COMPETITION POLICY

ISA Submission: Competition Policy Review

SUBMISSION

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ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members. Please direct questions and comments to:

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ISA SUBMISSION: COMPETITION POLICY REVIEW ISSUES PAPER

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KEY POINTS

- Superannuation is not simply another financial product; it is a critically important component of Australia's unique compulsory retirement system which is heavily subsidised by Australian taxpayers.

- Employees and employers as consumers of superannuation products do not drive competition in the superannuation industry.

- Australia has the highest level of banking concentration amongst G20 countries. The same banks employ or control 75 per cent of Australia's financial planners and provide the majority of retail superannuation products.

- Employers have an obligation to select a default fund for the 75 per cent of employees who fail to choose their own super fund. The system is designed to operate in the best interests of fund members.

- ISA is concerned that banks are targeting employers to maximise the commercial opportunities between an employer's banking and superannuation arrangements. Third line forcing behaviour is inevitable as banking staff are incentivised to link banking and superannuation products provided by related entities.

- ISA is making two recommendations:

    1. An inquiry consider a focussed investigation into inducements offered by Banks to the benefit of employers in exchange for securing exclusive rights to default super contributions of employees in a workplace.
    2. To avoid third line forcing type issues it is suggested that a bank or related entity should be prohibited from providing default super fund services to employees where the bank is the main banking provider to the employer.

EXECUTIVE SUMMARY

These brief submissions to the competition policy review are largely confined to matters regarding the competition law matters raised in section five of the issues paper released by the panel in April 2014. These submissions raise issues of concern relating to the concentration of market power and the vertical integration of related service providers within the finance sector, in particular the impact on the level of competition within the market for superannuation products and the related financial advice industry.

There has been much discussion regarding the unique position of the major banks and the economic and social impact flowing from the level of banking concentration in Australia. These are matters that are in part the subject of the Financial System Inquiry (FSI) currently underway.

These brief submissions limit themselves to competition issues in the superannuation industry and the potential regulatory changes which could mitigate negative impacts on competition within the superannuation industry.

Consumers do not drive competition in the superannuation industry. Default fund arrangements are in place which imposes an obligation on employers to choose a superannuation fund for the 75 per cent of their employees who do not exercise their right to choose a superannuation fund to receive the compulsory contributions made on their behalf by employers.

Australia’s four largest banks employ the majority of Australia’s financial advisors and control the majority of retail super funds. Incentivised banks are now targeting employers to link their choice of default superannuation product with their banking arrangements.

We argue there should be a targeted investigation into banks offering incentives to employers in return for providing default fund access for employee’s superannuation entitlements. Further we argue there are specific steps the Panel should recommend that would enhance existing provisions relating to third line forcing to ensure the provisions adequately protect the interests of employers and employees as consumers of superannuation and banking products.

1. Superannuation in Australia's retirement system

Superannuation is not simply another financial product; it is a critically important component of Australia's unique retirement system[1], notwithstanding that the implementation often is left to commercial parties. As a public policy, supported by a special legal regime, licensing, regulatory oversight and tax concessions, the public policy objectives of superannuation must always remain prioritised above individual and private interests. At the top of any list of public policy objectives for superannuation, must be that the system, to the greatest extent possible, results in broadly experienced improvement to retirement outcomes.

There is imperfect competition in the superannuation market with up to three quarters of members of a superannuation fund not actively choosing the financial product and failing to exercise the legal right to choose their own superannuation product.[2]

It is recognised that there is a significant investment of public monies into Australia's superannuation system via the concessional tax treatment afforded to superannuation[3]. The processes by which default funds within awards are selected are of interest to all Australians.

1.1 Role of superannuation regulators

A number of regulators play different but overlapping roles to ensure superannuation providers and agents fulfil their obligations within the retirement incomes policy framework.

The Australian Securities and Investments Commission (ASIC) regulates and administers consumer protection laws and the conduct of licensed businesses in the financial services sector.

The Australian Prudential Regulation Authority (APRA) is the body responsible for overseeing and licensing superannuation providers and products.

Until 2001 the Australian Competition and Consumer Commission (ACCC) was the body responsible for the protection of consumer interests in the superannuation industry. Whilst the consumer protection obligations have moved to ASIC the competition oversight component remains relevant.

Superannuation arrangements in Australia are correctly described as a superannuation system or superannuation industry and are an identifiable and unique sub-market of the market for financial products.

2. Market share and the role of banks within the superannuation industry

The superannuation industry has a number of competing sectors within it. The largest sector is the small funds and self-managed sector with 34.1 per cent of funds under management; the retail sector has 26.1 per cent of funds; the industry funds sector 20.1; public sector funds 15.0 per cent and employer specific corporate funds 3.8 per cent.

