

Choice and competition in the Australian default superannuation system

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Executive Summary

Effective competition policy is about facilitating choice. When consumers are free to choose the goods and services they desire, suppliers focus their efforts on serving customers in the best ways possible in order to win their business.

Competition policy has served Australia's broader economy well over the past decades. Public policy implemented by both sides of the political divide has favoured competition as a means of improving Australia's welfare and productivity. This same approach should logically be brought to bear in any reform of Australia's superannuation system.

Australia's superannuation funds collectively hold in excess of A\$2.1 trillion in assets under management.¹ Of that, around 22% of assets in the system are invested in MySuper default products.²

Despite the significance of default accounts, the default system is not designed with competition and choice in mind. This presents an opportunity for important microeconomic policy reform that could have a significant impact on Australians' income in retirement.

This paper applies established principles of competition policy to the default superannuation system and makes recommendations for reform.

The two principles

Competition Principle One

Awards and industrial agreements set remuneration, conditions of employment, hours of work and working conditions of employees. Employees' choice of products and services that are unrelated to a negotiation over their terms and conditions of employment, such as default superannuation, should not be restricted by industrial relations agreements.³ This is because markets for these products and services are subject to competitive forces unrelated to competitive conditions in labour markets.

Competition Principle Two

Policies and regulations binding the default superannuation system should not restrict competition unless the benefits of the restriction to the community as a whole outweigh the costs, and the objectives of the legislation or government policy can only be achieved by restricting competition.⁴

Application of principles to the default superannuation system

The current industrial relations system presents barriers to competition in relation to default superannuation, and in some cases these barriers are significant.

¹ ASFA, 2017.

² Analysis of APRA, 2017 and ASFA, 2017.

³ Adapted from the Australian Competition Policy Review, 2015, Recommendation 37.

⁴ Adapted from the Australian Competition Policy Review 2015, Recommendation 1.

For employees employed under Modern Awards, the available default superannuation products are limited to those selected by the Fair Work Commission. In 13% of awards, the employer is provided with no choice of the default fund it may offer to employees.

For employees employed under Enterprise Agreements, an analysis of a sample of agreements entered into in 2015 found that 56% of agreements specify a single default superannuation fund that an employer must offer its employees.⁵ Other analysis suggests that there are approximately two million people who are unable to choose their own fund, regardless of whether they wish to transfer away from the default product in favour of another fund.

For employees employed under individual contracts, the default superannuation product is chosen by their employer. This is in contrast to other financial products related to employment, such as bank accounts, which are chosen and provided by employees themselves.

This report considers a number of alternative policy options and provides five recommendations.

Recommendation 1

Employees should have greater scope to choose their own default superannuation funds and Competition Principle Two should be used to assess alternative policy options. A number of alternatives that policy makers should consider that would be likely to improve outcomes in the superannuation system:

- The idea of a 'default' superannuation option could be removed. When employees start a new job, they are not provided with a default bank account for their salary to be deposited into; they must provide their own bank account details. Similarly, when employees start in a workplace, they could be required to provide details of a superannuation fund. This removes trading restrictions, allowing employees to choose their fund, removes principal-agent complications and increases competitive rivalry among superannuation funds, allowing a larger number of firms to compete.
- Provide the employer with choice. This brings Enterprise Agreements and Modern Awards into line with the default system applying to individual contracts. This will obviate one of two principal-agent relationships and create an environment where choice and competitive tension are heightened. Rather than being just one part of a bargaining process around terms and conditions of employment, experience suggests that many employers will invite tenders for their default superannuation funds.

Recommendation 2

All employees under Enterprise Agreements should be able to choose to switch away from their default superannuation fund if they would prefer to be in an alternative fund. This would create policy consistency between Enterprise Agreements, Modern Awards and individual contracts.

⁵ DAE analysis of a random sample of 457 EAs entered into in 2015.

Recommendation 3

The current default system should be assessed against an analytical baseline of a 'no default' system. It should be assessed using Competition Principles One and Two as outlined in this report.

Recommendation 4

If policy makers were to introduce a national auction mechanism, it should be subject to the two competition principles outlined in this report. In particular, it should be clear that any benefits from the auction, such as lower fees through increased scale, outweigh any costs, such as a limiting of choice, risk of gaming, risk of increase in market concentration and adverse outcomes through design of selection criteria.

Recommendation 5

Policy makers should consider insights from behavioural economics when developing policy from a 'no default' analytical baseline. Small policy changes driven by insights from behavioural economics – such as changes to form design, product comparability, inducements and nudges – can drive big improvements in choice and competition in superannuation.

The benefits of increasing competition in the default superannuation system could be significant. If increased and effective competition in the superannuation system were to narrow the difference between the highest and lowest administrative fees applying to MySuper products, a reduction of at least \$292 million in administration fees paid per year across over 14 million MySuper product accounts could be realised. This would represent a significant decrease (13%) in administration fees across these products.

The Productivity Commission is currently undertaking a wide-ranging review of the efficiency and competitiveness of Australia's superannuation system. On 29 March 2017 it released a Draft Report on alternative default models for superannuation as part of that review process. This report is not a substitute for that review but it does support a robust competition framework and offers recommendations for thinking about choice and competition in default superannuation. The clear conclusion is that further choice and competition should be introduced into Australia's default superannuation system.

1 Competition policy

1.1 What is competition policy?

Effective competition policy is about facilitating choice. When consumers are free to choose the goods and services they desire, suppliers focus their efforts on serving customers in the best ways possible in order to win their business.

Businesses want consumers to choose them, meaning that competition between providers puts businesses under pressure to offer the best possible range of goods and services at the best possible prices. If businesses don't offer the best products at the best prices, then consumers take their business elsewhere. It is this competitive discipline that leads to economically efficient outcomes with consumers as the beneficiaries.⁶

Sometimes these competitive pressures will be interrupted or ineffective. For example, a provider might attempt to act in a way to try and limit competition. Or it might be because the nature of the good or service is such that individuals making an uninhibited choice may not generate sufficient or appropriate rivalry among firms.

Competition policy is about making sure markets work properly. It refers to the set of laws and regulations that have as their aim to ensure that the competitive process works as effectively as possible to bring about the best outcomes for consumers.

In Australia, the central piece of legislation governing competition and consumer rights is the *Competition and Consumer Act 2010*. The Act tends to focus on the competitive process, rather than individual competitors, and the interests of consumers. These are well established principles of competition policy globally.⁷

1.2 Competition policy in Australia

Australia has enjoyed twenty-six years of uninterrupted economic growth. It is generally accepted that the micro-economic reforms of the 1980s and 1990s, along with our natural resource wealth, are largely responsible for this economic success.

In 1992 the National Competition Policy Review, better known as the Hilmer Report, set out a range of economic reforms to improve competition in Australian markets. These included:

- extending the purview of the competition law (then the *Trade Practices Act 1974*) to cover behaviour by all governments and private businesses;
- introducing the concept of competitive neutrality, where government businesses would compete on an equal footing with private businesses for tenders;
- a national access regime to facilitate access to essential infrastructure; and
- an examination and reform of laws that hinder competition, except in cases where restrictions on competition are found to be in the public interest.

⁶ The European Commission, 2012

⁷ Australian Competition Policy Review, 2015, p.23.

The Commonwealth, States and Territories accepted the bulk of the reforms proposed in the Report in October of 1992. In 2005 the Productivity Commission estimated that the National Competition Policy Review reforms increased Australia's gross domestic product by 2.5% over a decade.⁸ Without these reforms it is less likely that Australia would have enjoyed well over two decades of uninterrupted economic growth.

In 2013, over two decades since that first round of competition reform, the Australian Government commissioned a new Competition Policy Review, better known as the Harper Review. This next wave of competition reform is considered necessary to continue to improve Australia's productivity performance and improve Australians' standard of living into the future.

In particular, the review pointed to trends such as the rise of Asia and other emerging economies, an aging population and new technologies as generating an impetus for reform.

The Productivity Commission's recent draft report into choice and competition in human services, the first of two reports commissioned by the Treasurer in response to the Australian Competition Policy Review, provides a useful case study of how choice can improve service delivery. The Productivity Commission considers that well designed competition policy reform could improve the quality of the services, increase access to the services, and help people have a greater say over the services they use and who provides them.⁹

1.3 Competition policy in superannuation

Competition policy has served Australia's broader economy well over the past decades. Public policy implemented by both sides of the political divide has favoured competition as a means of improving Australia's welfare and productivity.

This same approach should logically be brought to bear in any reform of Australia's superannuation system.

This was recognised in the Financial System Inquiry (FSI), a review of our financial system commissioned by the Australian Government, with its final report released in December 2014. The report stated that competition and competitive markets "are at the heart of the Inquiry's philosophy for the financial system". It noted that specific improvements to policy could be made in relation to superannuation, and provided a number of recommendations.

