



21 April 2016

Superannuation
Productivity Commission
Level 12, 530 Collins Street
Melbourne VIC 3000, Australia

Email: super@pc.gov.au

Dear Sir / Madam

Re. Study of superannuation efficiency and competitiveness

The Financial Planning Association of Australia (FPA) welcomes the opportunity to make a submission to the study.

While we have focussed our efforts on answering the questions raised in the issues paper, we also see this study as an opportunity to consider the role professional advice plays in promoting competition and efficiency in the superannuation system.

The FPA would welcome the opportunity to discuss with you the issues raised in our submission.

If you have any questions, please contact me on 02 9220 4500 or dimitri.diamantes@fpa.com.au.

Yours sincerely

Dimitri Diamantes
Policy Manager
Financial Planning Association of Australia



Superannuation Efficiency and Competitiveness

FPA submission to:
The Productivity Commission

21 April 2016



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INTRODUCTION

The FPA's submission focusses on practical ways to assess the superannuation system. While we have generally confined ourselves to the current policy settings, we have also highlighted where policy might impede competition and efficiency.

We recognise that cost is an important element in the system. However, we believe that value to consumers is of paramount concern; this view is reflected in our responses to the questions raised in the issues paper.

In addition to considering product providers, regulators and consumer, we have also – where appropriate – considered the role of the professional financial planner. We believe that professional advice can help promote competition and efficiency in the system and we would encourage the Commission to explore this issue.

SYSTEM EFFICIENCY OBJECTIVES

Within the current policy settings, what are the objectives against which the efficiency and competitiveness of the superannuation system should be assessed? How prescriptively should the objectives be assessed?

Competition and efficiency should be assessed against the following objectives:

- Maximizing value of investments, insurance and ancillary services
- Optimizing: investment allocation; withdrawal; and product choice and provision
- Maximizing efficiency over time

Further, in the FPA's view, efficiency should be understood broadly. Efficiency doesn't just mean optimizing risk-adjusted returns or ancillary services; it also means optimising the choice between consumption and savings to ensure consumers achieve their expected standard of living in retirement. In this broader sense, it can be seen that the system also includes professional advisers, who help members achieve their expected standard of living in retirement.

The FPA holds that, generally, objectives should not be set over-prescriptively. For example, value should not be conflated with price. Similarly, optimal investment allocation should not be reduced to an inflexible life-stage model of asset allocation; and optimal withdrawal patterns should not be reduced to an inflexible income stream model of withdrawal.

Ideally, a representative survey of individuals' preferences (e.g. risk preferences) and their superannuation (e.g. investment option) would be done, which would structure the objectives against which competition and efficiency are assessed.



APPROACH TO ASSESSMENT

Do you agree with the broad approach of combining performance benchmarks with a test of barriers to efficient or competitive outcomes in the superannuation industry?

In principle, the FPA agrees with this broad approach. However, the usefulness of this approach depends on the benchmarks and metrics used to assess the assessment criteria. For example, using downward pressure on fees as an indicator of competition is inappropriate where fund quality has improved.

Another example is that the problem with using scale of superannuation funds as an indicator of intensity of competition is that increased scale may involve a decreased number of competitors and, in turn, may decrease competition.

Ideally, the metrics would measure the intensity of competition on price and quality in a way that is not ambiguous.

How should the unique features of the superannuation system be taken into account in developing criteria and indicators for assessing its competitiveness and efficiency? Are there other possible approaches?

A problem is that some consumers would not act in their own interests, due to various behavioural biases and constraints, such as lack of financial literacy, myopia, loss aversion, reliance on mental shortcuts, a tendency to procrastinate and general apathy.¹ This means that even where the superannuation market bears the hallmarks of being competitive and efficient, the market may nevertheless provide less value to consumers than if those consumers were acting in their own interests.

Unlike other investment markets, the compulsory nature of superannuation and the general disinterest of superannuation members² mean superannuation inefficiencies are likely to turn on whether or not members are engaged and financially literate. To isolate the combined effects of disengagement and financial illiteracy, suitable proxies would need to be identified.

One approach is to compare disengaged members with engaged financially-literate members. A possible proxy for disengagement is where the member has invested in their default account and investment option. (Admittedly, some of these members may have actively chosen the default account and investment option.) A possible proxy for engagement is where the member has chosen to invest in

¹ Gerrans, P. and Yap, G. 2013, *Sophistication in retirement savings investment choices*, Working paper, Australian Centre for Financial Studies, Melbourne.

² Murray, D., Davis, K, Dunn, C., Hewson, C. and McNamee, B. 2014, *Financial System Inquiry Final Report. Final Report*, November 2014, http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf (accessed 1 April 2016).



a fund other than their default fund. (Admittedly, the investment decisions of some of these members may not align with their best interests.)

Even though the proxies are imperfect, a comparison of, say, MySuper and Choice members may yield valuable insights into how engagement affects allocative efficiency in the real world. For example, Choice members may derive better risk-adjusted returns (despite MySuper's limits on buys and sell spreads, exit fees and switching fees) and risk-adjusted insurance premiums.