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[1] As of June 2013 over 1.6 trillion was invested within Australia's superannuation system.

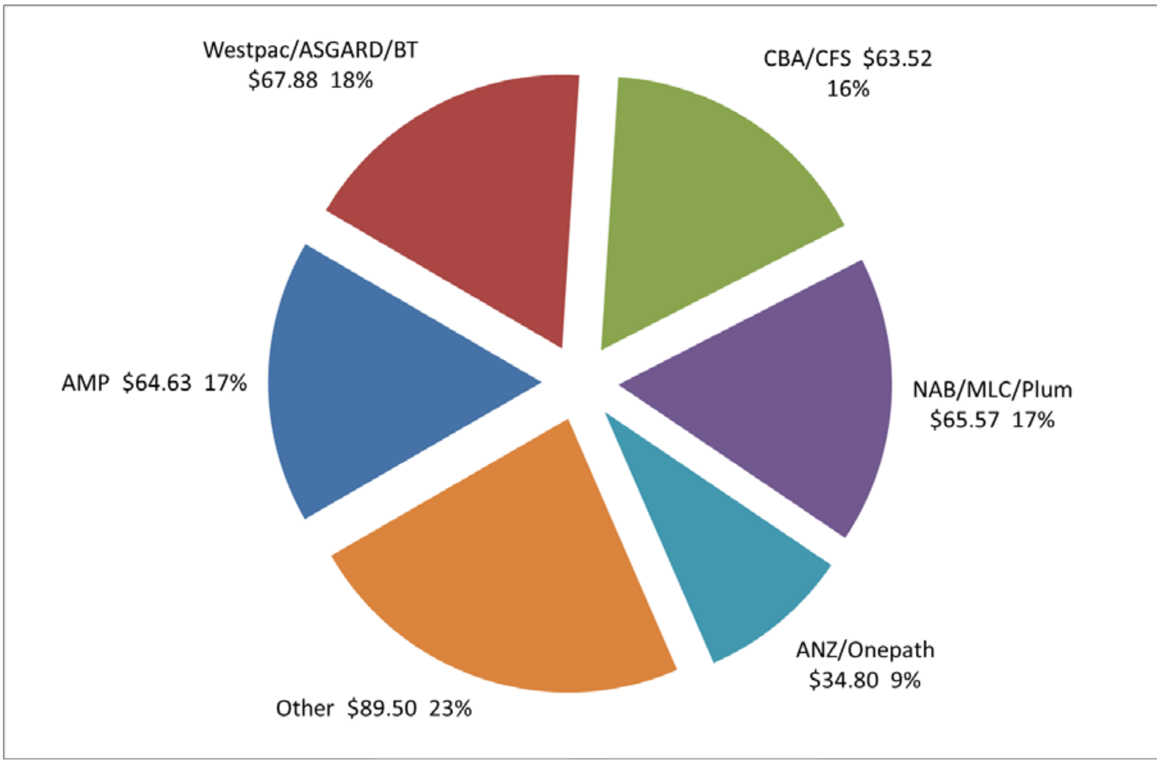
[2] The right of an employee to exercise choice of superannuation fund can be restricted in certain circumstances. Most notably where a workplace agreement or legislation nominates a particular fund that the employer must use as a default fund or the employee is a member of a defined benefit fund.

[3] The sum of Superannuation tax concessions C4-C8 is $39 Billion in 2014-15 (Treasury, *Tax Expenditure Statement 2013*)

2.1 Concentration of Australia's banking industry

As Figure 1 demonstrates the majority of the for-profit superannuation funds are operated by entities owned by the four largest banks.

