



**Review into the Governance, Efficiency, Structure and
Operation of Australia's Superannuation System**

ACTU submission on Operation & Efficiency

21 December 2009

Introduction

1. The ACTU represents nearly two million working Australians and their families. We are concerned that their superannuation contributions are managed and administered in a manner consistent with securing the highest possible long-term retirement benefits. In part this will require that government and regulators, with the co-operation of the industry whenever possible, take the steps necessary to minimise or eliminate those 'leakages' from the super system that may reduce the benefits that workers eventually receive. We therefore welcome the Review's focus on issues relating to operation and efficiency.
2. The Phase Two Issues Paper raises a large number of questions. In this submission we will focus most of our comments on two areas of particular concern to the ACTU and our affiliates: default funds and fees/commissions. We will deal with the issue of default funds and industrial awards in more detail in our submission to Phase Three. We would be happy to meet with members of the Review Panel to elaborate further on this submission.

Efficiency & Markets

3. An efficient superannuation system is one that manages contributions in ways that deliver the highest possible retirement benefits to members. A key task for legislators and regulators is to ensure that the many conflicting interests of the institutions and individuals that comprise the system are firmly subordinated to this end.
4. Securing an efficient super system is not the same as securing an efficient market. This is because the participants in our system do not behave in ways assumed by efficient market theory and, despite the 'choice agenda' pursued by the previous Federal government, are very unlikely to do so. It follows that reforms to the system will only serve the long-term interests of Australian workers and retirees to the extent that they recognise the real nature of the market, the limits to which that market can be made to function in a perfectly efficient manner, and the consequent need for appropriate government regulation¹.
5. The comments and recommendations we make in this submission flow from an understanding of the real structure and operation of the market for super in Australia. It is a market characterised by the following distinctive features:

¹ Bryan, D. et al (2009a) *Governance and Performance in the Australian Occupational Superannuation Industry*. Workplace Research Centre, University of Sydney.

- (i) Involuntary participation by consumers most of whom do not have the resources to make informed choices and are consequently passive. While having the formal right to exercise choice very few actually do so. Around 3 per cent of fund members switch funds each year. Around half of these do so only because they change job. Furthermore over 90 per cent of fund members do not exercise their right to choose investments².
- (ii) Profound information asymmetry between fund members on the one hand and super funds and financial advisers on the other. To many, the superannuation industry, in common with much of the financial services sector, appears dauntingly complex, opaque and shrouded in impenetrable jargon. The proliferation of funds and investment options in recent years, far from motivating and empowering customers, has often reinforced the image of an industry beyond the understanding of most ordinary people. 'Choice overload' in the context of limited understanding tends to reinforce consumer passivity and inertia. For most, the time and cost barriers to acquiring sufficient knowledge to make informed decisions about fund and investment choices are simply too great³.
- (iii) Multiple conflicts of interest. Private institutions participate in the super industry for the purposes of accumulating private profit. They serve the interests of fund members and those who seek advice to the extent that doing so is consistent with maximising revenues. The existence of a large number of customers who are compelled to participate in a market they do not understand and are unable to influence has provided many firms with ample opportunities to reap high levels of profit at the expense of member benefits. This is reflected in the fact that while retail funds have, on average, performed less well than most not-for-profit funds, they continue to charge members significantly higher fees⁴. This suggests that a major source of inefficiency in the Australian system, and one which therefore requires priority attention from government, is the retail super sector.

² Industry Super Network (2009) *Competition in the Superannuation Market*.

³ Fear, J. and G. Pace (2008) *Choosing Not To Choose: making superannuation work by default*. The Australia Institute, Discussion Paper Number 103.

⁴ Bryan, D. et al (2009b) *Agents With Too Many Principals? An Analysis of Occupational Superannuation Fund Governance in Australia*. Workplace Research Centre, University of Sydney.