Effective competition policy will ensure that every superannuation fund is able to compete for every Australian's business. Superannuation funds will be able to compete on the basis of providing lower fees, higher returns (subject to risk parameters), lower prices and higher quality insurance as well as better customer service.

In a competitive environment, if a superannuation fund is offering a substandard product, consumers will be able to switch away in favour of another fund. The flip side is that ineffective competition will ultimately mean that Australians will have less income to live on in retirement. Superannuation contributors will face higher fees, suffer poorer insurance options and poorer service.

⁸ Productivity Commission, 2005.

⁹ Productivity Commission, September 2016b.

When considering changes to the default superannuation system, this paper uses a baseline scenario of a 'no default' system. This is analytically appropriate as it allows the effect of various policies to be isolated and assessed against an environment where superannuation is offered on a basis consistent with the vast majority of other goods and services in the economy.¹⁰

One advantage of this analytical benchmark is that, as a starting point, it obviates principal-agent complications discussed further in Section 2 of this report.

1.4 A competition policy framework

The superannuation system is governed by a range of laws and regulations. The primary legislation governing superannuation is the *Superannuation Industry (Supervision) Act* which is administered by APRA. There is also the *Superannuation Guarantee (Administration) Act 1992* that governs compulsory superannuation contributions and the *Competition and Consumer Act 2010* will apply, for example, if two superannuation funds wish to merge.

It is the interrelationship between competition law and industrial relations law that is of particular interest in the context of the default superannuation system.

The industrial relations system revolves around the negotiation of terms and conditions of employment (i.e. remuneration, conditions of employment, hours of work and other working conditions of employees). It is excluded from most of the competition law provisions contained in the *Competition and Consumer Act 2010*.¹¹

It is widely considered that labour markets have a number of characteristics that make them not comparable in all respects to other product and service markets, and as such the negotiation of terms and conditions of employment is governed by a separate regulatory regime, the *Fair Work Act 2009*.

It is appropriate that the rate (above the legislated minimum) of superannuation contributions is negotiated under the industrial relations system, as this is relevant to the relative bargaining power of the parties in a labour market.

While labour market outcomes may be improved through the industrial relations system, from an economic perspective, the operation of product and service markets, such as superannuation, are unrelated and there are alternative policy prescriptions that will allow them to operate in an efficient, fair and competitive way.¹²

So while competition law does not apply to labour market negotiations, there is not a comparable policy basis to argue that the industrial relations framework should apply to other product and service markets, such as superannuation. The competition law does have

¹⁰ This is consistent with the approach adopted by the Productivity Commission in its *Superannuation: Alternative Default Models, Issues Paper*, September 2016.

¹¹ Specifically, see section 51(2)(a) of the *Competition and Consumer Act 2010*.

¹² Fairness in relation to default superannuation could be thought of as being largely driven through taxation and consumer protection measures. While important, taxation is outside the scope of this report.

provisions that should act to prevent the scenario described above, where an industrial relations agreement seeks to restrict employees' choice on goods and services that are unrelated to terms and conditions of employment,¹³ but it was observed by the Competition Policy Review that these provisions appear to currently be in conflict with the *Fair Work Act 2009*.¹⁴

The Competition Policy Review recommended that the law should be amended so it is clear that these competition provisions should be applied to awards and industrial agreements, except to the extent that they relate to the remuneration, conditions of employment, hours of work and working conditions of employees.¹⁵ The Government noted this recommendation but at the time of writing has not sought to legislate this recommendation.

In this report we will refer to the idea that employees choice of products and services unrelated to the negotiation over terms and conditions of employment should not be restricted by industrial relations agreements as Competition Principle One.

Competition Principle One

Awards and industrial agreements set remuneration, conditions of employment, hours of work and working conditions of employees. Employees' choice of products and services that are unrelated to a negotiation over their terms and conditions of employment, such as default superannuation, should not be restricted by industrial relations agreements.¹⁶ This is because markets for these products and services are subject to competitive forces unrelated to competitive conditions in labour markets.

Restricting competition

Competition Principle One suggests that trading restrictions should not be a part of industrial relations agreements. However, the competition law is flexible. If organisations can show that restricting competition is in the best interests of Australians then that conduct can be authorised to be exempt from the operation of much of Australia's competition law by the Australian Competition and Consumer Commission.¹⁷

The same competition principles that apply to firms should also be applied to government policy making. Only where the benefits of restricting competition outweigh the costs should that option should be chosen.

The National Competition Policy endorsed a public interest test for legislation and government policy in 1995 that formalised this concept. It was then subsequently re-endorsed by COAG in its 2007 regulatory impact analysis framework *COAG Best Practice Regulation: A Guide for Ministerial Councils and National Standard Setting Bodies*.¹⁸

¹³ Section 45E and 45EA of the *Competition and Consumer Act 2010*.

¹⁴ Australian Competition Policy Review, 2015.

¹⁵ Australian Competition Policy Review, 2015, Recommendation 37.

¹⁶ Adopted from the Australian Competition Policy Review, 2015, Recommendation 37.

¹⁷ See Australian Competition and Consumer Commission, 2013, Authorisation Guidelines.

¹⁸ Council of Australian Governments, 2007.

Most recently, it was again re-endorsed by the Competition Policy Review in 2015. That review considered it so important to effective policy making that the principle was stated in Recommendation One of the Review.

In this report we will refer to this as Competition Principle Two. This test, combined with Competition Principle One discussed above, provide a useful framework for considering whether the current policy settings around default superannuation are fit for purpose.

Competition Principle Two

Policies and regulations binding the default superannuation system should not restrict competition unless the benefits of the restriction to the community as a whole outweigh the costs, and the objectives of the legislation or government policy can only be achieved by restricting competition.¹⁹

¹⁹ Australian Competition Policy Review, 2015, Recommendation 1.

2 Superannuation

2.1 Superannuation in Australia

Australia has a three-pillar retirement incomes policy. Included in this are a means-tested government-funded age pension, individual voluntary savings, and compulsory superannuation contributions.

Superannuation has been available to a small percentage of the working population since the nineteenth century, but a national system was not developed until the 1970s.²⁰ In 1992 the government introduced the 'Superannuation Guarantee Charge', which effectively compelled Australians to contribute to their superannuation via their employers. At present compulsory contributions are set at 9.5% of earned income,²¹ scheduled to rise to 12% by 2025.²²

Given Australia's ageing population, it will be increasingly important to have an efficient superannuation system. Without it the cost to taxpayers of providing reasonable incomes for aged pensioners will continue to grow, placing strain on the economy as well as a higher taxation burden on younger workers.

Saving for retirement consists of three distinct phases:

accumulation of assets during working years;

consolidation of assets from various sources upon retirement; and

decumulation, where accumulated capital is drawn down as a lump sum or a retirement income stream or both.

Australia's superannuation funds now hold in excess of A\$2.1 trillion in assets under management.²³ Of that around 22% of assets in the system are in MySuper default products.²⁴ The value of assets under management now exceeds Australia's annual gross domestic product. Deloitte Actuaries predict that the value of assets held in superannuation funds could grow to \$9.5 trillion by 2035, this is around twice the size of projected gross domestic product in that year.²⁵

2.2 Default superannuation

If you do not deliberately choose where your superannuation contributions are directed, they will be deposited in a fund chosen by someone else.

The default superannuation system governs who chooses and how the default fund is chosen. It is an amalgam of various government policies. How the system affects you depends on the type of agreement you have with your employer.

²⁰ Deloitte Access Economics, 2013.

²¹ Productivity Commission, 2012.

²² Australian Taxation Office, 2014.

²³ ASFA, 2017.

²⁴ Analysis of APRA, 2017 and ASFA, 2017.

²⁵ Nominal dollars. Deloitte Actuaries and Consultants, 2015.

Table 1.1: Default superannuation by employment agreement type

Proportion of employees	41%	19%	37%
Employment agreement type	Enterprise Agreements	Modern Awards	Individual contracts
Choice of default superannuation fund	<ul style="list-style-type: none"> • MySuper fund(s) chosen as part of the enterprise negotiation in 67% of agreements. • In remaining agreements employer chooses from Modern Award list. • Employee is prevented from changing their fund in 19% of agreements. 	<ul style="list-style-type: none"> • FWC panel chooses MySuper funds available for an award. • Employer chooses from this list. • Employee free to change fund. 	<ul style="list-style-type: none"> • Employer chooses a MySuper default fund. • Employee free to change fund.

Sources: DAE analysis, ABS Employee Earnings and Hours. FWC refers to the Fair Work Commission. The EA figures for funds chosen and restriction employee choice are based on analysis of a random sample of 457 EAs entered into in 2015. Note: these proportions are representative and do not sum to 100 as a result of different data sources.

Table 1.1 above shows the main types of employment agreements in Australia and the default superannuation process for each of them. Regardless of employment agreement type, the default superannuation fund must be a MySuper-approved fund (see box). Beyond this, the process that governs the selection of a default fund varies depending on your employment agreement type.

