RW NEWSLETTER

Productivity Commission parts company with the evidence

The end of yet another superannuation inquiry

The Productivity Commission (PC) has just finished a three-year comprehensive analysis of the superannuation industry. It issued its final report to Government (and the Royal Commission into Misconduct in the Banking, Financial Services and Superannuation Industry) in late December and the report became public on 10 January 2019.

Advance copies were given to selected journalists from the national media to maximise publicity on release. Since then, there have been several uncomplimentary observations about much of the report from many superannuation experts.

This has been a worthwhile exercise and the quality was high up to the issue of the draft report in May 2018. However, many parts of the Technical Supplements issued in November 2018 and the underlying modelling used for the PC's benchmarking and analysis have not consistently demonstrated the same quality. Most disappointingly, the link between the PC's recommendations and its earlier analysis has become increasingly tenuous as the inquiry progressed.

Further, the PC appears to have been affronted by the lack of enthusiasm for its proposals in the draft report. Not only has it ignored many valid concerns about its initial proposals, it has adopted an aggressive tone in the final report, with many unsubstantiated assertions. For example:

- ***The super system's role in intergenerational wealth means it will play a growing role in wealth inequality*** *(Productivity Commission Inquiry Report, Superannuation: Assessing Efficiency and Competitiveness, page 3)****.*** This is a curious statement as superannuation provides a role in improving community equality, allowing all Australians to share in growth and keeping our Gini Index low.
- ASFA pointed out that we have a world-class system that is not broken. The PC's view – ***the evidence suggests otherwise*** *(page 5)****.*** This remarkable statement is contrary to much of the evidence available including analysis by the PC, noting that international comparisons are inherently difficult.

- ***Competition is at best superficial... and the PC's new model will harness competition to deliver for members rather than funds and providers** (page 22).* Competition has driven major change – for example, the oldest segments, Corporate and Retail, have market share reducing from 42% of all FUM in 2004 to 27% in 2018. Similarly, the SMSF segment is very large – all of this is caused by having a robust competitive marketplace.
- ***There is little precedent in Australia and internationally for reviewing the efficiency and competitiveness of a superannuation and pension system in its totality. The inquiry has been unique in its breadth and use of evidence.*** While we agree with the PC about the level of ambition of the study, it has been hampered by poor data and analysis leading to inconclusive results, making it difficult for the study to achieve its objectives.

In the PC's opinion, we now require further national inquiries into the impact of superannuation on national savings in funding retirement income before the legislated increase in the Superannuation Guarantee (SG) rate is implemented. It is scheduled to increase from 9.5% to 12% in 0.5% increments from 2021 to 2025. This wanders well outside the PC's Brief. Further, it is a random comment made without any relevance to it in all the PC's reports for this inquiry, and there is no evidence of the PC having considered the impact on retirement outcomes and capital formation if this recommendation were to be accepted.

How good is our system?

We agree with the PC that our superannuation system needs to have very strong defaults as most members are unengaged throughout large parts of their careers. We note that there is huge variability in value between funds and it is, as the PC eloquently states, *an unlucky lottery for members who are defaulted into poor funds*. It is important to address these issues, though it is fair to say that there has been continual debate, legislative change and improvement over the last few decades, to the extent that the system is far better now that it was last century.

