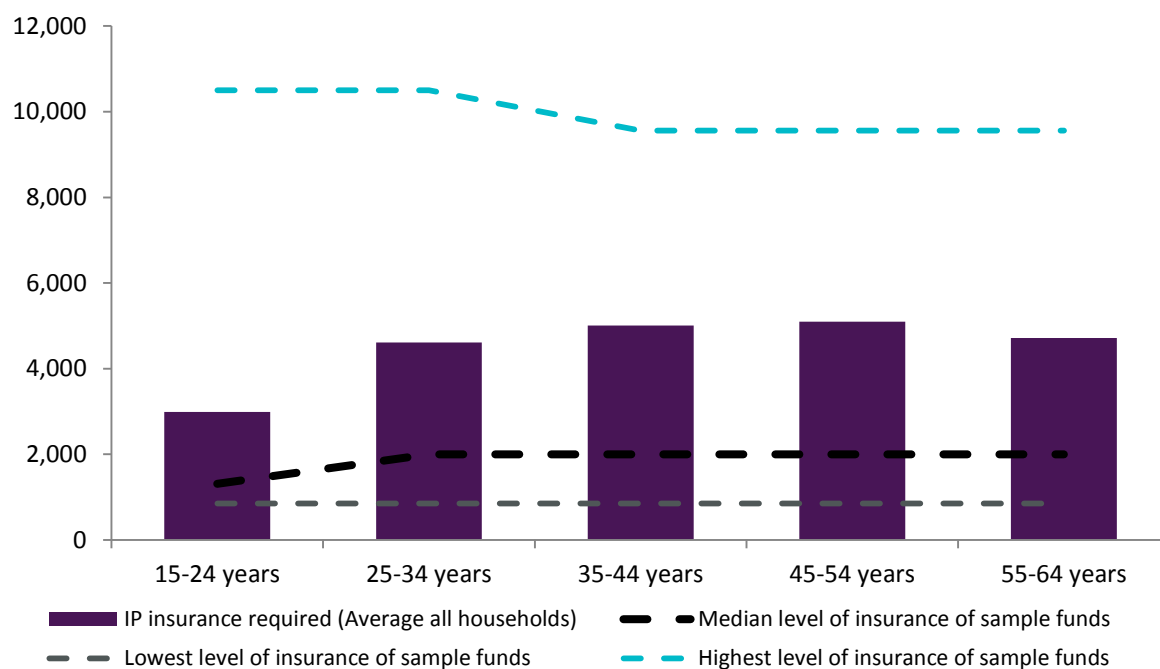
Graph 1. Life insurance needs versus median insurance cover of sample funds



Graph 2. TPD insurance needs versus median insurance cover of sample funds



Graph 3. Income Protection insurance needs versus median default insurance cover of sample funds



2.5 Cost to the government of underinsurance

Rice Warner estimates the cost of underinsurance to the government by calculating (for each benefit type):

- The probability of claim (death, TPD, total disability)¹, multiplied by
- The present value of [social security payments after claim if fully insured, less social security payments claim if not insured] x (1-y)%, plus
- The present value of [social security payments after claim if fully insured, less social security payments after claim if x% insured] x y%
- Where x% is equal to the median level of life insurance as a percentage of needs and y% is the percentage of the working population with insurance cover.

The current cost to the government of underinsurance is measured in Table 5. Without any group insurance this cost would balloon to **\$1,956 million p.a.** Consequently, we can state that insurance within superannuation reduces the annual cost of social security by about \$403m a year.