Getting Defaults Right

Default funds

6. According to research conducted at the University of Sydney, in the period from March 2004 to December 2008 for-profit funds with trustees appointed by the parent financial institution consistently underperformed other funds by up to 2.4 per cent per annum on a risk adjusted basis. A key reason for this is the relatively high level of fees and other charges they levy from members. It has been estimated that every 1 per cent of sustained underperformance will translate into a cut in final retirement benefits of about 20 per cent⁵.
7. It follows that if government is truly concerned about the long-term adequacy of retirement incomes it must take action to protect the interests of those workers who do not actively make decisions about their mandatory super contributions and are therefore assigned to a default fund. Because markets cannot work efficiently in the context of the Australian super industry significant fee differentials, and therefore significant performance differentials, are very likely to persist. In relation to the value of the benefits workers eventually receive it matters a great deal which fund they are assigned to and remain within. This is not an issue government can legitimately stand-back from and leave to individual choice and market forces. Nor can the Australian community afford to have the matter decided by lobbying and special pleading from the retail sector.
8. At present where a default fund is not named in an award or industrial agreement it is the responsibility of the employer to select a fund. The Issues Paper asks: what do employers want from the super system? A few employers use their super arrangements as part of their recruitment and retention strategy. Most do not. The available evidence strongly suggests that many employers view their super responsibilities as a burden that they attempt to expend as little time and money on as possible⁶.
9. This attitude has the potential to generate significant problems for many employees who effectively delegate the choice to their employer. Employers are likely to choose funds for default purposes on the basis of how easy those funds make it for them to meet their minimum obligations rather than on the basis of what is in the best long-term interests of their employees. Once selected the evidence suggests that many employers will not routinely review their decision because of the costs and hassle it would involve. Even if employers intended to prioritise the interests of their employees, letting them do so assumes they have the resources to make appropriate choices in a large and increasingly complex market environment.

⁵ Bryan, D. et al (2009b)

⁶ Cameron Research Group (2007) *The Australian Medium Sized Business Market for Superannuation*, May/June.

10. For these reasons the ACTU believes that employers should not be responsible for choosing a default fund.
11. Instead public policy should act to ensure that those who do not actively make a choice become members of a default fund that will best represent their interests.
12. In our view the best interests of default members are best served when funds meet the following criteria:
 - (i) They have representative trustee structures;
 - (ii) Do not pay commissions or ongoing advice fees to intermediaries;
 - (iii) Operate within specified regulated fee caps (including entry, exit and ongoing fees);
 - (iv) Ensure that when contributions cease the employee remains a member of the default fund until he/she consolidates into a new active fund or is rolled into a suitable Eligible Rollover Fund (ERF);
 - (v) Meet prudential regulatory standards and comply with relevant legislation;
 - (vi) Have effective procedures in place for following-up payment arrears.
13. The Fair Work Act provides for the regular review of modern awards. The first review in 2014 will allow for Fair Work Australia to include or remove particular funds from awards. However, the review will also allow a Full Bench of FWA to establish principles for the purpose of guiding the Tribunal in dealing with the nomination of default funds. At the appropriate time the ACTU intends to submit to FWA that the above criteria be adopted as the best basis for selecting such funds.
14. A number of industry funds with these characteristics already exist. They have a proven record of good governance, strong performance, prioritising the interests of members and resilience in the face of external economic shocks. The most efficient and effective way to protect the interests of workers who do not express a fund choice, and who are not covered by a relevant award/agreement, is for government to mandate that one of these funds serve as the default.

Default investments

15. The large majority of fund members do not exercise choice in relation to how their contributions are invested. It therefore falls to trustees to decide an appropriate default asset allocation. It is important that such decisions are made in the best long-term interests of members.

16. The Issues Paper asks if there is a case for government regulation of default asset allocations. Our view is that trustees are best placed to make these decisions in the context of the particular size, structure and performance of their funds. Our experience is that trustees are aware of the risk, age and lifecycle issues pertaining to members who do not actively choose between investment menus, that these issues already play an important role in determining fund strategies, and they are subject to active consideration and review.