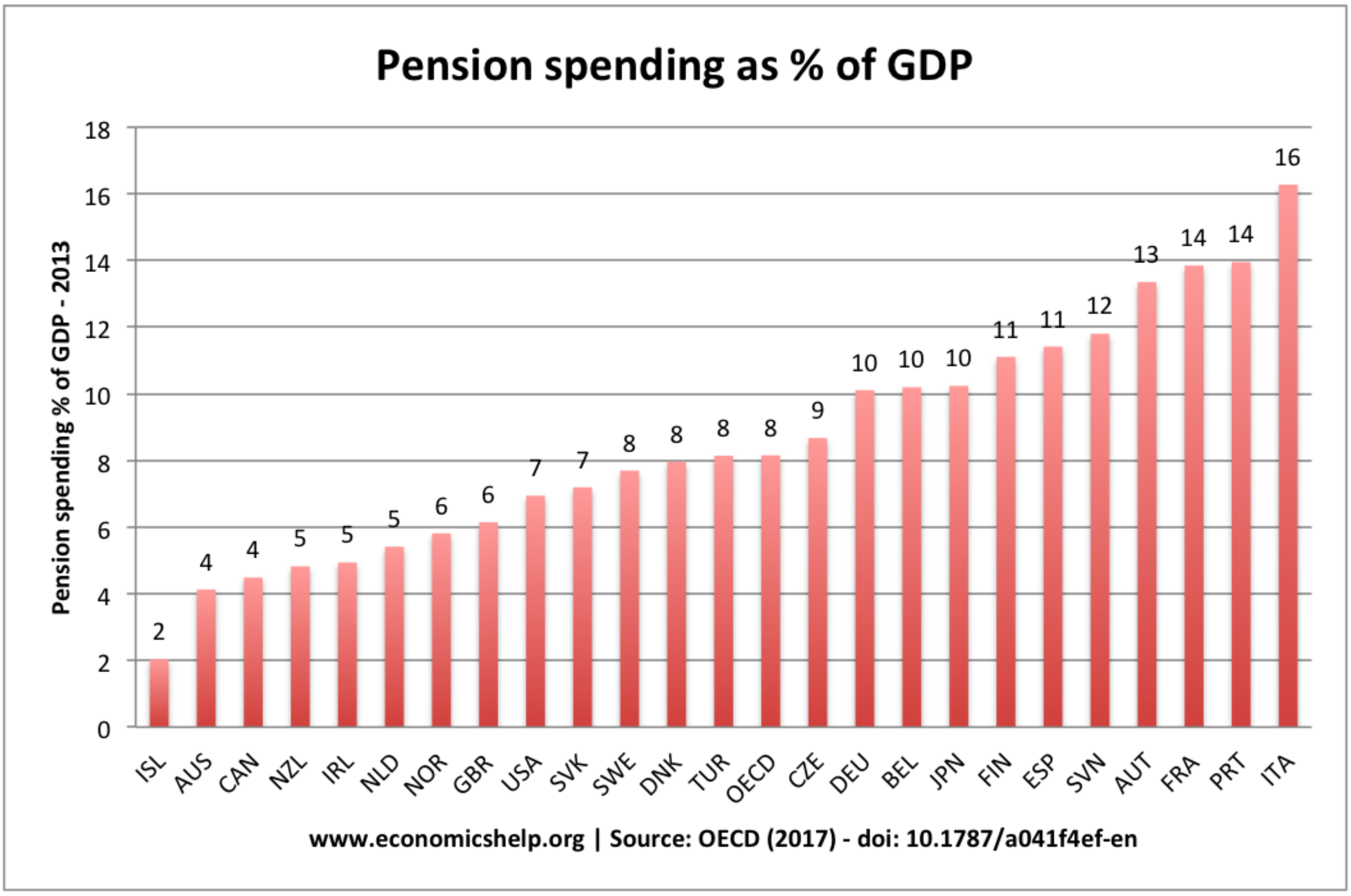
Further, Australia already has one of the world's best systems, and it is far from *broken*. For example:

- There is compelling evidence that our system is world-leading from international reports such as the Melbourne Mercer Global Pension Index, where Australia usually features as one of the four best systems. Similarly, Willis Towers Watson's annual Global Pension Asset Study usually ranks Australia's superannuation system as the fastest growing of any developed country.
- Our social security system is well-structured with Age Pension payments at 2.7% of GDP and declining (see Graph 1 by the OECD – noting Australia's number is overstated). Not only do most developed countries pay much more than us, their costs are rising[1].
- Australian companies have very low levels of unfunded pension liabilities, due to our shift away from defined benefit funds over the last 30 years. This protects against employers being constrained or brought down by defined benefit funding issues, as has happened with numerous businesses in the US and UK.
- The PC's analysis shows that Australian superannuation funds, compared to large pension funds in other developed countries, performed well across most asset classes. In fact, Morningstar figures show the large MySuper funds (previously Balanced funds) had real returns of 5% per annum over the last 25 years – far beyond the achievements of any other country[2].
- The Australian system does not force people to buy annuities in retirement, though the government rightly accepts that we do need to develop appropriate longevity products.