Of course, behavioural bias might still mean that no sector of the superannuation market realises a perfect alignment between their best interests and how their superannuation is actually invested and used.

Another issue is that – especially because of the relationship between professional associations or trade unions and superannuation funds – members of a superannuation fund may want to invest subject to social or ethical screens or even in specific projects. Where the fund shows through its constituting document (or by a resolution made with fair representation of members) that it is investing in such a way, it would seem appropriate to assess the performance of this part of the system by reference to the return of an appropriate benchmark (or in the case of a specific project, by reference to that project).

To what extent do different data reporting formats make it difficult to compare SMSFs and APRA-regulated funds, and hence to assess the performance of the superannuation system as a whole?

The fact that the data fields (and associated labels) for SMSFs and APRA funds are not aligned makes comparison of the fund types difficult. Comparison is made more difficult by the fact that the ATO and APRA reports aren't consolidated.

The FPA recommends that a common set of data fields (and associated labels) are developed for SMSFs and APRA-regulated funds. We understand that additional fields will be required to capture information peculiar to certain types of fund, however there is still substantial room for comparison based on common types of characteristics.

For example, it would be useful for both types of funds to provide annual and long-term net risk-adjusted returns and insurance data on a member and fund level.

The FPA also recommends that ATO and APRA consolidate reports on fund statistics to make it easier to compare SMSFs and APRA funds.

Which of the existing cross-country composite measures of pension system performance would be most relevant to this study and why? What are the challenges in using these measures to assess the efficiency and competitiveness of Australia's superannuation system? What measures and criteria are comparable across different countries?

The FPA is not sure that any of the existing cross-country composite measures of pension system performance would be suitable for the study. For example, the Melbourne Mercer Global Pension Index



assesses median retirement income, whereas we would suggest that adequacy be based on the member's cohort (which might be divided along the lines of pre-retirement income).

The present study's purposes would also be at odds with those of the Allianz Pension Sustainability Index, which includes downward pressure on replacement rates as an indicator of improved pension sustainability.

Which of the existing composite measures of Australian superannuation fund and/or product performance would be relevant to the study and why?

The FPA does not express a preference as to existing composite measures of Australian superannuation fund and/or product performance.

ROLE OF COMPETITION IN SUPERANNUATION

What are the key ways in which competition can improve efficiency in the superannuation system? Is there sufficient emphasis on competition in the regulation of superannuation? Are there any current circumstances where competition is not delivering efficient outcomes and why?

The clearest case for competition putting downward pressure on price is where products or investment options are materially similar. For example, where the gross risk-adjusted returns on different investment options are materially similar on a consistent basis, there would be a clear case for price competition. Further, consistent differences in gross risk-adjusted performance would signal that fees may need to be adjusted to align net risk-adjusted returns.

Care would need to be taken to identify an appropriate investment horizon. For example, some investment options may be designed to provide superior returns in the short-to-medium term only.

Of course, providers can compete on price or quality. Regardless of the type of competition, the FPA's view is that regulation needs to put more emphasis on enhancing the competitive environment. In particular, more emphasis needs to be put on ensuring the selection of superannuation products and investments signals to providers the value informed consumers place on these products and investments. This is particularly important in a compulsory market such as superannuation, where high levels of disengagement or lack of financial literacy can lead to consumers not making decisions in their own best interests.

Advice is a key way to facilitate better alignment between consumers and product/investment selection. However, advice has the potential to be compromised. For example, general advice has the potential to influence consumers to acquire a particular product even though the advice does not take into account the consumer's personal situation. The problem is heightened in vertically integrated firms.

A similar problem arises where financial advice is actually given. Professional advice has the potential to drive efficiency gains through competition. This is because advice can help consumers understand the costs, benefits and risks of superannuation better. In turn, consumers can make more informed



choices and pressure is put on product providers to base their offer on the informed price consumers are willing to pay for any given level of quality. Implementing the 'best interests' duty and excluding conflicted remuneration have the potential to enhance efficiency by helping align advice with the consumer's interests.

What are the key sources of economies of scale? What are the ways of realising economies of scale, in addition to fund mergers? Are there any parts of the system that may be operating with diseconomies of scale? What are the best indicators for measuring the current realisation of scale economies, and the scope for future increases?

Sources of scale include funds' outsourcing the supply of services such as actuarial services, administration, asset consulting, auditing, custody, legal services, and investment management, legal services, sales and marketing. Of course, on the downside, competition among these service providers may be diminished if a small number come to dominate the market.

The production process for a specific output (say, dollar value of assets or number of members) is said to exhibit economies of scale when average cost (AC) (i.e. cost per unit of output) declines over some range (where $AC = TCAC/Q$).³ We understand that econometric techniques exist to estimate superannuation providers' cost curve.⁴

One researcher looked at Australia's 200 largest superannuation providers (based on 1999 data).⁵

The main findings were as follows. First, there is an evidence of ray economies of scale (assuming that the composition of outputs remains unchanged) up to at least 300 per cent of mean output in both investments and operations.