MySuper²⁶

MySuper was introduced as part of the 2011 Stronger Super reforms. MySuper funds are funds required to meet certain standards that relate to product characteristics such as fee structure, minimum insurance coverage, and reporting. All MySuper default funds offer MySuper products.

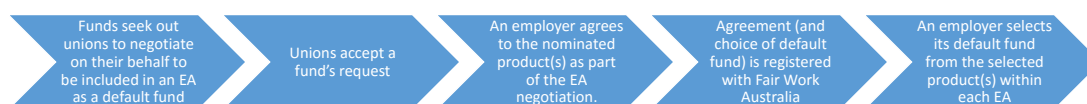
Superannuation funds can apply to APRA to be authorised as a MySuper provider. If they meet all criteria and standards regarding fees, insurance and reporting (among others), APRA will license the fund, allowing it to participate in the default superannuation market.

Currently, there are 115 MySuper products offered by 87 fund trustees.

²⁶ APRA, 2016a and APRA, 2016b.

2.3 Enterprise Agreements

Figure 2.1: Default superannuation selection process for EAs



The first column in Table 1.1 describes arrangements that apply to Enterprise Agreements (EAs), which cover 41% of employees. EAs between employers and their employees establish the terms of employment, including terms and conditions of employment (such as salary, leave and working hours). Unlike awards, which apply to all employers and employees in an industry, EAs are usually specific to a single business enterprise. EAs are generally negotiated between employers and unions, acting on behalf of employees.²⁷

EAs are subject to a ‘no disadvantage’ test, which means that an employee cannot be left worse off than he or she would have been under the relevant Modern Award.²⁸

The Fair Work Commission governs the EA system and registers an agreement once the parties concur and the Commission is satisfied that no employee is worse off than under the corresponding award.

In an EA environment a default superannuation fund or funds can be chosen as part of the negotiation process between employers and unions and then specified in the resulting EA.

Deloitte Access Economics analysed a sample of EAs from 2015 and found that in 67% of cases the EA specifies which superannuation fund (84%) or funds (16%) must be offered to employees as their default superannuation fund.²⁹ In the remainder of cases the employer is required to choose a default superannuation fund that is listed in the applicable MA.

Some EAs also prevent employees from exercising any choice over their fund for the duration of their employment with that employer. That is, the default fund is not a default option but rather a condition of employment which the employee must accept. In the sample of EAs analysed that were entered into in 2015 and analysed by Deloitte Access Economics, 19% were found to offer no employee choice.

2.4 Modern Awards

Modern Awards (MAs) are legal documents outlining minimum pay and conditions. There are 122 MAs that apply based on industry or occupation. The second column of table 1.1 shows that 19% of employees have their minimum wages and conditions set out by a MA.

²⁷ Employees can also choose to be represented by a bargaining representative. For the purpose of this report we ignore this possibility as it only applies to a small number of agreements.

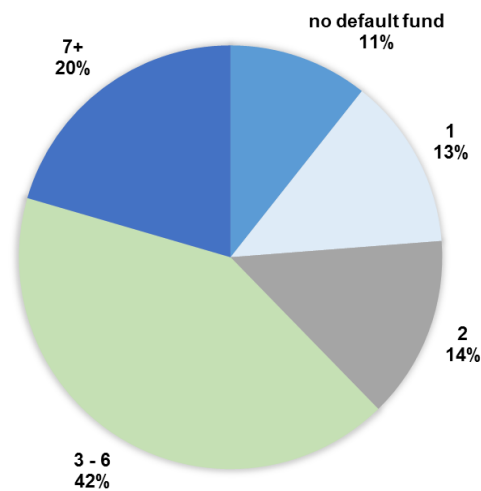
²⁸ Modern Awards are discussed in Section 2.4 of this report.

²⁹ A random sample of 457 EAs was reviewed from the 5,122 EAs entered into in 2015. To the extent that EAs differ from year to year these figures should be thought of as representative of EAs entered into in 2015, rather than all EAs.

MAs apply in the absence of EAs or other non-enterprise or non-award-based arrangements. They form part of the minimum safety net for national system employees.

Most MAs list default superannuation funds that apply if employees fail to exercise their right to choose their own fund. Of the 122 MAs, 109 list at least one default fund. For the 13 awards that do not list a default fund, the employer has the discretion to select any fund with a MySuper product as the default.³⁰

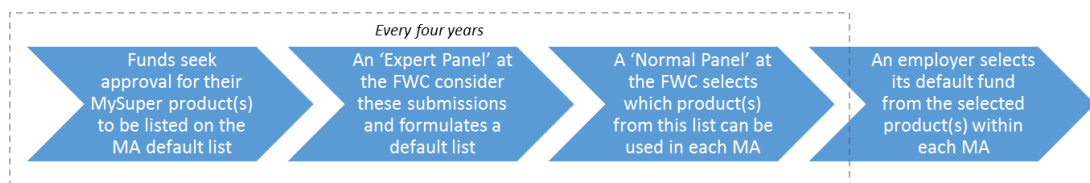
Figure 2.2: Modern Awards - number of default funds that an employer can choose



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

In order for a MySuper product to be listed on an MA as a default superannuation product it must satisfy the process detailed in Figure 2.3.

Figure 2.3: Modern Award default superannuation selection process



The selection process

The selection process can be broken down into two stages. The first stage involves an “Expert Panel” formulating a list of the default superannuation options from which employers can choose. The second stage involves a “Normal panel” deciding which particular MySuper funds are allocated to each award.

An “Expert Panel” formulates a Default Superannuation List

The Fair Work Commission is empowered to formulate a ‘Default Superannuation List’, setting out the names of superannuation funds that can be used as default funds in MAs. The pool of funds for the selection process includes MySuper products approved by APRA.

³⁰ Financial Services Council, 2016.

This is currently done via a panel process with quadrennial reviews, the last review having been conducted in 2014. The Commission is required to set up an expert panel which formulates this list.³¹

The *Fair Work Act 2009* also states that the President has a discretionary power to determine which members of the Commission are to form part of the expert panel.³² An “Expert Panel” formed by the Commission must include:

- the President, Vice President or Deputy President appointed by the President to be the Chair of the panel;
- three expert panel members who have knowledge of, or experience in finance, investment management or superannuation; and
- three other members of the commission.³³

The Default Superannuation list must be determined by taking into account a range of criteria,³⁴ any decision made by the majority of the panel will prevail. However, in the absence of a majority, the President is to make the decision unless a Chair has been appointed by the President, in which case the Chair’s decision prevails.³⁵

A “Normal Panel” selects funds from the Default Superannuation list for each MA

The second stage dictates that a “Normal Panel”, which must include at least three Fair Work Commission members must review the default fund terms of MAs.³⁶ Apart from employees and employers, the legislation allows for organisations entitled to represent industrial interests of employees or employers, to make written submissions in relation to the default fund term of awards.³⁷

Upon completion of this review, the Commission is to specify at least two, but no more than fifteen, MySuper funds for each award.³⁸ The super funds chosen must satisfy a second test that the funds are in the ‘best interests’ of the default fund employees to whom the MA applies.³⁹

Employers select a default fund from the MA list

Employers operating under a MA must select one of the listed default superannuation funds as their nominated default fund for employees. Employers must pay the Super Guarantee (SG) to this default fund for employees covered by the award who do not choose their own super fund.

³¹ *Fair Work Act 2009 (Cth)* s 617(4).

³² *Ibid*, s 620(2).

³³ *Ibid*, s 620(1A).

³⁴ *Ibid*, s 156F.

³⁵ The criteria includes: the appropriateness of the product’s long-term investment return target and risk profile, the expected ability of the fund to deliver on the product’s return target, given its risk profile, the appropriateness of the fees and costs, given the stated long-term investment return target and risk profile, and the quality and timeliness of services provided and the quality of advice given to a member.

³⁶ *Fair Work Act 2009 (Cth)* s 156A(4), s 156G(1).

³⁷ *Ibid*, s 156G(2)(b).

³⁸ *Ibid*, s 156H(1). There are some limited circumstances where more than fifteen superannuation funds can be listed for a particular award, but this is subject to the discretion of the Commission.

³⁹ *Ibid*, s 156H(2).

2.5 Enterprise Agreements and Modern Awards: it matters who chooses

There are a number of decision makers in our default superannuation system. Depending on the nature of an employee’s employment arrangements, employers, unions and Fair Work Commission panel members and employees themselves will be involved in choosing a default superannuation fund for the employee.

Competition Principle One – choice should not be restricted

By requiring employers to provide a particular default superannuation fund or funds EAs and MAs introduce a trading restriction. The employer may not be free to deal with their preferred supplier when choosing a default fund.

Similarly, superannuation funds are not completely free to compete with each other for business by offering lower fees, higher returns and better products.

In the case of EAs fund choice is introduced as part of a negotiation around terms and conditions of employment between employer and union. This appears to be a poor substitute for its own competitive process, superannuation funds may not be exposed to effective competitive rivalry when they are just one part of a broader negotiation. In MAs it is not a competitive process but the FWC that selects the default super funds.