[1] The full report is available at: https://www.ricewarner.com/the-age-pension-in-the-21st-century/
[2] See https://www.ricewarner.com/benchmarking-the-industry-investment-performance/

- Our system provides universal group life insurance cover cheaper than can be acquired in retail markets and competitive with premium rates globally, accounting for about 70% of the total life insurance cover held by Australian families.
- Funds provide intra-fund financial advice which helps members to engage with their retirement at a reasonable price (often provided as an inclusive benefit by many funds).

Graph 1. Pension spending as a % of GDP



We have an unusual taxation system for superannuation. It was far too generous for high-income earners, but the 2016 Budget changes removed the worst excesses and the concessions are now broadly fair.

More work must also be done in designing retirement products and strategies, which are made more complex by the means-tested Age Pension system.

What points are well made?

During the inquiry, the PC identified several problems with the current superannuation system which need to be improved. These include:

- removing unnecessary multiple accounts
- removing poorly targeted life insurance
- developing good retirement products and strategies
- eliminating funds with persistently poor investment strategies

- addressing those funds with fees that are excessive relative to the services they offer
- addressing the remaining trail commissions on superannuation accounts.

Key remedial changes

Several recommendations were flagged in the draft report and some were then built into the 2018 Federal Budget, but are yet to be legislated:

- remove under-performing funds (APRA Outcomes test)
- raise the bar for MySuper products (APRA Outcomes test)
- remove unnecessary life insurance (2018 Budget change)
- remove multiple accounts (2018 Budget change).

We agree with these improvements but not with the report's hyperbole. For example, it states that shifting to a better-quality fund would save $533,000 for a new entrant today. This figure assumes someone would be in a bottom-quartile fund for their whole career and that someone else would be in a top quartile fund for their whole career, both of which are highly unlikely.

The PC has also inflated the size of the saving, by assuming that members will grow their wages (and therefore contributions) at 4% per annum while only discounting the retirement savings back to today at 2.5% per annum – this apparently innocuous difference has the potential to overstate the savings by 95% compared to industry standards.

Choice members in APRA-regulated funds

The PC, albeit based on a relatively small sample, concludes that Choice members earn lower investment returns than MySuper members and they have higher fees. Rice Warner reached a similar conclusion for work done for AIST in 2018[3].

The PC suggests raising the outcomes test for Choice products. We have commented before on the proliferation of poor-value Choice products targeted at Millennials. It is important that APRA and ASIC ensure the standards of all Choice products are raised.

Role of regulators

The report is highly critical of the performance conduct of the twin regulators, APRA and ASIC. It claims APRA has not dealt with scores of under-performing funds. It suggests the regulators should be strategic and proactively identify instances of material member harm. While well-intentioned, this could be subjective and inherently difficult to achieve. The PC suggests the method to achieve this but its own analysis (*benchmarking performance*) and solutions (*Best in Show*) would not work.

It also states that regulators should be made to focus on the interests of consumers, which unfairly implies that they don't do that at present. The PC simultaneously says we have a ***cornucopia of regulations,*** and that these should simply be applied, and that most of the system is not working well and should be replaced.

[3] http://www.aist.asn.au/media/1212739/analysis_of_mysuper_vs_choice_final.pdf

Some of the sensible recommended changes:

- APRA would be required to conduct an annual outcomes test across all portfolios (including MySuper, all other fund investment options and stand-alone Choice products). This will be done at *an elevated level* to the current level of fund review.
- APRA should invest in collecting and analysing data. This recommendation is required if APRA is to monitor funds' performance more effectively.
- The regulators should do more to facilitate mergers.
- APRA should require funds to monitor all major service contracts triennially. Further, there should be more rigour in these contracts (reflecting some of the issues raised in the Royal Commission into Misconduct).