After this point, there is some evidence that diseconomies of scale in operations may arise and so there is little incentive for superannuation funds to expand output far beyond that level. However, the economies of scale in investment costs increase at an increasing rate up to 300 per cent of the current level of output, and this suggests that diseconomies in investment costs (if they do exist) will only apply at very much higher levels of output than currently found in the Australian superannuation fund industry.

Second, in contrast, the evidence for economies for scope is very weak, with GES [global economies of scope, i.e. global (as opposed to product-specific) economies from diversity of production] only found in operations and then only at very high levels of output. This suggests that only the largest funds will benefit in cost terms from full in-house production of administrative services and that for the typical superannuation fund there are substantial cost

³ Higgs, H., Worthington A.C., 'Economies of scale and scope in Australian superannuation (pension) funds', *Pensions* (2012) 17, pp 252-259

⁴ *Ibid.*

⁵ *Ibid.*



savings in contracting-out many administrative tasks and nearly all investment activities (or at least there are no significant cost savings for in-house production).

Given the changes in the industry since 1999, an updated study is required. However, recent data and longitudinal data may be difficult to source, presenting a practical challenge. Another challenge is that the quality of products may be different. For example, one fund may provide education and advice, whereas the other might not.

COMPETITION IN THE SUPERANNUATION SYSTEM

What are the key outcome-based indicators of competition in the superannuation system?

While we agree that fee reduction over time is an indicator that competitive pressure is being felt, invested-related fees and insurance premiums generally cannot be considered in isolation because, for example, an increase in investment fees may add more risk-adjusted value to the investment than the fee increase took away. The assessment would need to strip away any loss in gross efficiency, to isolate beneficial investment fee reductions.

We also think that improvements in efficiency – regardless of whether the improvement is fee driven - can indicate that competitive pressures are being felt. For example, where the insurance premiums rise more slowly than the probability of payout, this is a sign of competitive pressure.

Supply side conditions

The key outcome-based indicators of barriers to entry and exit are:

- existence of regulatory barriers
- high minimum viable scale

The key outcome-based indicators of competition between providers are:

- economies of scale being achieved
- downward pressure on fees over time
- downward pressure on insurance premiums relative to expected payout

Demand side pressures

The key outcome-based indicators of member engagement and understanding are:

- availability and cost of information on key decision factors for members
- surveys of member awareness of key features of the service and availability and nature of substitutes

The key outcome-based indicators of member switching behaviour are:



- costs of switching funds and products
- surveys of motivation for switching

Market definition

For each of the levels in the vertical supply chain, who are the relevant consumers, and which market participants within or outside of the superannuation system are the most likely source of competitive pressure?

Wholesale level

- outsourced functions are typically just suppliers, but, for example, investment managers may be consumers of investments too and platform service providers are consumers or quasi-consumers (in the sense of aggregating consumption on behalf of members) of investments or investment products

It seems likely that funds would apply competitive pressure on outsource providers (assuming the market is not dominated by a few outsource providers) given that reducing outsourcing costs increases the fund's profit margin (all other things equal).

Retail level

- funds/trustees are consumers of outsourced functions and complementary services
- employers are quasi-consumers (in the sense of choosing funds on behalf of their employees who are default members) under default superannuation fund arrangements
- members are consumers of funds
- members are also, indirectly, consumers of investments or investment funds via member-directed investment

It seems likely that financially literate, engaged consumers would exert competitive pressure on funds. Consumers who aren't financially literate or engaged won't exert the same pressures and given the default market appears to be distinct from the Choice market, it is possible that the pressure exerted by Choice consumers does not strongly affect default fund/option value.

It is also possible that, in selecting a default fund, employers exert competitive pressure on funds.

For each of the levels in the vertical supply chain, is there evidence of competition on factors other than price, and if so what are they (for example, performance, investment options, and additional features)? On what factors and features do default funds compete in corporate tenders? What drives choice?

It is possible that superannuation funds compete for members and default fund arrangements on factors other than price, for example, investment performance and insurance offering.



The FPA recommends that research be undertaken to determine the extent to which non-price factors drive choice. We propose that risk-adjusted returns (net of fees and tax on earnings) over time on short, medium and long-term horizons and risk-adjusted insurance premiums be used to assess the drivers of choice.

A similar approach could be taken in assessing competition at the wholesale level. For example, risk-adjusted returns (net of wholesale fees) from the fund's underlying investment managers or investment products could be used to assess whether investment manager performance over the short, medium or long-term is driving fund's investment manager or investment product choices.

What factors are relevant for the assessment and selection of platform service providers by funds?

We'd suggest that cost, management quality and quality and speed of service are key criteria for the assessment and selection of service providers. Management quality might be measured by level of relevant education and experience. Quality of service might be measured by error rates and satisfaction ratings by funds.

*What is the degree of substitutability between different types of superannuation funds and products?
How can this be evaluated or measured?*

Large funds include industry, public sector, corporate and retail funds. Retail funds are typically public offer funds, meaning members of the general public can join. Small funds include small APRA funds (SAFs) - i.e. APRA regulated funds with an independent trustee and fewer than five members - and self-managed superannuation funds (SMSFs), which are ATO-regulated funds.