¹ ABS Life Table 2009 – 2011 was used to estimate mortality statistics

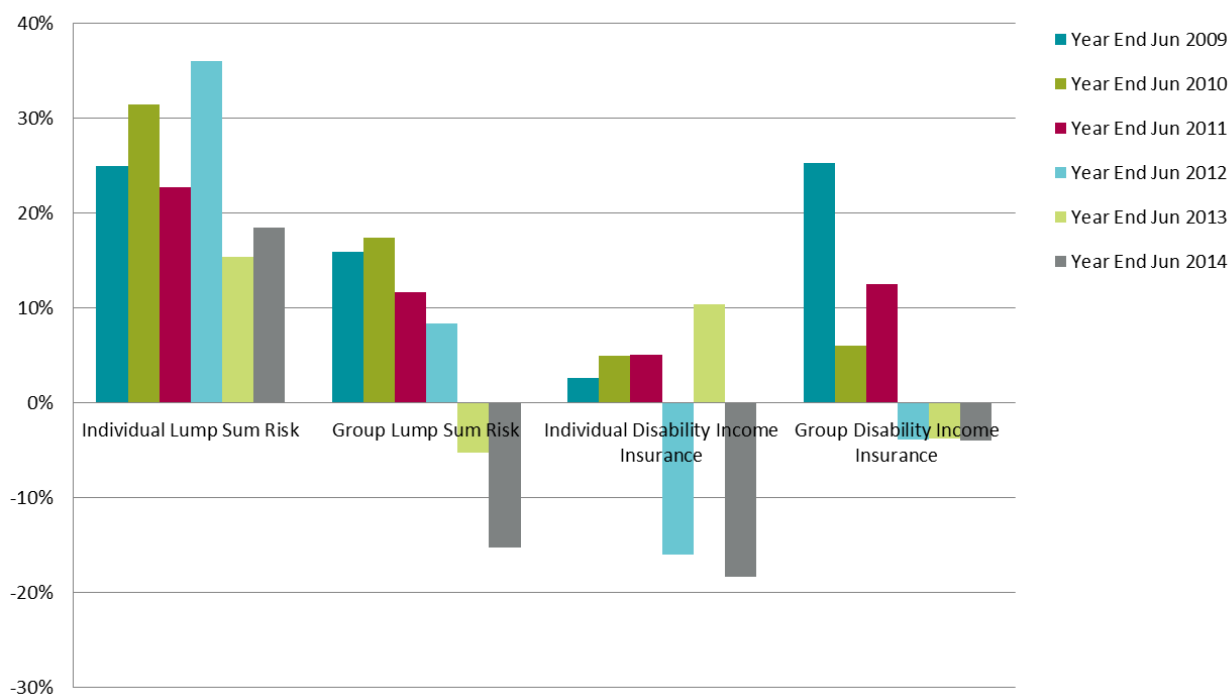
Table 5. Impact of underinsurance on social security payments by government 30 June 2013

Cover Type	Cost of underinsurance (\$ million p.a.)	Cost of underinsurance without group insurance cover (\$ million p.a.)
Death	46	99
TPD	1,260	1,527
Income protection	247	330
Total	1,553	1,956

2.6 Claims vs. premiums - recent trends

ASFA has requested that Rice Warner comment on recent trends in claims payments vs. premiums collected and the impact on the underinsurance gap. Rice Warner can confirm that in recent years experience in the group insurance market has been poor, resulting in negative profits realised by group insurers. This is illustrated in Graph 4.

Graph 4. Insurer profit margins (post tax profit as percentage of premiums)



There are a number of reasons why this has occurred:

- Claims experience - as sources of deterioration in claim experience, we can identify:
 - Poor death claim experience between 2008 and 2010, thought to be connected with the GFC.
 - The increased incidence of mental illness and cancer claims.
 - The increased incidence of heart related medical conditions, possibly reflecting the growing obesity problem.

- Increases in default sums insured over recent years, combined with an increased propensity to claim as sums insured increase.
- The involvement of legal firms which appears to be pushing up the incidence of claims.
- Product Design
- Greater awareness amongst customers of the ability to join superannuation funds and obtain substantial amounts of life insurance cover, often with the only requirement being that they are at work when they join and receiving employer contributions. This anti-selection is a result of Member Choice where employees can shop around for the most suitable fund – and those who are sub-standard risks can game the rules.
- The enhancement of benefit features and disability definitions to levels approaching those of the retail market has increased the value of benefits (at no extra immediate cost).
- The provision by the life insurers of three year premium rate guarantees which caused extended losses even when it was seen that experience was deteriorating.
- Price War
 - The very high premium income under group life contracts for large funds led to a price war where life companies were attracted to the size of the accounts. They expected continuing improvements in mortality and were slow to notice the deteriorating trends in claims.

We note that although high claims vs. premiums payout ratios are generally good for customers, ratios that result in negative profit margins are unsustainable and are already resulting in premium increases for many funds.

3. Additional costs of maintaining insurance within super

3.1 Administration costs

Administering insurance within superannuation creates an additional layer of cost which is ultimately passed onto members in the form of additional fees. Some aspects of this additional cost are difficult to separate from other administration costs such as benefit processing, member communications and account creation.