A few recommendations are less fully considered:

- APRA would use the PC's benchmark portfolios to measure the success of funds. This would be a retrograde step as discussed later.
- The APRA Outcomes test needs to be enhanced such that inadequate default funds would lose the right to remain in the super system. This is a noble ambition, but it requires careful analysis before implementation (which the PC has not provided).

Advice

Whilst the PC's draft reports were largely silent on recommendations to improve advice in superannuation, the final PC report includes recommendations relating to financial advice. Notably, it has recommended that the term advice can only be used with *personal advice*, and not be used for information or general advice.

It has also recommended disclosure and monitoring of Approved Product Lists, with a focus on how often in-house products are recommended. These recommendations have carried forward from the PC's separate *Competition in Australia's Financial System* inquiry handed to the Government on 29 June 2018.

What points are poor?

In the early stages of the inquiry, the PC took the view that the current system is inefficient. It came up with four alternate systems to capture contributions from new entrants. In doing so, it incorrectly assumed that the current structure is *broken* and could not be remedied with targeted improvements. This was a fundamental flaw as it has ended up recommending a system worse than the current one.

Award Super

At an early stage of the inquiry, the PC grappled with the problem of some members being defaulted into poor funds due to Award restrictions. There is no doubt that the Award system is anti-competitive (and will be more so when appointments are made to the independent Expert Panel of the Fair Work Commission). However, this is a legacy of the genesis of Industry superannuation, where award contributions were collected by employers and steered into nominated funds (many of which were created for this purpose). It provides economies from multiple employers contributing to a single fund. Without the Award system, many of the best funds in Australia would have never started!

Further, the PC has not provided any evidence to suggest that the Award system has provided less favourable overall outcomes than any other method. While concerns about inclusion of some poor funds should not be discounted, they are best resolved by removing such funds' eligibility to receive default contributions.

We do not need *Best in Show* as an alternative to the Award system. Rather, we need the bar to be raised for MySuper such that all default funds are of a reasonable standard. Then, employers should be allowed to change their default, but only following independent advice or research on the merits of a new fund against the incumbent. If this were not done, employers could be pressurised to change – the PC said it had evidence that some funds offer benefits to influence employer decisions.

Best in Show

The *Best in Show* system makes two precise statements:

- There should be **10** funds to take contributions from new entrants.
- Performance should be measured over the last **eight** years.

There is no particular reason why 10 funds should be picked to capture money from new entrants. Surely, if the bar is raised for MySuper, any of these funds would be appropriate? If 10 funds were picked, there would be severe dislocation as they would then promote themselves over all other funds. This would be misleading – for example, a suitable fund for new entrants might have a poor retirement strategy.

Over time, the top-10 would seek mergers to get bigger and the list would shrink. When the list is reviewed every four years subjectively by non-experts (they could not come from the industry), some funds would drop out and others would enter. What would then happen to members of a fund which dropped out?

The PC claims that this structure would lead to heightened competition as funds try to make the short-list. However, it is more likely to lead to uniformity of structure and investment strategy of funds as they make peer comparisons. Funds which do not make the initial list of 10 would have an embedded disadvantage over those which make the list, reducing competition over time. Innovation would decline, benefits could reduce, and investment strategies might become less risky, leading to lower retirement outcomes.

Benchmarking performance

The PC attempts to undertake an attribution analysis of investment performance. It looks at the gap in performance between Retail and Industry funds but cannot explain most of the difference. Some of this will be the poorer performance of some related-party investment managers and some will be the lack of scale in the parts of the Retail segment which are constricted by having too many products and platforms.

The measurement over 13 years includes a significant period prior to the introduction of MySuper. For some retail institutions, the early period will have multiple default products, embedded adviser commissions and some conservative products targeted towards older members. None of this is directly comparable to MySuper products.