Historically, industry funds were not public offer funds, however many have become public offer funds. Retail funds are public offer funds. By contrast, public sector funds are typically not public offer funds. Similarly, the large majority of corporate funds are not public offer funds. SMSFs and SAFs are also not public offer funds.

The distinction between funds that are public offer funds and those that are not clearly affects the substitutability of funds, as some individuals would be excluded from the latter (but not the former). In broad terms, public offer funds can be substitutes for non public offer funds (but not necessarily vice versa); and industry and retail funds have a potentially high degree of substitutability with each other.

Even where public offer status doesn't exclude substitutability, funds may differ in material ways. For example, a corporate fund might have heavily subsidised fees and insurance premiums compared to an otherwise materially similar retail fund.

The degree of member control is also going to affect substitutability. For example, SMSFs are totally member-controlled, whereas SAFs are controlled by an independent trustee. While both funds can have member-directed investment, the difference in trustee structure (and, indeed, to some extent regulation) makes these funds imperfect substitutes.



Substitutability is measured based on cross-elasticity of demand, which is the percentage change in quantity demanded for the first product or investment option, that occurs in response to a percentage change in price of the second product or investment option.

What is the relative contribution to member fees from the various participants through the vertical value chain?

We understand that further research would need to be undertaken to answer this question.

Criteria and indicators

What are the most reliable and relevant assessment criteria and indicators for measuring the competitiveness of the superannuation system?

The FPA generally agrees that the assessment criteria and indicators mentioned in Table 1 of the Commission's discussion paper are the most relevant for measuring the competitiveness of the superannuation system. However, when assessing competitiveness care should be taken to ensure that lower fees are not accompanied by material deterioration in the quality of products or investment options.

We'd add an additional indicator of competition between providers, namely downward pressure being placed on insurance premiums relative to expected payout, over time.

What are the barriers to efficiency-enhancing competition in the superannuation system? In particular, what are the policy impediments to competition? How can the impact of these barriers be measured?

Member disengagement and gaps in the regulation of advice might be allowing underperforming funds (particularly in the default fund market or where product providers are vertically integrated with advice and distribution channels) to continue. Restricting the use of the term 'advice' and enhancing the quality of financial advice could enhance competitive pressure, incentivising sub-scale funds to merge or otherwise achieve economies of scale, and putting upward pressure on value.

The following extract from the FPA's submission to the Financial Systems Inquiry explains these practical problems arise due the conceptual framework of the relevant legislation:

Financial product advice is presently divided into general advice and personal advice. The crux of the difference between the two is that personal advice takes into account the specific objectives, needs, and circumstances of the client, whereas general advice is limited to information about financial products. This general/personal distinction informs the regulation of financial product advice in a similar fashion to the retail/sophisticated investor distinction.

We are concerned that defining financial product advice on this basis makes it more difficult for investors to distinguish personal financial advice from marketing material or product sales. This



risk is confirmed by ASIC's *Report 384 – Regulating Complex Products*, where the Report states;

“Our research has indicated that marketing information plays a particularly strong role in product distribution and may influence investors’ decision making more than other product disclosure. In particular, when investors approach product issuers or other intermediaries responsible for selling products directly, rather than going through advisers, the information contained or implied in product issuers’ marketing information is often the first, and may be the only, information that investors use to decide whether or not to invest in that product.”⁶

In particular, we believe that financial product advice, if it is to be called advice, should always be based on whether it concerns the personal circumstances of the client. Furthermore, this distinction does not address more salient factors, such as the client’s financial literacy and capability. Framing ‘general advice’ as advice plays into the behavioural aspects of financial decision-making by giving the impression that the advice has a reasonable basis or is appropriate for the client, and thereby exposes retail investors to decisions made under uncertainty about the regulatory framework for that advice.

In relation to financial advice, the FPA believes that coregulation and self-regulation can enhance the quality of advice (and, in turn, help align consumer preferences with product/investment selection decisions). The suggested primary benefits are that coregulation and self-regulation are:

- more responsive to market developments
- achieve cost efficiencies relative to the ‘command-and-control model’

However, as stated in the FPA’s submission to the Financial Systems Inquiry:

While Australia divides prudential regulation from markets, services, and corporate regulation through a twin-peaks model, it is still fundamentally based on regulation by a central authority. The character of command-and-control regulation is to enforce a clear structural distinction between regulators and financial system participants, and use methods of regulation which are ultimately backed by criminal sanctions.⁷ ASIC and APRA are command-and-control regulators for the majority of the financial system, despite the availability of civil penalties and other forms of enforcement, as our regulatory structure relies on the compulsion of criminal sanctions as opposed to industry or professional sanctions, or incentives through tax.

In order to facilitate coregulation and self-regulation, there would therefore need to be a fundamental shift in regulatory attitude.