Figure 2.4: Average annual administration fees and returns for MySuper products offered across Modern Awards from July 2014 to June 2016



Source: APRA Annual MySuper Statistics back series (issued 1 February 2017) and FSC analysis of Modern Awards. The data chosen corresponds with the two full years since the commencement of the MySuper regime.

Looking at Figure 2.4 it can be seen that there is a range of administration fees charged through various MAs.⁴⁰ Even if some funds nominated in MAs have lower fees, this is of little use to employees that are placed in a default fund that has higher administrative fees, and whose employer is not able to choose to move to another default fund.

From the figure above it can also be seen that higher administration fees tend not to be correlated with higher returns and that larger funds tend to have lower fees. This latter observation is consistent with the idea that larger funds benefit from greater economies of scale in administration. It has been widely noted that increased competition is likely to lead to some consolidation of smaller funds, this charts suggests that this consolidation would place downward pressure on administrative fees.

Because the employee is not themselves choosing a superannuation product, the default system therefore introduces principal-agent relationships between employees (as the principal) and employers, unions and the Fair Work Commission (as the agents). These relationships are only problematic from an economic perspective if the incentives of the principal and agent differ and the ability of the principal to monitor the agent is imperfect.

Principal-agent relationships

A principal-agent relationship refers to a situation where one individual or organisation (an agent) makes a decision on behalf of another organisation or individual (a principal). From an economic perspective, principal-agent relationships can be problematic when a principal cannot effectively monitor an agent (because of an information asymmetry between them) and the agent has different incentives to the principal.

A classic example of a principal-agent relationship is between shareholders of a business (the principal) and the manager of that business (an agent). The shareholder's incentive is likely to be to maximise profit, whereas the manager's incentive might be to (for example) maximise their salary. Because the shareholders cannot perfectly monitor the manager (an information asymmetry), this is likely to lead to an outcome where the manager is less focused on making the business profitable than the shareholders would like.

When someone other than the employee is choosing their own superannuation fund the nature of the principal agent relationships becomes important.

Unions as agents

In EAs any default fund is specified in the EA is a result of a negotiation between the employer and union. The union will nominate a fund or funds as part of the negotiation. Incentives between principal and agent may differ where a union member sits on the board of a superannuation fund and/or funds from a nominated super fund flow to the union.

⁴⁰ We consider that administration fees are a more reliable indicator of competition than investment fees. See discussion at Appendix A. The choice of \$3 billion in assets has been chosen for illustrative clarity.

In MAs, unions are entitled to make nominations to the FWC over funds included in the MA. Incentives between principal and agent may differ where a union member sits on the board of a superannuation fund and/or funds from a nominated super fund flow to the union.

Principal-agent relationship: employees and unions

A number of superannuation funds have both union and employer representatives that sit on their board. This appears to create conflicting incentives. Other funds may offer a product that is better, or more appropriate, for a particular employee. But in an EA union and employer incentives may lead them to preference a fund with which they have a relationship.

Both EAs and MAs appear to restrict choice. This manifests itself through the creation of a range of principal-agent relationships. This restriction of choice is in contrast to Competition Principle One, which argues that Awards and industrial agreements set remuneration, conditions of employment, hours of work and working conditions of employees. They should not restrict competition and choice of products and services.

Although the employee may subsequently be able to choose their fund in the majority of cases, behavioural biases (discussed below) mean that this is unlikely to be an adequate substitute for employee choice at the default stage.

The Fair Work Commission panel as agents

The Fair Work Commission panels act as an agent in MAs, with the default fund selected by the FWC based on a recommendation from its “Expert Panel”. Conflicts may arise where a panel member previously sat on the board of a superannuation fund, has close relationships with a superannuation fund and/or is a financial beneficiary of superannuation funds.

Principal-agent relationship: employees and the Fair Work Commission

Differing incentives between employees and the Fair Work Commission panel have been recognised by The Hon Justice Nye Perram.⁴¹ The Fair Work Act sets out that three expert panel members who have knowledge of, or experience in finance, investment management or superannuation must be chosen.

In considering whether it was possible to for the Fair Work Commission panel to form itself free of conflict, His Honour noted that “the qualification provisions [which set out who can be a panel member] are likely to generate [conflict] problems of the very kind which have arisen.”

Sources: Fair Work Act 2009, FSC vs Industry Super Australia, transcript of proceedings, 6 June 2014

⁴¹ Financial Services Council Ltd v Industry Super Australia Pty Limited, 2014.

If the interests of employees differ too much from those of its agents, employees may end up paying higher fees, being involved in risky investments, being stuck with an underperforming fund or with a product that is inappropriate for their risk preferences.⁴²

Even if it were assumed that the incentives of the principal and agent were aligned employees may not be in a position to receive a product that satisfies their own unique preferences.

For example, a younger employee may preference a higher risk super fund as it is a long time before they will need to draw on their superannuation, while another employee may wish to invest in an ethical fund. Employees with young families or multiple dependents are likely to prefer more comprehensive life insurance than unattached singles.

Having a compulsory default fund, or a choice of a small number of funds limits the ability of employees to express their preferences and choose the super fund that best meets their individual needs. While many funds can offer investment and insurance choice this is not a substitute for choice and competition at the point of default across the full range of MySuper products.

Employers as agents

Employers act as agents in EAs as the default fund selected is a result of a negotiation between the employer and union. In the context of securing favourable terms and conditions of employment it is not clear that the employer has a strong incentive to negotiate effectively on behalf of the employee. Further, there may be conflicting incentives when an employer sits on the board of a superannuation fund or has other arrangements in place with the union.

In MAs the employer can choose a default fund on behalf of its employees from those listed in the relevant MA. Employers may conduct research but they have no personal financial stake in the outcome. So it is not clear that they will have as strong an incentive as the consumer of the policy to choose the most appropriate policy. Incentives between principal and agent may also differ where an employer sits on the board of a superannuation fund.

Principal-agent relationship: employees and employers

Employers' incentives differ from employees. For example, because there are no direct financial implications at stake for the employer they may not invest an optimal amount of time shopping around for an appropriate superannuation product for their employees. It has been noted that employers might instead choose a fund on criteria of greater relevance to them, such as less onerous administrative requirements.⁴³ Further, the Council of Small Business Australia (COSBA) has noted its concerns that some of its members may lack the relevant skills to choose an appropriate fund.⁴⁴

⁴² These principal-agent relationships also exist in relation to negotiation around terms and conditions of employment. An examination of the regulation of the labour market is beyond the scope of this paper.

⁴³ Productivity Commission, 2012.

⁴⁴ Council of Small Business Australia, 2016.

The principal-agent relationship between employee and employer would be particularly problematic if superannuation funds were able to provide financial incentives to employers (as opposed to employees) to choose particular superannuation funds.

This practice is illegal under section 68A of the *Superannuation Industry (Superannuation) Act 1993*. A recent ASIC inquiry found no evidence that this law had been broken in the superannuation industry.⁴⁵

If further inquiries were to find problems in relation to financial incentives, policy makers should consider whether the magnitude of penalties and scope of the Act should be expanded to promote the competition principles outlined in this report.

Competition Principle Two – benefits should outweigh costs of restrictions

Competition Principle One does not appear to be met under the existing default superannuation system, with choice and competition particularly restricted in EAs and MAs.

Under Competition Principle Two, however, this restriction on choice and competition may still be considered acceptable if it can be shown that the benefits of the restriction to the community as a whole outweigh the costs; and that the objectives of the legislation or government policy can only be achieved by restricting competition. For example, unions or employers (agents) can act to reduce search costs for, or increase the bargaining power of, employees (principals).

It can also be argued that the process may act to protect employees to the extent that employees suffer from the behavioural biases.

Behavioural biases

Behavioural economics draws on human psychology to explain why people behave in the ways they do. Behavioural biases are generally thought of as deviations from standards of rationality or prudence. Consumers are likely to be more susceptible to behavioural biases where products are complex.

If people do not always behave rationally and in calculated ways then this can mean that their choices may not in fact serve their best interests. Indeed the very rationale for a compulsory savings system lies in the behavioural bias of myopia.

Economists have classified a range of specific behavioural biases.⁴⁶ The following is not a comprehensive list, but are those biases that appear most relevant in relation to competition and choice of superannuation products:

Myopia is an observed phenomenon that people over-value something today, when compared to its value tomorrow. Given that the benefits of superannuation are realised in the future, people will place a far greater emphasis on consumption today over

⁴⁵ ASIC, 2015.

⁴⁶ Hillman, A., 2009.

consumption in the future. It also means that consumers may not place any significant emphasis on shopping around for a superannuation product that best meets their needs, even when this might make a significant financial difference in retirement.

Bounded rationality is an observed phenomenon that people have bounds on the extent to which they can rationally process the information. People cannot be expected to solve difficult problems optimally given their ability and time constraints.⁴⁷ In the case of superannuation, given its relatively complex nature, bounded rationality means that consumers may face difficulties in comparing different superannuation products.