The report concludes that there is a wide discrepancy in performance between funds over extended periods. This has been well known for years and should be addressed by weeding out under-performing funds. The media has quoted the $660,000 ($108,000 in today's money) a new entrant would lose if placed in a bottom quartile fund. This is implausible and suggests that a poor fund would survive for a member's full career without any intervention from the regulator (and that the member would not notice and change funds).

There is no commentary about adjustment for the related topics of differences in risk levels and differences in target objectives set for members, nor of the potential for retirees to have a different risk tolerance from accumulation members.

The PC has suggested a method of measuring the investment performance of funds using rolling eight-year periods. It is unclear why this unusual period has been selected – conventionally, funds set objectives for members to achieve CPI + x% over rolling 10-year periods.

The PC has proposed that funds with results 0.5% a year less than benchmark over rolling eight years would have 12 months to lift performance or be withdrawn from the market. This appears to be punitive for those seeking high returns with higher risks. It could lead the industry into a more conservative investment structure with poorer retirement outcomes. Further, if we ever had an investment period such as that following the *oil shock* of 1974, it is possible that all funds would fail the test in ensuing years.

We all know that investment structures and governance are important as well as asset allocation. Past performance is useful in weeding out persistent non-performers, but it is only one factor in evaluating a fund, and it is essential that decisions be based on valid analysis.

In one of our submissions to the PC, *Investment performance: supplementary analysis* dated 16 November 2018, we commended the PC for its effort but found that "*the results are not valid due to current limitations in available data. This limits the scope for valid use of the results to reach conclusions and develop policy recommendations*" [4].

We are disappointed that the PC has nonetheless formulated conclusions and policy recommendations based on this analysis, without correcting gaps which prevent it being fit for the purposes for which the PC sought to use it.

Fees

The commentary on fees is mixed. The PC starts by stating that total fees are more than $30 billion a year, or 1.1% of assets. They use 2017 as a base when total fees were about $22 billion, and the industry total was less than 1% of assets[5].

While $22 billion sounds a lot, the big four banks have profits exceeding $30 billion a year, so it needs to be seen in perspective. Further, Australian superannuation is too different to the rest of the world to make meaningful international comparisons:

- Australia's system is mandatory for all employees, whereas many countries have corporate funds with little coverage of higher-cost small business.
- Australia has high levels of unlisted assets compared to other countries. These have generated excellent returns overall. However, the cost of these investments is higher than for listed assets.
- Australia has mandatory life insurance which needs to be administered.
- Funds have choice of investment strategies.
- Members can opt to join any public-offer fund through Choice.
- Funds provide intra-fund advice with the cost built into administration fees.
- Many of the advantages of MySuper and Super Stream have not yet spread to all products.

The PC does show that fees are too high in many funds (above 1.5% a year in 3 million legacy accounts and another 1 million Choice accounts). We agree that the regulators should work with these funds to improve the position for their members.

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[4] https://www.pc.gov.au/__data/assets/pdf_file/0003/232923/subdr225-superannuation-assessment.pdf
[5] https://www.ricewarner.com/fees-versus-value/

The PC concludes that fees should not exceed cost recovery levels. The intent is to address conflicts within retail funds where trustees have the incompatible duty between seeking to provide a financial return to shareholders and looking after members' best interests. This is not an easy problem to solve but the proposed solution would ensure that we end up with a system bigger than the banking system yet absent of any capital.

One consequence would be that the Retail sector, including those with good products, would stop providing superannuation. All profits would be driven through service suppliers, which would provide the capital for the system (and would expect long-term contracts in return). Funds would not be able to build reserves on a cost-recovery basis, and it is not clear how reserves could be funded under this proposal.

SMSFs

The report showed that SMSFs outperformed APRA-regulated funds over the 11 years to 2016. The PC could not find data to explain this difference, but it is likely to be partially due to tax treatment – moving from accumulation to pension phase without crystallising CGT, and astute milking of franking credits (which Labor intends to restrict).