We do not know of a perfect way to measure the effects of these barriers in advance of changing policy. However, once policy reform is implemented and professional associations are actively involved in

⁶ ASIC, ‘*Report 384 – Regulating Complex Products*’ (January 2014), at [46]

⁷ Robert Baldwin, Martin Lodge and Martin Cave, *Understanding Regulation: Theory, Strategy, and Practice* (Oxford University Press, 2012) 106-107.



regulation of financial advice, the criteria for competition and efficiency could be reassessed based on the indicators discussed above.

How would you measure the effectiveness of regulation in promoting competition within the superannuation system?

In theory, key competition indicators (e.g. net risk-adjusted returns) could be measured pre and post-implementation of a reform measure, to determine the competitive impact. However, in practice it will be very difficult to separate the reform from other changes to the market. Further, care would need to be taken to measure consistent (rather than one-off performance).

How would you measure the extent of competitive pressure from the SMSF segment on the rest of the superannuation system?

The FPA recommends performing regression analysis to determine the effect (if any) SMSF status has on, for example, net risk-adjusted returns. (Care would need to be taken to strip out any material differences in, for example, service quality and ancillary benefits, which might account for fee differences.) Materially and consistently higher net risk-adjusted returns in the SMSF segments would suggest that competitive signals from that segment aren't fully flowing through to the non-SMSF segment. Materially similar net risk-adjusted returns would suggest competitive alignment between the two segments.

Can levels of transparency on aspects such as conflicts of interest and details of reporting to members (for example, as income stream equivalents) be used as a measure of competition?

Potentially, these elements could indicate competition. However, given the level of disengagement and possible asymmetry in competitive pressures in engaged and disengaged segments, it is possible that in some parts of the market transparency would be a poor indicator of competition.

OPERATIONAL EFFICIENCY OF THE SYSTEM

Do you agree with the proposed objectives for operational efficiency? If not, what should they be?

The FPA generally agrees with the proposed objectives for operational efficiency. However, as discussed below, maximising investment return and value of retirement income needs to be tempered by the possibility that some funds or investment managers will apply ethical or social filters. These filters need to be accommodated when assessing performance.

Benchmarking

What are the most reliable and relevant assessment criteria and indicators for benchmarking operational efficiency of the superannuation system? What are the evidence requirements and current gaps in using your proposed criteria and indicators? What are the best measures of post-fee risk adjusted rates of return? How comparable are these measures?



In principle, we agree that maximising net (post fees and earnings tax) risk-adjusted returns on contributions; maximising net present value (post fees and earnings tax) for given levels of savings; and cost effectiveness of ancillary services are appropriate assessment criteria for benchmarking operational efficiency.

If the fund or investment option was driven purely by financial value, maximising net risk-adjusted returns and maximising the net present value for given levels of savings are the most appropriate assessment criterion. However, these measures are problematic where other factors, such as ethics or social goals, might constrain net risk-adjusted returns.

A better approach is to assess performance relative to an appropriate benchmark. For example, if a fund or investment option is constrained by ethics, the appropriate benchmark may be the best-performing fund or investment option with a materially similar ethical filter.

Where a fund has, say, ethical investment options as well as options that aren't so constrained, this creates an additional complexity as a member may have constrained and non-constrained investment options or may change their investment filter over time. A practical approach might be to develop benchmark returns for different investor profiles (e.g. ethical or purely financial) and to report the historical net risk-adjusted return on contributions (relative to the benchmark) for each of these profiles.

We understand that no single risk-adjusted return measure is perfect or fits all situations.⁸ However, there are practical benefits in using the Risk-Adjusted Value-Added ('RAVA') metric.⁹

RAVA measures a portfolio's excess returns over a benchmark, relative to the benchmark's volatility. For operational efficiency, returns are net of fees and taxes that aren't triggered by the member.

The benchmark has the same asset allocations as the portfolio being measured but is a real, realisable, low cost, passive alternative. The benchmark would typically be made up of different index funds.

RAVA: $(R_S - R_B)/\sigma_B$ where R_S is the total fund return of a superannuation fund, R_B is the total benchmark return for the superannuation fund, and σ_B is the total benchmark volatility

An advantage of this metric is that it avoids the contradictions sometimes experienced when using the Sharpe ratio.¹⁰ Another advantage of this approach is that data requirements are minimised as volatility only needs to be calculated for the benchmarks. This means that using RAVA overcomes data limitations as the only volatility that needs to be measured is that of the benchmark (rather than the actual fund being measured):¹¹

⁸ Australian Superannuation: Operational Structure, Investment Performance and Trustee Governance (PhD thesis, June 2013), http://ses.library.usyd.edu.au/bitstream/2123/9264/1/Liu_K_Thesis_2013.pdf pp 193-197 (accessed 13 April 2016)

⁹ *Ibid.*

¹⁰ *Ibid.*

¹¹ *Ibid.*



'[t]he superannuation performance data is normally only available on a quarterly basis, which implies that the volatility of the actual fund cannot be accurately estimated over a practically useful period. In comparison, most of the benchmark indices are available on a more much [sic] frequent basis. The greater data availability enables an easier and more accurate estimation of volatility of the benchmark, which represents the underlying investment risk of the fund.'¹²

Further, the risk measure – being benchmark volatility - can't be manipulated by adjusting the asset allocation.¹³

The disadvantage is that RAVA does '... not measure the efficiency of risk-taking relative to the volatility'.¹⁴ However, in ranking portfolios, it's assumed that efficiency increases as RAVA increases.