Financial Literacy, Fees & Advice

17. We welcome measures to enhance financial literacy. It is important that more fund members understand and take an active interest in their superannuation and how they will secure an adequate retirement income.
18. However, the experience of recent years is that member disinterest remains, despite some important and worthwhile initiatives, stubbornly high. There are complex social and psychological reasons for this. The key point is that while efforts to increase literacy should continue, they must not become a substitute for substantive public policy intervention that reduces the risk that individuals make poor choices in the context of a superannuation market in which the distribution of knowledge, information and power is overwhelmingly skewed toward funds and financial advisors.
19. In the absence of a population of perfectly informed market participants expert advice is important to many of those who wish to take an active interest in how their contributions should be managed and invested. Such consumers have to pay for independent advice – a significant disincentive for many to seek it. Alternatively they can approach an advisor who will offer advice shaped by the commission they receive for advocating particular products and services. Not surprisingly, many of those who obtain advice opt to pay via some form of commission. It has been estimated that upfront and trailing commissions of various types constitute 84 per cent of revenues to financial planners in Australia⁷.
20. Commissions are harmful to consumers and the broader market in a number of important ways:
 - (i) They constitute a clear conflict of interest between the customer and the advisor with the result that in 2007, for example, not one of the top 30 financial planning groups had an industry fund on their approved product lists⁸;

⁷ Fear and Pace (2008)

⁸ Rainmaker Information (2007) *Financial Planning Industry Report*, prepared for Industry Super Network.

- (ii) They erode the value of final benefits more than one-off fees. It is estimated that commissions can have a twenty-fold negative impact on total retirement accumulation⁹;
 - (iii) They undermine competition by acting to promote the sale of high-commission products when lower cost products may be of equal or better value to the consumer;
 - (iv) They are often unrelated to the quantity and quality of advice the customer receives over the period the commission is paid.
21. In relation to how compulsory contributions are invested the ACTU does not accept that commission-based financial advice, even when combined with disclosure of interests and improved literacy, is an acceptable alternative to independent advice. We agree with the conclusion of the recent Parliamentary Joint Committee inquiry into financial products and services when they stated:

‘...the reality is that better investor education is not the only answer to protecting investors from poor financial advice. It is a solution often proposed by those in the industry wishing to maintain the regulatory status quo.’¹⁰

Where individuals are compelled by government to participate in a market for complex products government has a special responsibility to ensure they can access advice that helps them to make informed choices that best represent their interests.

22. We know from research in behavioural economics and consumer psychology¹¹ many individuals do not participate in markets for complex goods and services with fixed and independently formed preferences. Preferences are shaped by exposure to the most readily accessible forms of information. Choice-environments dominated by information intended to maximise profit will tend to cultivate choices different to those made when independent advice has been obtained. To combine mandatory participation with barriers to obtaining such advice is to significantly increase the risk that individuals will make poor decisions. This helps to explain why many individuals continue to contribute to funds characterised by relatively high fees and persistent underperformance.

⁹ Industry Super Network (2009)

¹⁰ Parliamentary Joint Committee on Corporations & Financial Services (2009) *Inquiry into Financial Products and Services in Australia*, Canberra, p. 69

¹¹ For example: Kahneman, D. (2003) ‘Maps of bounded rationality: psychology for behavioral economics’ *The American Economic Review* 93(5) pp. 1449–1475; Simon, H., M. Egidi, R. Viale & R. Marris (2007) *Economics, Bounded Rationality and the Cognitive Revolution*, Edward Elgar.

23. The ACTU therefore believes that the Review Panel should recommend the following actions are taken by legislators and regulators:
- (i) Commissions and similar forms of 'asset-based advice' for financial advice relating to superannuation should be prohibited;
 - (ii) Customers should be able to pay for superannuation advice only by means of a time-based upfront and tax deductible fee. Customers should have the option of having this fee deducted from their super account;
 - (iii) Government should explore the cost and practicality of establishing a means-tested scheme for low-income workers that would enable them to access a given quantity of advice hours at key points in the super-cycle that would be paid for by government directly to the advisor;
 - (iv) Financial advisors should be subject to a fiduciary duty to serve the best interests of their clients;
 - (v) The regulatory framework should be permanently altered to allow funds to provide advice to existing members about within-fund choices relating to such issues as investment, insurance and additional contributions;
 - (vi) Exit fees should be capped to reflect the actual administrative costs to funds of members leaving. There is evidence that exit fees are being used by some funds to promote member retention – not only to cover essential costs¹².