The PC notes that SMSFs with less than $500,000 have much higher costs as a percentage of assets, and it questions whether smaller funds are viable. While the amount is subjective, it would not be unreasonable to require an SMSF to have (say) $250,000 at establishment.

It concludes by accepting the adequacy of the current regulation of SMSFs. However, it raises concern about the quality of financial advice provided to many of these funds, largely based on ASIC research. Hence, it recommends extending the *product design and distribution obligations* to the establishment of SMSFs. This would be difficult to police given the individuals establishing the funds are simply setting up a new structure. It would be possible to introduce rules around the investment strategies, which would highlight concentrated assets such as leveraged properties.

Insurance

Like the Cooper inquiry, the PC showed its ignorance of the value of group life insurance. It noted that "*some have argued that insurance in super has been a key factor in addressing an underinsurance gap in Australia, though we have not assessed this as part of this inquiry" (page 19)*. It is remarkable that the PC can recommend sweeping change to life insurance without understanding its role and value.

Nonetheless, the idea of removing automatic (default) insurance from those under age 25 has merit and legislation has been drafted. There are arguments for exemptions or variations notably for high risk occupations, but the principle is generally accepted.

The PC is critical of the Code of Practice and suggests APRA and ASIC take carriage of this, rather than have a voluntary Code.

The PC concludes by suggesting an independent public inquiry into the role of insurance in superannuation be held in four years. We have noted on several occasions that life insurance is not within the proposed Objectives of Superannuation and its role should be clarified. We fail to see why the industry needs to wait four years for this to be done.

Retirement

The retirement section is informative but adds nothing new to the debate. It focuses on retirement products rather than strategies. There is nothing on the role of financial advice, the integration of the Age Pension with superannuation or the impact of being married at the time of retirement (with a partner's superannuation in a different fund).

Future Fund

There has been some media speculation about using the Future Fund as a default fund for new entrants. The Future Fund is a special purpose fund manager and is not able to manage superannuation accounts. Further, partial nationalisation of the system would be detrimental for all. Indeed, the PC are rightly unsupportive of a Government run default fund.

The state governments have all exited management of superannuation, resulting in some good public offer funds including the very large QSuper, First State Super and VicSuper. All of these and their equivalent funds in the smaller states can take contributions from new members. Consequently, there is no gap in the market which the Future Fund could fill.

Conclusions

The PC's earlier analysis made a major contribution to identifying areas of the Australian superannuation system which can and should be improved. It rightly highlighted the problems caused by unintended multiple accounts, unnecessary life insurance for young people, entrenched underperformers and a tail of products with very high fees. Government and industry will work towards addressing these problems.

The final report focuses on replacing rather than improving a system that is already world-leading. The main suggestion of a 10-fund *Best in Show* structure for new default members will lead to an oligopoly in time, reducing competition and increasing systemic risk. Fortunately, no Parliament will pass this deeply flawed recommendation.

One of the strangest comments from the PC was the recommendation that the Government holds a full inquiry on national savings and retirement before the SG rises from 9.5% to 12%. The PC's three years of work provide no insight into the reasoning for this recommendation.

Our modelling shows that the legislated increase in the SG will not have much impact on the Age Pension for many years but will reduce it by about 0.1% of GDP in the second half of this century on current means testing settings. Conversely, the tax concessions from the increase are more immediate and they will average about 0.22% of GDP throughout this century. This seems to have been the main reason for the increases to SG having been repeatedly delayed, but this is a small cost to pay for the improvement in retirement incomes which it would deliver. We should point out that these values (Age Pension costs and personal tax concessions) do not need to equate; it is desirable to give tax concessions for those who save and lose access to their funds until they retire.

This research gave the PC the opportunity to define the agenda with a cohesive, evidence-based package of recommendations. Sadly, the growing disconnect between the PC's analysis and its recommendations means that this opportunity has been lost.

Contact Us

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