We'd also suggest using RAVA to assess net risk-adjusted returns for account-based products in decumulation phase because data limitations make it difficult to work out the appropriate discount rate for working out the net present value of an income stream.

For insurance, premium relative to expected payout could be used to measure the value of the cover. However, from a practical perspective, the data requirements would be enormous. However, the task would be less difficult if the meaning of common terms used in insurance contracts were standardised.

While we would accept that advice fees charged by the fund regardless of the member's take-up would be operational costs, advice fees triggered by the member should not be deducted as an operational cost (but should be deducted for the purpose of assessing allocative efficiency).

What are the appropriate benchmarks against which the operational efficiency of Australia's superannuation system should be measured? Are there countries that have superannuation systems that could provide an appropriate benchmark?

The benchmark against which overall operational efficiency should be assessed is the consistently best-performing product in the relevant category (e.g. accumulation or pension). Returns should be calculated on a net (post-fees and earnings tax) risk-adjusted basis and after stripping out distortions to market-based pricing, such as employer subsidies.

However, a separate benchmark should be used where constraints, such as ethical or social filters apply. For example, for an ethical fund, the best consistently performing fund with a comparable ethical filter should be used.

¹² *Ibid.*

¹³ *Ibid.*

¹⁴ Wilson, S. and Lew, K., *Investment performance ranking of superannuation firms* (working paper) 2009



What types of fees are relevant to assessing the competitiveness and efficiency of the superannuation system? How should these fees be measured? What data sources are available and to what extent are these comparable with one another?

For a meaningful comparison, it is crucial that the totality of product fees be taken into account. The over-riding principle should be that any fee that is charged by the product for itself or for a third-party under an arrangement with the fund should be taken into account. The following list may not be exhaustive:

- entry fees
- exit fees
- buy-sell spread
- investment management fees
- administration fees
- cost recovery fees

Generally, fees should be measured as a percentage of different levels of savings. For example, an annual fixed dollar fee would represent a higher proportion of the lower of two balances than the higher balance. This makes it easier to compare fixed dollar and percentage fees.

However, the percentage or fixed dollar amount of fee per period may not be known in advance. For example, while the percentage buy-sell is known in advance, the time period over which it is spread is not known in advance. Therefore, the buy-sell spread cannot be readily compared with other fees.

Regardless of whether a fee is readily reducible to a regular rate of return, it would already be factored into net risk-adjusted return calculations, and the net withdrawal benefits on which drawdown efficiency is calculated.

What aspects of operational efficiency cannot be reliably measured using a benchmarking approach? How could this assessment incorporate aspects such as service quality? What are the advantages and disadvantages of using techniques such as data envelopment analysis over conventional approaches such as simple benchmarking of a single criterion?

We understand that service quality can be measured using SERVPERF, which measures 22 items covering five underlying dimensions of quality corresponding to tangibles, reliability, responsiveness, assurance and empathy. We understand that most researchers have upheld the idea that SERVPERF is a better alternative than SERVQUAL in terms of validity and explanatory power.¹⁵ And that SERVPERF has been suggested to be used for assessing overall service quality and making comparisons across units, firms, and industries, thanks to its higher validity and explanatory power.¹⁶

¹⁵ Lee H., Kim C., 'Benchmarking of service quality with data envelopment analysis' *Expert Systems with Applications* 41 (2014) pp 3761–3768

¹⁶ *Ibid.*



We also understand that one of the deficiencies of using SERVPERF alone is that the overall quality score is based on a simple aggregate of the scores based on the 22 items. However, benchmarking based on a simple aggregated measure has the limitation that there is little guidance to whom to benchmark and to what degree service quality should be improved.¹⁷

We understand that data envelopment analysis ('DEM') allows quality-outputs to be weighted based on what is most efficient for the firm (rather than the weightings being chosen in advance). This then allows an appropriate benchmark to be identified, against which the firm can be assessed.¹⁸

By ensuring funds are assessed against appropriate benchmarks, we understand that DEM will give a more accurate assessment of quality efficiency.

Barriers to operational efficiency

What elements of regulation have the greatest effect on the operational efficiency of the system and which aspects of operations are affected? How could those impacts be measured?

The FPA would suggest that compliance and regulation change would have the greatest effect on the operational efficiency of the system. We would also suggest these effects could be measured based on the additional upfront and ongoing costs associated with these elements, reported by providers.

Allocative efficiency

Do you agree with the proposed objectives for allocative efficiency? If not, what should they be?

In principle, the FPA agrees with the objectives of optimal investment allocation; optimal withdrawal; and optimal product choice and provision.

Benchmarking

What are the advantages and disadvantages of using benchmarking to assess the allocative efficiency of the superannuation system? What aspects of the system most lend themselves to such assessment?