Status quo bias refers to an observed phenomenon where people have a tendency to prefer the status quo, even when there could be benefits to changing products.⁴⁸ In general, this tendency has been found to result from the uncertainty which individuals have and leads them to stick to what they know.⁴⁹ In relation to superannuation, it means that the selected default product may not subsequently be exposed to appropriate competitive pressure through consumer choice.

Acknowledging the above factors does not mean that competitive forces are unworkable, or that the current policy settings are inappropriate. As an example, the rationale for compulsory superannuation, known as the Superannuation Guarantee, can be thought of as being grounded in the behavioural bias of myopia.

The existence of behavioural biases means that careful consideration of these biases is required when designing laws and regulations to improve the competitive process and choice in relation to default superannuation accounts. Policies grounded in behavioural economics can act to facilitate choice.

Indeed competition itself can help to overcome these biases. In the area of superannuation there is a range of online comparison sites that help consumers compare superannuation products, and advertising by superannuation funds can also assist in overcoming these behavioural biases.

Recommendation 1

Employees should have greater scope to choose their own default superannuation funds and Competition Principle Two should be used to assess alternative policy options. A number of alternatives that policy makers should consider that would be likely to improve outcomes in the superannuation system:

- The idea of a 'default' superannuation option could be removed. When employees start a new job, they are not provided with a default bank account for their salary to be deposited into; they must provide their own bank account details. Similarly, when employees start in a workplace, they could be required to provide details of a superannuation fund. This removes trading restrictions, allowing employees to choose their fund, removes principal-agent complications and increases competitive rivalry among superannuation funds, allowing a larger number of firms to compete.
- Provide the employer with choice. This brings Enterprise Agreements and Modern Awards into line with the default system applying to individual contracts. This will obviate

⁴⁷ Thaler and Mullainathan, 2000.

⁴⁸ The Behavioural Insights Team, 2016.

⁴⁹ This may also be driven by risk aversion, another phenomena identified in the behavioural economics literature.

one of two principal-agent relationships and create an environment where choice and competitive tension are heightened. Rather than being just one part of a bargaining process around terms and conditions of employment, experience suggests that many employers will invite for tenders for their default superannuation funds.

Insights from behavioural economics could be utilised to improve the operation of choice and competition in the superannuation system. See Section 2.9 of this report for a discussion on how insights from behavioural economics might be used.

An alternative policy option that does not promote choice, but will change the nature of competition in the default superannuation system is an auction. See Section 2.8 of this report for a discussion on auctions.

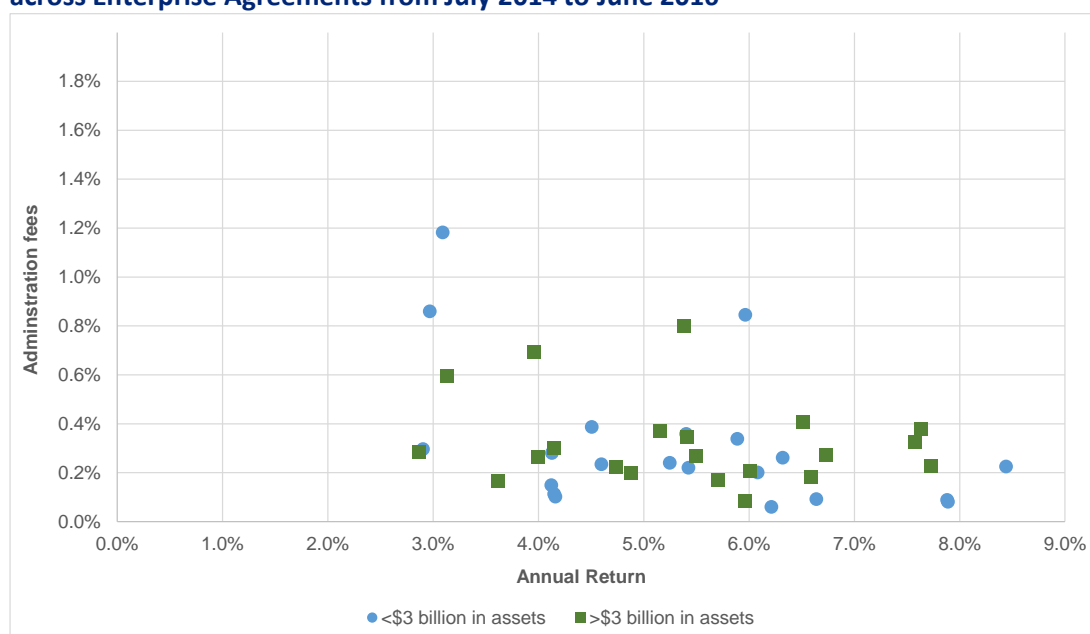
Finally, it should also be noted that where Competition Principle One is not being met there may be arguments for maintaining trading restrictions to enhance consumer welfare. Trading restrictions may be appropriate to protect employees that may be disengaged when choosing between complex products, and to increase the bargaining power of large employers acting on behalf of employees.

2.6 Enterprise Agreements: Employees should be able to switch funds

Current environment

It has been estimated that there are approximately two million people who are unable to choose a fund other than the default.⁵⁰ That is, even once starting with an employer, an employee is unable to choose to move to another fund.

Figure 2.5: Average annual administration fees and returns for MySuper products offered across Enterprise Agreements from July 2014 to June 2016



Source: APRA Annual MySuper Statistics back series (issued 1 February 2017) and DAE analysis of a sample of EA entered into in 2015. The data chosen corresponds with the two full years since the commencement of the MySuper regime.

Looking at Figure 2.5 it can be seen that there is a range of administration fees offered through various EAs.⁵¹

Even if some funds nominated in EAs have lower fees, this is of little help if you are restricted from choosing an alternate fund. For example, the chart above suggests that you could be locked in a fund that has average annual administration fees of around 1.2% per annum, which is around three times the average administration fee charged amongst MySuper products.

Competition Principle One – choice should not be restricted

Because these employees cannot exercise a choice they may find themselves in a fund that does not best suit their needs. Although the MySuper regime provides some protection, it is not a substitute for competition, so employees may also find themselves in a fund that

⁵⁰ The Hon Kelly O'Dwyer, 2015.

⁵¹ We consider that administration fees are a more reliable indicator of competition than investment fees. See discussion at Appendix A.

underperforms, has poor corporate governance or high fees. This is a clear trading restriction.

The current policy settings are in conflict with Competition Principle One. The EA process is restricting competition and the choice of products and services.

Competition Principle Two – benefits should outweigh costs of restrictions

Even though Competition Principle One has been broken and choice and competition have been restricted, under Competition Principle Two this restriction on choice may still be considered acceptable if it can be shown that the benefits of the restriction to the community as a whole outweigh the costs; and that the objectives of the legislation or government policy can only be achieved by restricting competition.

The historical justification for preventing employees from changing to their own fund was that it would create extra administrative costs for employers if they were to have employees in multiple funds.⁵² While in the early 1990s this may have provided some benefit, technological advances and policy changes have meant that administration has become less cumbersome and the superannuation system more digitised.

Another justification could be the risk that people are “churned” through funds by advisors that receive a commission every time an account is changed. Particularly when an employee has a low balance they may have little incentive to resist exaggerated claims of providers or properly inform themselves.

It appears clear that any small administrative benefit is not material enough to offset the costs of the restriction on competition. The risk that people are “churned” through funds by financial advisors is now largely an historical concern. The Future of Financial Advice (FOFA) reforms that were introduced by the Australian Government in 2012 now acts to prohibit this conduct.⁵³

Recommendation 2

All employees under Enterprise Agreements should be able to choose to switch away from their default superannuation fund if they would –prefer to be in an alternative fund. This would create policy consistency between Enterprise Agreements, Modern Awards and individual contracts.

At the time of writing this report draft legislation proposes that employees covered under Enterprise Agreements or workplace determinations that are made from 1 July 2016 be allowed to choose their own super fund. On 17 March 2016 the measure was reintroduced in Superannuation Laws Amendment (Choice of Fund) Bill 2016. The Bill was before parliament at the time the election was called and has lapsed.

⁵² *Superannuation Guarantee (Administration) Act 1992*.

⁵³ ASIC, 2016.

2.7 Individual Contracts

The third column in table 1.1 shows that for around 37% of Australians individual contracts, between employer and employee, govern their employment relationship. In this situation the employer is given responsibility for choosing a superannuation fund. The only legislative requirement is that the product must be MySuper approved.

How the employer chooses its fund can depend on the size of the business. Larger businesses will often run corporate tenders while smaller firms are likely to compare MySuper approved products before deciding on a default product for their workforce.

Upon entering employment under an individual contract employees have an option to choose any complying superannuation fund or to use the default fund selected by the employer.

In the case of individual contracts it is the employer rather than the employee that decides the default fund although individuals then have the ability to choose any complying fund into which their employer SG contributions will be paid.