3.1.1 Insurance expense components

Rice Warner has identified the following areas where the administration of insurance within superannuation does create an additional administrative burden:

- claims
- underwriting
- consulting/legal/tax advice (around insurance)
- record establishment
- record updating
- reporting
- communication/disclosure
- compliance.

3.1.2 Quantifiable costs

Claims and underwriting costs are the largest components of insurance costs which are directly quantifiable and are often provisioned for separately via an additional insurance administration fee which is added to premiums.

Rice Warner estimated, as part of its superannuation expense survey as at 30 June 2013, that insurance administration expenses made up 19% of total base administration expenses in 2013, a median expense of \$6.36 per account. This is equivalent to about \$204m a year.

Graph 5. Administration expenses per member by component as at 30 June 2013 (Peer group)

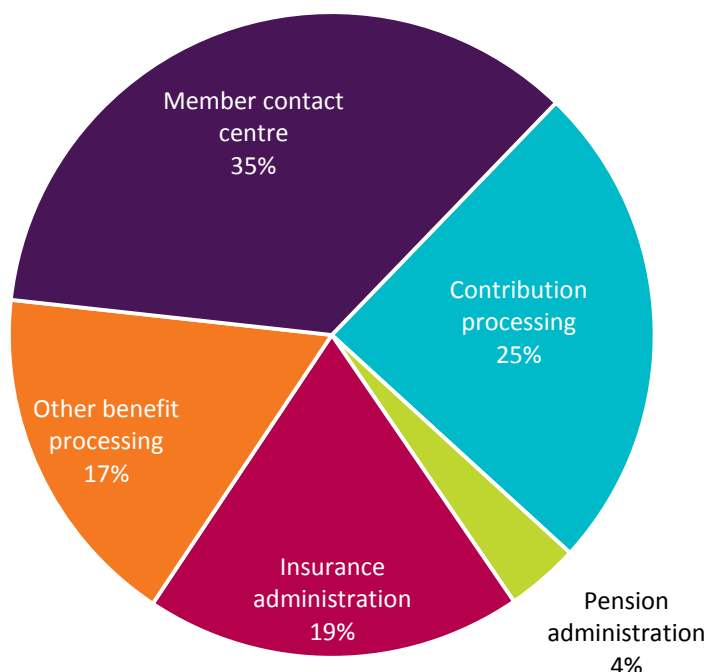


Table 6. Administration expenses per member by component (Peer group only)

Expense component	Median
Contribution processing	8.00
Pension administration	1.42
Insurance administration	6.36
Other benefit processing	8.02
Member contact centre	12.86
Total	33.35

Note that numbers may not reconcile as the sum of median components is not the same as the median of the total

3.1.3 Unquantifiable costs

Other aspects of insurance administration costs are not readily quantifiable. This arises because they form a part of other administrative activities and are not separately provisioned but are bundled into the overall administration fee.

Table 7. Unquantifiable expenses related to insurance

Expense	Description	Why it is difficult to quantify
Consulting/legal/tax advice (around insurance)	Advice provided by external parties around insurance.	Consulting costs are usually bundled with compliance/trustee support expense items.
Record establishment	Checking eligibility for default cover; generating welcome letters; offering increase in cover, etc.	This is bundled with other record establishment expenses e.g. setting up investment, account creation.
Record updating	Increase or decrease in cover.	This expense is not segregated and is included in 'other benefit processing'.
Reporting	Generating annual statements – on insurance and other features.	Marketing and communication expenses are bundled. This would be accounted for in Printing Costs and Member regular communications.
Communication/disclosure	Significant event notices, disclosure materials PDS, website, contact centre answering member queries regarding insurance.	Marketing and communication expenses are bundled. This would be accounted for in Printing Costs, Member regular communications and Member Contact Centre.
Compliance	Producing insurance management framework (APRA); board committees; claims underwriting committees etc.	Compliance costs are usually combined e.g. a single compliance / risk officer may be responsible for multiple compliance functions, not just insurance.

3.2 Note on plaintiff lawyers

The industry has recently seen an increased involvement of plaintiff lawyers seeking a resolution to claims before internal reviews are undertaken or before an SCT review would be possible.

Rice Warner recognises that the vast majority of these claims would be paid regardless of the involvement of plaintiff lawyers. The inclusion of lawyers in the process increases costs for the trustee and also reduces the benefits paid to members (due to legal fees being deducted). Anecdotal evidence suggests these fees can be as high as 40% of the insured benefit.