In principle, benchmarking is an appropriate approach for assessing allocative efficiency. The challenge is in choosing an appropriate benchmark. The FPA is against prescribing benchmarks *a priori*. In particular, the FPA is concerned that assessing optimal investment allocation against conventional life cycle benchmarks ignores the heterogeneity of risk preferences; and the potential benefits of adjusting target asset allocations within the same life stage.

¹⁷ *Ibid.*

¹⁸ *Ibid.*



We'd prefer instead that representative surveys be conducted to determine the risk attitudes (and their spread) for various demographic cohorts, and the results used to allocate benchmark asset allocations and confidence intervals.

Which criteria and measures are most relevant to assessing the allocative efficiency of the system, and how should they be interpreted? What are the evidence requirements and current gaps in using your proposed criteria and indicators?

Broadly speaking, the FPA agrees with the assessment criteria mentioned in Table 3 of the Commission's discussion paper, being:

- optimizing life cycle risk-return trade-off
- achieving adequate retirement withdrawals for given levels of superannuation savings
- users being satisfied with product choices and quality

We accept that managing sequencing risk and setting asset allocations appropriate for the member's life stage are indicators of an optimal risk-return trade-off. However, we would be concerned with a traditional life cycle model were inflexibly applied in assessing the trade-off. We'd prefer instead that representative surveys be conducted to determine the risk attitudes (and their spread) for various demographic cohorts, and the results used to develop benchmark asset allocations.

We acknowledge that data limitations may make it impractical to assess the risk of particular products or investment options. This limits to what extent we can be confident consumers are investing in line with their risk preferences.

Adequacy of retirement incomes for given levels of retirement savings covers:

- the extent to which retirement savings are likely to be enough to provide an appropriate standard of living in retirement
- the erosion of retirement benefits due to fees and taxes
- how withdrawals are distributed across retirement

We would suggest that post-retirement withdrawals across retirement stages, benchmarked across particular standards is an appropriate indicator of adequacy. However, as discussed below, care should be taken in identifying the relevant standards.

It should be noted that, when assessing adequacy of withdrawals, fees and taxes triggered by the member should now be taken into account, for example, adviser service fees buy-sell spreads, CGT and withdrawal tax on redemptions: and exit fees.

Heterogeneity of retirement income expectations and preferred withdrawal patterns means the criterion shouldn't be reduced to a single inflexible standard. For example, it would be concerning if an adequate standard of living was reduced to a single real dollar amount per person or couple. Different people have different retirement expectations, which are likely driven by pre-retirement income. Further, superannuation is not people's only source of income or wealth.



It would also be concerning if *maintaining* a post-retirement income from a given level of superannuation savings was necessarily deemed to be the optimal withdrawal pattern. Again, different people have different preferences about how they draw down their superannuation.

A possible solution is to benchmark adequacy and drawdown of retirement income against drawdown patterns for the relevant demographic cohort. A cohort used to a high standard of living during their working life might expect to draw more from superannuation in retirement - and make more one-off withdrawals - than someone who is not used to such a high standard of living. (Depending on the outcome of the consultation on the objectives of superannuation, it may be appropriate to prescribe a retirement benefit standard that's equivalent to a minimum real income throughout retirement, against which the adequacy of the system is assessed. This minimum would apply regardless of the retirement benefits people in the relevant cohort actually have.)

Perhaps the most important point is to assess what impact professional advice has on adequacy of retirement outcomes. For example, are advised consumers more likely to achieve a median retirement outcome (or greater) for their cohort than non-advised members?

In principle, user satisfaction with product choice and quality is an appropriate assessment criterion. The appropriate indicator is responses to user surveys. However, we would suggest that, given the long-term nature of superannuation, the survey should focus on permanent indicators of satisfaction rather than temporary ones.

Barriers to allocative efficiency

How can the magnitude and cost of principal-agent problems be assessed?

The magnitude and cost of principal-agent problems can be assessed by comparing the indicators as to operational efficiency, in the non-advised SMSF segment with such indicators in the non-advised Choice segment. The difference in alignment between each segment, on actual and optimal asset allocations and retirement savings may point to the loss in allocative efficiency due to the principal-agent problem.

The criteria for assessing the effect on allocative efficiency of the system would be the extent of: sub-optimal risk-return trade-offs; inadequacy of retirement withdrawals; and user dissatisfaction with product choice and quality. The indicators would be the same as for optimal life cycle risk-return trade-off; adequacy of retirement income for given levels of superannuation savings; and user satisfaction with product choice and quality.

As, generally, all the trustees of an SMSF are members and all the members are trustees, the principal-agent divide (group of trustee-members-each individual member) is presumably weaker than in the Choice segment, in which governance and membership are at best remotely connected. Further, by comparing SMSFs with the Choice segment, differences in level of engagement seem likely to be minimised.



In both cases, other factors which might account for differences in each segment would need to be stripped out.

Should the criteria and indicators for assessing the extent and magnitude of principal-agent and governance problems focus on outcomes or inputs and processes, such as best practice governance principles, or a combination of both? What existing measures of governance could the Commission draw on, and what are their strengths and weaknesses?