When considering the role of the employer from the perspective of a principal-agent relationship between employee and employer, employers can conduct research and bargain with super funds, but they have no personal financial stake in the outcome. It is not clear that they have as strong an incentive as the consumer of the policy to get the best deal. As already discussed, incentives between principal and agent may also differ where an employer sits on the board of a superannuation fund.

Attention should be given to whether the introduction of a principal-agent relationship between employee and employer is the best way to address competition and choice issues that exist absent a default system.

Recommendation 3

The current default system should be assessed against an analytical baseline of no default system. It should be assessed using Competition Principles One and Two as outlined in this report.

2.8 Auctions

The FSI and policy think-tank The Grattan Institute have both suggested that instead of providing employers or employees with greater choice in their default superannuation option the government could run a large scale auction.

Auctions are systems designed to buy and sell goods or services where the participants looking to purchase the good or service place bids, with some set criteria used to determine the winning bid (usually the highest bidder).

In superannuation it is likely that the winning bid would need to be awarded based on a range of criteria such as historical net returns, fees, investment strategy, governance and service quality.⁵⁴

Chile

Under the Chilean model, every two years a tender is put out for the national default retirement fund. Funds must provide a tender for five defined asset allocation options, each set at the same fee. The fund with the lowest fee receives all new default accounts until the next auction.

Chile's pension system is dominated by a small number of very large pension funds. It has been observed that Chile's pension system is heavily weighted towards government bonds. Such investments carry low investment fees and reduced risk, but exhibit lower long-term growth.

Financial System Inquiry

The Financial System Inquiry argued in 2014 that a lack of strong customer-driven competition in default superannuation arrangements dampened competitive pressure to reduce fees. It therefore recommended introducing “a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system”.

The inquiry did not set out a specific structure for the competitive process. It did, however, suggest that there should be a focus on after-fee return to avoid “fee reductions at the expense of member returns”, as well as a number of other design approaches to avoid potential concerns, such as participants gaming the system.

Grattan Institute

The 2014 Grattan institute report, *Super Sting*, argued super fees in Australia were high by international standards. Caution must be exercised in making this comparison. For example, Australia's superannuation tends to be more complex and flexible when compared to many overseas systems, especially those which are predominantly defined benefit.

The report recommended the introduction of an auction system, where the right to become a national default super product is tendered out using a fee-based auction. It suggested that the fund or funds that offered the lowest bid should become the sole default products for a set period until the next auction.

Comparing fees and net returns can be complex. Appendix A provides a discussion of the complexities that can arise if an auction model attempted to make such comparisons between superannuation products. This complexity creates the opportunity for an auction to

⁵⁴Productivity Commission, 2016a.

be gamed by participating organisations potentially undermining the effectiveness of the auction.

Recommendation 4

If policy makers were to introduce a national auction mechanism, it should be subject to the two competition principles outlined in this report. In particular, it should be clear that any benefits from the auction, such as lower fees through increased scale, outweigh any costs, such as a limiting of choice, risk of gaming, risk of increase in market concentration and adverse outcomes through design of selection criteria.

Limiting choice

Employees generally have divergent superannuation product needs. Younger workers may prefer a higher risk product that is likely to offer higher returns over the long run, while older workers approaching retirement may prefer a lower risk more defensive product. Others may prefer investing in property over shares or vice versa.

It may be difficult to design an auction system that will cater to these differing preferences, this may lead to allocative inefficiencies as fund products are allocated to individuals that may not have a strong preference for them.

In contrast, under the current regulatory regime, employers with employees on individual contracts can under the MySuper rules seek out products that are tailored towards their specific business' workforce. An auction method, particularly one designed as a 'one size fits all' takes away this choice.

Gaming

Auctions are by no means a panacea to competition problems. It is well-established in the academic literature that auctions can be vulnerable to manipulation, or "gaming", by those seeking to win the auction.⁵⁵ More generally, competition problems that exist outside of auction markets can persist when auction mechanisms are introduced, and in some cases the introduction of auctions can facilitate competition problems.⁵⁶

For example, in Germany firms bidding for radio spectrum were able to signal their bidding intentions to each other and divide the spectrum on offer amongst them at a lower price. In the United States the costs of entering the bidding for a drug company meant that smaller players did not enter, lowering the eventual price paid for the company.⁵⁷

Any competitive process to choose default super products would need to be carefully designed to avoid funds gaming the process. For example, a focus on minimising fees is likely

⁵⁵ Klemperer, 2002.

⁵⁶ A comprehensive discussion of this point is beyond the scope of this paper. For more see the discussion in Klemperer, 2005.

⁵⁷ These examples are from Klemperer, 2002.

to create a strong incentive for funds to create hidden or indirect fees in order to keep the official bidding fee low.⁵⁸

The academic literature on collusion has identified a number of risk factors that might facilitate both tacit and explicit collusion.⁵⁹ While implicit or explicit collusion can occur in auctions, it is not clear that the risk factors identified, such as highly concentrated markets, are significant in the case of default superannuation products.

A risk of increasing market concentration

The revenue stream from default super products make up a large proportion of incoming revenue for many superannuation funds. A large scale auction that allocates all default superannuation revenue to one fund for a number of years has the risk of increasing market concentration. This is because other competitors may become weaker over time as a result of a loss of scale from being unable to secure any new default superannuation funds.

A fund that does not win the auction for a number of years will retain growth opportunities through direct channels, but lose the generally large proportion of revenue gained through its default superannuation channel.

Where changes in net revenue lead to a significant reduction in net assets held there is a risk that funds may exit or become sub-scale such that they are no longer able to compete effectively in an auction. To the extent that this occurs it effectively increases market concentration which may lead to a lessening of competition over time.

Potential impacts on innovation

When the main focal point of competition is a large scale auction, like that proposed for default superannuation accounts, firms will focus on how they might best meet the criteria set out in that auction. For example, if the auction focuses on lower fees, this is where firms will focus their energies, so that they are most likely to be successful in the auction.

This can be problematic for innovation. Innovation is often about finding new ways of delivering or offering products. If those new ways of delivering products, say through a more comprehensive web site offering, are not part of the auction criteria then the auction provides no incentive for funds to explore or invest in these new innovations, inhibiting dynamic efficiency.

Challenges of auctions for products with many characteristics

When an auction has many characteristics designing a set of criteria around which bids can be made can be challenging. In the case of superannuation products the multitude of criteria that might reasonably need to be considered can mean that any government administrative process resembles more of a tender process rather than a simple auction. This suggests that there may be a burden on government to effectively act as a fund manager for those being allocated to default accounts.

⁵⁸ Financial System Inquiry, 2014

The field of combinatorial auctions is also instructive. This academic field of study demonstrates that when bids need to be placed on combinations of products (as might be the case for default superannuation products) a range of design complexity is introduced. A complete discussion of these complexities is outside the scope of report, although there are a range of publicly available sources.

Outcomes sensitive to selection criteria

The results of any auction where products are differentiated can be quite sensitive to its design. For example, a narrow focus on fees will likely deter investment in growth assets that have high investment costs in favour of passive investment. It's not clear that this is an optimal outcome for longer-term retirement funds.

The focus of any selection criteria will therefore need to be broader than just fees. This will necessarily result in the government making decisions that shape how funds allocate resources. Where there are multiple criteria for judging a winning bid, it would appear to be difficult to be able to weigh the relative importance of each criterion.⁶⁰

Kiwisaver

New Zealand's Kiwisaver default selection process uses a set of weighted criteria that looks at organisational capacity, member education and investment capability and fees. The government determines the asset allocation of the defaults. By design the default asset allocation is highly conservative, default funds tend to have a growth asset allocation of around 20%.

Some have argued that this has resulted in an insufficient allocation of growth assets for a pension fund (Gaynor, 2016). Consequently, over the past five years the New Zealand Superannuation Fund (which has a greater bias towards growth assets) has significantly outperformed aggregate KiwiSaver funds: 13% per annum to 7.9% per annum.

⁶⁰ Cramton, P., Shoham, Y., and Steinberg, R., 2006.

2.9 Behavioural economics

Consumer behaviour effects the way markets work. By utilising insights from behavioural economics, policy makers may find adopting heavy handed regulatory instruments, such as auctions, unnecessary in order to improve market outcomes.

Small policy changes driven by insights from behavioural economics can drive big improvements in choice and competition in superannuation. For example, the Financial System Inquiry recommended that funds be required to publish retirement income projections on member statements in order to improve members' awareness of their likely balance in retirement. The Australian Government has agreed to implement this recommendation where it is found to be practical and cost effective.⁶¹

This section outlines a few ideas based on well-known insights from behavioural economics. There are likely to be more ideas that could be adopted, and policy makers should further investigate policy options with behavioural economics in mind.

Improve the standard choice form

Most employers are required to provide new employees with a *Superannuation Standard Choice form* from the Australian Tax Office (ATO). Using this form employees can opt to choose the employer's default superannuation fund or nominate their own fund.