End notes

- i In the early 1990s, the new superannuation policy was also seen as delivering a wage increase in an economically sustainable way. At the time, there were concerns about the rate of inflation and superannuation contributions were seen as a form of deferred wages that would not have immediate inflationary effects.
- ii www.pensionspolicyinstitute.org.uk/briefing-notes/briefing-note-66---freedom-and-choice-in-pensions-comparing-international-retirement-systems-and-the-role-of-annuitisation
- iii Financial System Inquiry Interim Report, July 2014, page 2-81.
- iv Comments by FSB Chairman Mark Carney at the G20 meeting, Sydney, February 2014.
- v See, for example, ASFA Submission – Super System Review, ‘MySuper’ preliminary report, 2 June 2010.
- vi SuperRatings – Media Release: MySuper sees fees reduced by 30% but not before Australians set to pay an extra \$2 billion due to delays, 5 February 2014.
- vii Centre for International Finance and Regulation – MySuper: a new landscape for default superannuation funds.
- viii Centre for International Finance and Regulation – Working paper No. 030/2014, op. cit, page 13.
- ix *Superannuation Industry (Supervision) Act 1993*, section 29VN(b).
- x ASFA submission – Super System Review – Phase Two: Operation and Efficiency, 14 December 2009.
- xi There were 290 APRA-regulated funds with more than four members as at 31 December 2013: APRA: Insight – Issue One 2014, page 12.
- xii Productivity Commission Inquiry Report No. 60: Default Superannuation Funds in Modern Awards, 5 October 2012, page 261.
- xiii Productivity Commission Inquiry Report No. 60: Default Superannuation Funds in Modern Awards, 5 October 2012, page 261.
- xiv Edgar Robles, Ph.D., Superintendent of Pensions, Costa Rica: Controlling pension system costs – IOPS project on costs and fees – presentation to OECD/IOPS Global Forum on Private Pensions, October 2012.
- xv Financial System Inquiry – Interim report, op cit, page 2-112.
- xvi Chant West, presentation to ASFA lunch: MySuper and the year that was, 23 July 2014.
- xvii Centre for International Finance and Regulation – MySuper: a new landscape for default superannuation funds, op.cit, page 3.
- xviii Regulatory Guide RG229: *Superannuation forecasts*, December 2011 and Class Order [Co 11/1227] *Relief for providers of retirement estimates*.
- xix Located in the *Corporations Act 2001* and *Corporations Regulations 2001*.
- xx ASIC – Consultation Paper 203: *Age Pension estimates in superannuation forecasts: Update to RG229*, March 2013.
- xxi Super System Review: Final Report, Chapter 8, page 221 – “Submissions overwhelmingly supported the retention of the trust structure for SMSF’s. The Panel supports the trust structure in the large APRA fund sector and it sees no reason why the SMSF sector should operate under a different structure.....given its substantial size and history and the costs and challenges of replacing it”.
- xxii Financial System Inquiry Interim Report, July 2014, page 3-44.
- xxiii Financial System Inquiry Interim Report, July 2014, page 3-46.
- xxiv Financial System Inquiry Interim Report, July 2014, page 3-47.
- xxv “Underinsurance – Death Protection Gap in Australia”, KPMG (on behalf of the FSC), 2013; and “Underinsurance – Disability Protection Gap in Australia”, KPMG (on behalf of the FSC), 2014.
- xxiv TAL media release, 25 June 2014.
- xxvii The total cost to government of life underinsurance across Australia is \$47 million per annum.
The total cost to the government of total and permanent disability (TPD) underinsurance is \$1.26 billion per annum.
The total cost to government of income protection underinsurance is \$247 million per annum.
- xxviii The insurance claims management and underwriting services, being primarily paper driven, are inherently inefficient. There are significant economic benefits to be gained through more efficient exchanges of fund membership data and by creating an electronic chain of processes for dealing with insurance claims.
- xxix Knowledge-based authentication, commonly referred to as KBA, is a method of authentication that seeks to prove the identity of someone accessing a service, such as a website. As the name suggests, KBA requires the knowledge of personal information of the individual to grant access to the protected material. There are two types of KBA: ‘static KBA’, which is based on a pre-agreed set of ‘shared secrets’; and ‘dynamic KBA’, which is based on questions generated from a wider base of personal information. The ATO uses dynamic KBA with reference being the most recent interactions with the ATO - such as the issuing of an income tax assessment.



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