Fees for Managing Investment

24. In addition to the fees charged by funds to members and advisors to customers, the ACTU is further concerned by the fees charged by investment managers and asset consultants to funds in return for managing fund assets.
25. Around two-thirds of all superannuation assets are placed with fund managers and asset consultants. While the quantity of super assets under external management has increased significantly over the past 20 years there has been a parallel trend toward the concentration of management companies and often only marginal fee reductions for many asset types and fund sizes¹³. Moreover this has occurred in a context where there has been a trend away from active to passive investment strategies in recent years. In short, increasing asset scales have often not yielded sufficient fee economies.

¹² CHOICE (2006) *The Super Secret: How multiple accounts cost consumers billions*. Research Report.

¹³ Reserve Bank of Australia (2003) *Australian Funds Management: Market Structure and Fees*.

26. The market for super fund asset management services has developed in ways conducive to the interests of the small number of companies, mostly owned by large banks and international financial groups, who now dominate it. If this market structure persists millions of ordinary Australians are likely to lose-out.
27. We believe super funds and their representative bodies should initiate a dialogue with the fund management industry about fees that recognises some important realities. Firstly, increases in the size of funds under management rarely entail additional business costs. Secondly, good investment performance is often driven by factors other than the skill and effort of those managing the assets. In this context funds are right to expect that asset managers negotiate base fees that reflect actual business costs. Furthermore, they should be willing to negotiate caps to performance-related fees and have such fees linked to performance over the long-term.

Other issues

Administrative efficiency

28. The ACTU agrees there is scope for the Australian super system to become more cost efficient by reforming aspects of how payments, information and member accounts are managed. To this end we welcome the recent announcement by the Federal government that Medicare will provide a payments clearing service to many small businesses. In addition we also call for the following reforms:
 - (i) The more flexible use of Tax File Numbers to facilitate the more efficient administration of super accounts;
 - (ii) Regulators should work with fund peak bodies to agree how greater standardisation of forms, data quality and electronic information transfer can be secured;

Promotional spending

29. We believe there is a legitimate role for funds to spend reasonable amounts on advertising and sponsorship as part of their marketing strategies. However, there should be regulations that require funds to standardise how funds account for and report these expenditures to aid transparency, comparison and accountability.

Employer non-compliance

30. The non-payment of employer contributions has been a growing problem, even before the current global financial crisis and recession began in 2008. The amount of collectable debt from employers who have failed to pay employees' superannuation increased each year from \$122.5 million in 2003 to almost \$300 million in 2007¹⁴. The ACTU believes that such contributions should be covered by the General Employee Entitlement and Redundancy Scheme (GEERS).
31. However, the matter cannot rest with a willingness by government and the taxpayer to cover non-payment. The experience of many workers impacted by employer non-compliance is that the approach of the ATO to the problem is ad hoc, secretive and slow. The investigation time between a complaint being lodged and then finalised increased from 309 days in 2005-06 to 340 days in 2006-07. The ATO often gives the impression that it does not take the issue sufficiently seriously. This impression then contributes to cultivating a culture of non-compliance among some employers.
32. The ACTU believes part of the solution to the problem of non-compliance should involve the following measures:
 - (i) All employers should be required to pay super contributions on a monthly basis and provide their employees with a monthly statement of what has been paid;
 - (ii) Government should review ATO policies, processes and resources relevant to policing non-compliance with the aim of increasing their transparency, efficiency and effectiveness. A comprehensive and authoritative audit of collectable debt should be compiled by the ATO along with the production of a strategic compliance plan that contains clear time-limited targets agreed with government for reducing debt and investigation times.

¹⁴ 'More bosses fail to pay super dues', *The Age*, 25 June 2007