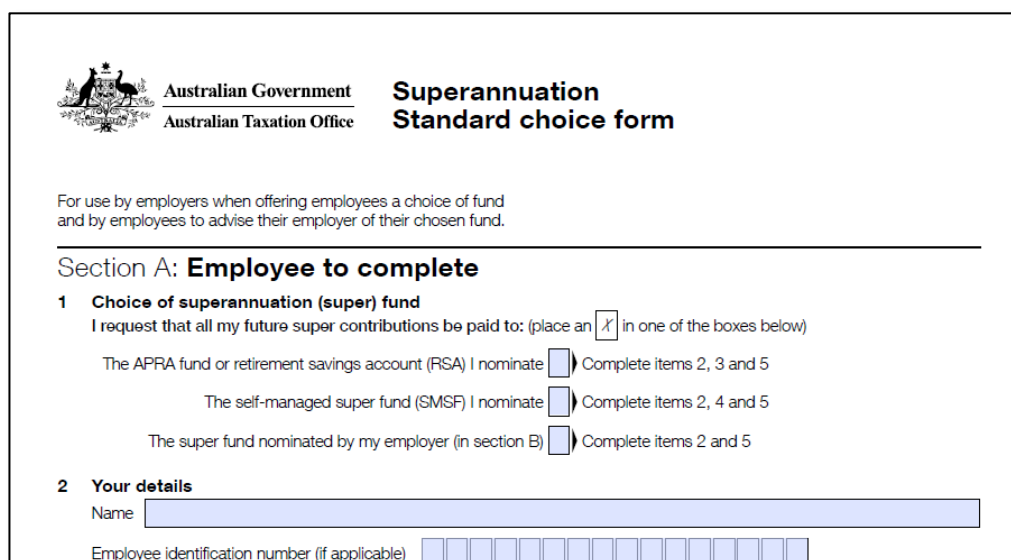
This form represents an important opportunity where employees can exercise choice over their superannuation fund. However, at present the form is not designed with the principles of choice and competition in mind.


At present the form is worded in a complex way and purely administrative. This is a missed opportunity given that a range of evidence suggests that small changes in the way information is provided, or 'nudges', can have a significant impact on the extent of engagement and competition in a market.⁶² These changes should be made with a view to decrease rather than increase complexity.

The government provided form represents an opportunity to highlight the long term benefits of shopping around for a competitive superannuation product. The form might detail how fees and returns can differ between products and what this means at retirement. The form could also detail how consumers might best shop around to ensure that they are able to choose the superannuation product that is right for them.

⁶¹ Productivity Commission, 2016.

⁶² University of East Anglia, 2013

Figure 2.6: The current standard choice form does not encourage choice or competition


 **Australian Government**
Australian Taxation Office **Superannuation
Standard choice form**

For use by employers when offering employees a choice of fund
and by employees to advise their employer of their chosen fund.

Section A: Employee to complete

1 Choice of superannuation (super) fund
I request that all my future super contributions be paid to: (place an in one of the boxes below)

The APRA fund or retirement savings account (RSA) I nominate Complete items 2, 3 and 5

The self-managed super fund (SMSF) I nominate Complete items 2, 4 and 5

The super fund nominated by my employer (in section B) Complete items 2 and 5

2 Your details

Name

Employee identification number (if applicable)

Source: <https://www.ato.gov.au/>

Tax returns to provide a nudge

All employees paying tax in Australia receive an annual tax return statement. This annual statement could be used to remind or ‘nudge’ employee’s to check whether their current superannuation product best meets their needs.

The Government’s SuperStream system means that the ATO is able to access more information on our superannuation system than it has in the past.⁶³ This information could be utilised in a number of ways.

Behavioural insights suggest that information that relates us to our peer groups, referred to as ‘social nudging’ can be particularly powerful.⁶⁴ The ATO could provide information on the number of Australian’s that have switched their accounts in the previous year in order to encourage more to consider if they would be better off elsewhere.

The ATO could also provide clear information on how switching to a lower fee fund with the same projected rate of return can improve incomes in retirement.

Disengagement

One rationale for a default system is that Australian’s are disengaged in their superannuation. In this paper this is thought of in terms of a range of behavioural biases. However, it may be that the default system itself acts to exacerbate this disengagement.

It appears clear that an effective default system would lower the costs of disengagement, hence making disengagement a more attractive strategy, all else equal. Despite this, there appears to be a lack of robust analysis or evidence on the extent of this effect. That said, it

⁶³ ATO, 2016b.

⁶⁴ University of East Anglia, 2013. p. 53.

seems logical that if consumers were ‘nudged’ to shop around through the removal of the default superannuation system consumer engagement would be likely to increase.

In markets for other financial products without default systems consumers actively shop around and compare deals. For example, in mortgages there are a number of product comparison calculators and consumer engagement is high, despite the complexity and long term nature of the product.⁶⁵

One survey found that 84% of people who plan to take out a mortgage or refinance their current home are likely to shop around before selecting a product.⁶⁶

This would be a worthwhile area for further consideration and analysis by the Productivity Commission in its upcoming reports.⁶⁷ For example, it might be useful to consider the level of engagement that exists in other financial products that offer returns at a future time period (such as term deposits) but are not part of the default superannuation system policy environment.

Comparability of products and limits on inducements

If the default system were to be removed and employees were forced to choose a fund when they started at a new place of employment, this would be likely to generate a range of additional sales and marketing activity from superannuation funds. This is likely to be a positive thing, with superannuation funds seeking to improve their products so that employees are more likely to choose them.

However policy makers should be aware of behavioural insights when considering the appropriate regulatory environment in which this choice could take place. Regulatory instruments such as MySuper already exist to improve the comparability of products and provide a minimum standard of product quality. This type of regime can be appropriate in the face of behavioural biases such as myopia, bounded rationality and status quo bias.

Policy makers should carefully consider the costs and benefits of this and other regulatory interventions through the lens of Competition Principle Two. For example, some forms of product tying and bundling can add to complexity and have been shown to confuse consumers.⁶⁸ Similarly, up front inducements may work to exacerbate biases such as myopia, therefore it may be sensible to design policy that limits the level and type of inducements that can be offered.

⁶⁵ A mortgage product and associated decisions seem to be as complex as those made in relation to superannuation. There are a range of fee structures to compare, and the decision involves consideration over long time horizons across multiple financial dimensions. An important difference is that the benefits of choice in mortgages are realised by the individual immediately, whereas the benefits of superannuation choice is received in retirement.

⁶⁶ Your Mortgage, 2016.

⁶⁷ Put another way, the qualitative and quantitative evidence provided in *Box B.3 Disengagement with superannuation*, in the Productivity Commission, 2016a.

⁶⁸ University of East Anglia, 2013. p. 42.

Recommendation 5

Policy makers should consider insights from behavioural economics when developing policy from a 'no default' analytical baseline. Small policy changes driven by insights from behavioural economics – such as changes to form design, product comparability, inducements and nudges – can drive big improvements in choice and competition in superannuation.

Conclusions

The Productivity Commission is currently undertaking a wide-ranging review of the efficiency and competitiveness of Australia's superannuation system.

This report is not a substitute for that analysis but it does support a robust competition framework and offers recommendations for thinking about choice and competition in default superannuation.

It is a clear conclusion of this report that further choice and competition should be introduced into our default superannuation system.

Competition Principle One states that awards and industrial agreements set remuneration, conditions of employment, hours of work and working conditions of employees. Employees' choice of products and services that are unrelated to a negotiation over their terms and conditions of employment, such as default superannuation, should not be restricted by industrial relations agreements. This is because markets for these products and services are subject to competitive forces unrelated to competitive conditions in labour markets.

Competition Principle Two states that policies and regulations binding the default superannuation system should not restrict competition unless the benefits of the restriction to the community as a whole outweigh the costs, and the objectives of the legislation or government policy can only be achieved by restricting competition.⁶⁹

Using these principles this report provides a number of policy recommendations that we recommend be considered further as part of the Productivity Commission's review.

There are a number of alternatives to the current system that can be considered:

- The idea of a 'default' superannuation option could be removed. When employees start in a workplace they could be required to provide details of a superannuation fund.
- The employer could be provided with choice when employees are under Modern Awards or Enterprise Agreements, this would bring policy for these employees into line with the default system around individual contracts.
- Insights from behavioural economics could improve the operation of choice and competition in the superannuation system.

It is important that these recommendations be carefully considered by policy makers. The stakes are high. Australia's superannuation funds now hold in excess of A\$2.1 trillion in assets under management⁷⁰ and Deloitte actuaries predict that the value of assets held in superannuation funds could grow to A\$9.5 trillion by 2035, which is around twice the size of projected gross domestic product in that year.⁷¹

⁶⁹ Australian Competition Policy Review, 2015. Recommendation 1, p.33.

⁷⁰ ASFA, 2017.

⁷¹ Nominal dollars. Deloitte Actuaries and Consultants, 2015.