In our view, the criteria and indicators should focus on outputs (as discussed in the answer to the previous question). However, the results of the outputs-based analysis could be used to work out what effect certain governance attributes (inputs) have on outputs. For example characteristics of board size; board composition; board meetings; review and evaluation; director tenure; expertise and competence; multiple directorships; and director compensation and ownership may turn out to help explain the extent of the principal-agent problem in the superannuation industry.¹⁹

What are the most important behavioural biases and cognitive constraints affecting the key superannuation saving, investment and withdrawal decisions of users? What are the best assessment criteria and indicators for examining the magnitude and effect of those biases and constraints? What are the key gaps in the evidence to enable such assessment?

Infrequency of superannuation fund switching has been directly connected to consumers displaying a 'status quo bias' when presented with complex decisions.²⁰ The same assessment criteria and indicators as we proposed for the assessment of the principal-agent problem, could be used to assess behavioural bias.

However, the analysis would need to compare members who are more and less affected by inertia. For example, MySuper membership might be a reasonable proxy for inertia and Choice membership a reasonable proxy for mobility.

An obvious difficulty is that Choice membership may be driven by misalignment of the interests of product providers or advisers (on the one hand) and consumers (on the other). Further, MySuper may be affected by competitive pressures from Choice member, which may mean that any differences between the two segments of the market aren't driven by inertia bias.

What are the best assessment criteria and indicators for examining the extent to which the outcomes for users are optimal with respect to the current taxation settings?

¹⁹ see Australian Superannuation: Operational Structure, Investment Performance and Trustee Governance (PhD thesis, June 2013), http://ses.library.usyd.edu.au/bitstream/2123/9264/1/Liu_K_THesis_2013.pdf pp 193-197 (accessed 13 April 2016)

²⁰ Clark et al., 'A Review of Retirement Savings Investment Behaviours: Theory and Evidence' (CSIRO-Monash Superannuation Research Cluster, June 2013)



Our suggested assessment criterion is minimizing tax on superannuation. An appropriate indicator is the effective tax rate on superannuation, benchmarked against the relevant cohort.

All taxes on superannuation, for example, tax on contributions and earnings; CGT; and lump sum tax, should be deducted from returns to work out an effective total tax rate on contributions. Different cohorts would need to be identified to take into account the fact that multiple tax rates can apply. Members' effective tax rates should then be compared with the relevant benchmark.

Again, user preferences are heterogeneous. A particular course of action may have a worse tax outcome, but nevertheless bring greater utility to the consumer. We would again suggest analysing withdrawal patterns for different cohorts to determine distribution of effective tax rates from tax triggered by the member. Where the effective tax rate is well above acceptable parameters for that cohort, this is an indication of tax inefficiency.

Dynamic efficiency

Do you agree with the proposed objectives for dynamic efficiency? If not, what should they be?

In principle, we agree with the proposed objectives for dynamic efficiency.

Benchmarking

What are the most reliable and relevant assessment criteria and indicators for measuring the dynamic efficiency of the superannuation system? What are the evidence requirements and current gaps in using your proposed criteria and indicators?

A high degree of innovation, cost reduction and quality improvement is an appropriate assessment criterion. We'd prefer this criterion to be measured based on improvements in value (rather than reduction in fees), for example, cost relative to quality. Obviously, a quantitative measure of quality would need to be identified or developed.

We question whether rate of introduction of new products and services is an appropriate indicator, as not all products and services add value. We would suggest that, instead, new products and services be assessed according to the quality metric or the service metric (as applicable) discussed above.

Alignment of investments with risk-return preferences over time is also an appropriate assessment criterion. However, again we would be concerned with the inflexible use of prescribed asset allocations for different life stages. We'd prefer a measure based on deviations from the asset allocation of the member's cohort.

We are comfortable that 'changes in system-wide assets allocations relative to broader demographic change' is an appropriate indicator of alignment of investment risk-return preferences over time. However, those asset allocations need to be understood flexibly, in the context of the relevant cohort's actual distribution of risk attitudes.



Barriers to dynamic efficiency

What are the key impediments to dynamic efficiency and how could they be measured?

It would seem likely that the key impediment to dynamic efficiency are:

- lack of engagement by members
- policy uncertainty
- regulatory barriers to efficient allocation of investments – e.g. excessive liquidity due to fund portability requirements
- regulatory barriers to product development

As discussed, lack of engagement could be measured by comparing the rates of change of operational and allocative efficiency of default and Choice products/investments, respectively.

The impact of fund portability could possibly be assessed by comparing SAFs with SMSFs. As the liquidity requirements don't apply to the latter, the extent of excess liquidity due to portability rules may be able to be isolated. However, large funds can rely on the 'law of large numbers' to manage their portability risk. On the other hand, SAFs may have a lower probability of rollover.

Conclusion

Generally, we agree with the objectives, assessment criteria and indicators proposed by the Commission in its discussion paper. Where we have concerns, we have tried to provide practical suggestions as to how to modify the approach.