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Appendix A - Comparing fees and returns is complex

There are two primary types of fees fund members pay: administration and investment fees. It is often difficult to draw direct comparisons between fees and returns charged by Australian super funds and retirement funds from overseas due to different regulatory environments, member expectations and investment strategies.

Administration fees cover the various costs associated with setting up and running a super account regardless of the investment strategy, such as providing account statements. They include establishment fees and general member fees. Superfunds may also charge fees for financial advice that members seek.

Investment fees are the fees associated with managing an investment. Most Super funds do not manage their investment in-house, instead using external investment managers. Such fees depend heavily on the investment decisions of the fund. Passive investments tend to attract lower fees, while more active investments higher.

International comparisons

Deloitte Access Economics has previously noted that cross-country comparisons of fees (as well as returns) in superannuation can be challenging. Returns and fees are affected by a range of factors which vary significantly across jurisdictions, including:

- product proliferation and the level of choice;
- competition impeding economies of scale;
- flexibility and the regulatory environment;
- investment strategy;
- benefit design (defined benefits v defined contribution);
- average fund size in terms of assets and number of members;
- imbedded products and services such as life insurance and financial planning;
- bundling;
- tax; and
- the economic cycle.⁷²

Australia's superannuation system is characterised by a relatively high reliance on active mandates including an emphasis on investments in equities, and the ability to support individualised services. Both features add benefits and costs to the system.

⁷² Deloitte Access Economics, 2014.

Administration fees

Australia's super system is marked by heavy user services – a standard characteristic of defined contribution schemes. Funds are expected and required to provide a number of services to members.

For instance, they must provide standardised reporting of performance and fees, year-round engagement options (such as call centres), the ability to handle inter- and intra-fund transactions, investment choice option and opt-out life and disability insurance (and the ability to increase cover). In contrast, defined-benefit, government-run retirement funds such as Norway's funds are not required to provide member services or interactions and frequently have much of the operating costs embedded in the employer contribution rate.

Investment fees

The most significant determinant of difference in investment fees is the extent to which a fund is actively or passively managed. Funds usually have some mix of passive and active investments. As an example, unlisted assets, such as infrastructure, commercial property and private equity, are by their nature actively managed and provide a number of benefits for pension funds (including diversification, stability and a focus on long-term return).

A factor that can influence fees is how actively investments are managed. Passive investment incurs lower investment costs, because less time and resources are expended on choosing assets and disposing of them.

Australia's superannuation system overall focuses on actively managed assets. This is partially attributable to a relatively higher weighting on equities, which tend to be a more active class. Other surveys of asset allocation, such as Mercer (2014) suggest other countries hold relatively higher equity shares than suggested by the OECD survey.⁷³

In either case, Australia still stands out for the relatively low allocation to fixed income by domestic pension funds. Fixed income incurs lower investment management fees; e.g. the Mercer (2010) survey found that investment fees for equity products were around 70% higher than for fixed income products.

That said, the costs of actively managing assets in Australia are low relative to other advanced countries. For example, Mercer (2010) shows that Australians have the second lowest investment management fees in the world.

Australia's superannuation system is relatively young, so a large proportion of the funds are held in growth assets. While offering higher potential returns, growth assets are more expensive to manage than defensive assets, resulting in higher investment costs.⁷⁴ A significant proportion of members are in accumulation phase. Also, unlike many international funds, there is generally no minimum requirement for government bonds or other similar assets (Israel, for instance, requires funds to invest a minimum of 30% of assets in earmarked bonds).

⁷³ Ibid.

⁷⁴ Financial Systems Inquiry, 2014.

Returns net of fees

The expected returns from a super fund depend on a number of factors: the risk-profile of the fund and its investment strategy, the capabilities of the investment managers and general market conditions. The Australian super industry is characterised by an extensive range of products that allow members to match their investment strategies to their risk profile (and other preferences). This range of choice is beneficial for a heterogeneous member-base; however, it makes international comparisons of returns net of fees difficult.⁷⁵

Japan

According to Towers Watson (2012), the largest active Australian (industry) superannuation fund, AustralianSuper, ranks 68th globally by assets under management. In contrast, Japan's Government Pension Investment Fund – with the lowest fees of those surveyed – ranks first, with over 30 times more assets. Given that it is accepted that there are economies of scale in the operation of superannuation funds, this difference in scale may have an impact on fees charged in Australia.

Domestic comparisons

Administration fees

Differences in administration fees may reflect differences in standards of customer service, efficiencies from technology and scale.⁷⁶ Differences in administration fees could also reflect a lack of effective competition. Given that administration offerings could be thought of as reasonably homogenous, especially relative to different investment options, in a competitive market you would expect to see similar administration fee pricing amongst products. Those with higher administration fee offerings would no longer be attractive to consumers and would be forced to lower their fees. Currently this is not what is observed, amongst MySuper products there are variations of well over one percentage point between the lowest and highest fee products.

Analysis by Deloitte Access Economics suggests a narrowing of the difference between highest and lowest fees administration fees that might result from increased competition could mean a decrease in MySuper product fees of \$292 million per year.⁷⁷ This amounts to over \$19 per account holder in one year alone.

Investment fees

As with international comparisons, difference in investment fees between funds largely reflect the extent to which the fund is actively managed. Members are generally free to

⁷⁵ Financial Systems Inquiry, 2014

⁷⁶ Association of Superannuation Funds of Australia, 2014

⁷⁷ Deloitte Access Economics analysis of APRA MySuper Annual Statistics 2016. The difference between the highest and lowest fee was narrowed by taking all administrative fees that were above the weighted average administrative fee and replacing them with that weighted average administrative fee. This is likely to be a conservative assumption, as there is reason to think that (given a relatively homogenous product) only those with the lowest fees (rather than those at the weighted average) would survive greater competitive pressure.

choose an investing style that matches their preferences. Actively managed investment can offer benefits to members besides the management of risk or return. For instance, active management allows for ethical discretion by investors, avoiding investments associated with environment or social damage, as an example, Australian Ethical Super is dedicated entirely to environmental and socially responsible investing.

Returns

As with international comparisons, the expected returns from a super fund depend on a number of factors: the risk-profile of the fund, the capabilities of the investment managers and general market conditions. As noted above, the Australian super industry is characterised by an extensive range of products. This range of choice is beneficial for a heterogeneous member-base, but makes comparisons of returns net of fees between funds difficult.

Appendix B – History of competition policy in superannuation reviews

The Wallis Financial System Inquiry, 1996-1997 examined the consequences of the deregulation of the financial system since the 1980s. The report argued for stronger consumer choice in the market and stated that the industry was highly fragmented, in part because of government regulation. The Productivity Commission (PC) later stated that “despite the relevant recommendations being gradually implemented by government, concerns regarding competition remained”, noting that demand-driven competition is tempered by compulsory purchases of super products and behavioural biases.

Super System Review, 2010 (Cooper review) – A systematic review into the superannuation industry led by Jeremy Cooper, the former Deputy Chairman of ASIC, recommended that the superannuation market be regulated in light of the growing evidence that behavioural biases limit efficient outcomes in the industry. The review recommended the ‘MySuper’ scheme with a view to maximising the welfare of disengaged consumers while offering choice for engaged consumers. Default funds would have to offer MySuper products, which must follow standards regarding fee structure, reporting, and other areas.

Default Superannuation Funds in Modern Awards, 2012 – The PC conducted an inquiry into default superannuation. It found that default funds have generally outperformed non-default funds, but that there was scope for improvement. The report saw the MySuper requirements as a “first filter” for selecting default funds and recommended a second, non-prescriptive, quality filter that looked at fund performance, governance practices and administrative efficiency. A new Default Superannuation Panel within Fair Work Australia would make decisions on what funds were suitable for becoming a default fund, based on these filters.

Financial System Inquiry (Murray Report), 2014 – The 2014 Financial System Inquiry was tasked with examining how the Australian financial system could best meet Australians’ needs and foster economic growth. The report argued that while Australia has a strong financial system, “superannuation is not delivering retirement incomes efficiently”, due to a lack of strong price-based competition. The report made a number of recommendations concerning superannuation funds, including setting clear objectives for the system as a whole, improving operating efficiency during the accumulation stage, and greater use of risk pooling to improve efficiency during retirement.

Productivity Commission inquiries, 2016 onward – The Australian government has asked the Productivity Commission to undertake a range of inquiries into the superannuation system. This includes a study to develop criteria to assess the efficiency and competitiveness of the superannuation system, and an inquiry to develop alternative models for a formal competitive process for allocating default fund members to products. The Productivity Commission’s reviews are due to report back at various times over the next three years.

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Contact us

Deloitte Access Economics
ACN: 149 633 116

Grosvenor Place
225 George Street
Sydney NSW 2000
PO Box N250 Grosvenor Place
Sydney NSW 1220 Australia

Tel: +61 2 9322 7000
Fax: +61 2 9322 7001

www.deloitteaccesseconomics.com.au

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