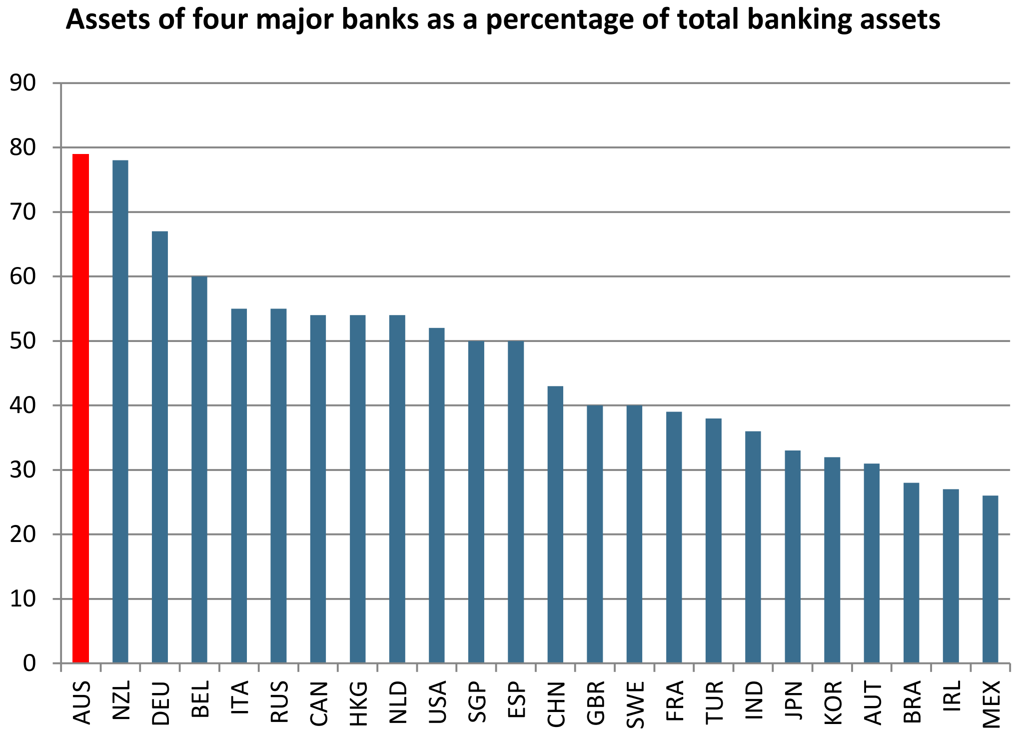
Figure 1. Superannuation Assets of Major Retail Fund Families ($b, %), June 2013



Source: APRA Fund level rates of return – 200 largest funds (2014); ISA Analysis (2014). Superannuation funds have been classified by their fund families. Only funds with 10 years of returns data have been included in this analysis.

Australia also has the most concentrated banking sector of any G20 country.

Figure 2. Concentration of Banking Sector: G20 Countries



Source: International Monetary Fund's (IMF*) Financial System Stability Assessment of Australia in 2012* (figure 2)

An analysis of the number of ADI's per head of population confirms that Australia's banking market is highly concentrated. Australia has 14,000 inhabitants per ADI compared to the USA with 23,000 and Germany and Canada both with 42,000.[4]

Market concentration in the Australian banking market ensures that 4 of the 8 'world's most profitable' banks reside in Australia.[5]

2.2 Market dominance by banks in the financial planning industry

Australia's largest four banks all have significant wealth management divisions. The market share within the financial planning and advice sector of the four major banks in the six years to June 2013 grew from 15 per cent to 36 per cent. The other significant player in the industry, AMP Ltd, during the same period increased its market share from 3 per cent to 13 per cent. AMP Ltd combined with the four major banks has increased its market share since June 2007 from 19 per cent to 49 per cent.[6]

The *Rainmaker, Financial Planning Report, Vol 3 No 1, February 2014* found that:

- the four largest banks and their wealth arms in association with AMP have market domination after capturing 77 per cent of all relationships between platforms and advisers (page 16);
- these organisations have control over 55 per cent of all financial advisers and 79 per cent of all platforms advisers utilise (page 18); and

[4] Sources: Official country population estimates, APRA Quarterly Statistics June 2013, IMF studies

[5] Dave Grace and Associates; *Competitive Dynamics in Retail Banking: An International Comparison* March 2014. Page 7

[6] Macroeconomics; *Review of the Major Banks Control of the Wider Financial Sector*, April 2014, Page 13

- since the GFC institutional adviser groups have been acquiring platforms (to reach 76 per cent ownership) and adviser groups to build a vertically integrated wealth management distribution system. (page 30).

These developments must be overlaid against evidence that adviser groups are strongly incentivised to recommend specific products. According to an ASIC review of financial industry practice:

- A review of the top 20 licensees found that the majority indicated that they "remunerated their advisers based on the volume of financial products sold", with 90 per cent of total licensee remuneration paid by product providers (incl. asset-based fees), and only 10 per cent paid directly by clients.[7]

- The same survey found that despite all licensees using relatively large approved product lists (median number of products on APL was 400) "there remained a tendency to concentrate product recommendations into a few key products"[8]: around 95 per cent of funds in platforms with wrap structures are held in the top three products, while around 60 per cent of all funds are in the top three retail superannuation products.[9]

- This concentration in product recommendations is reflected in the revenue streams of the top 20 licensees with ongoing commissions from the top three products representing 37 per cent of all ongoing fees and up-front commissions on the top three products generating 43per cent of all up-front commissions.[10]

- A 2013 ASIC survey of the next 21-50 largest licensees found results consistent with those found in the survey of the top 20 licensees, with a higher proportion of revenue from fees paid directly by clients (36 per cent). [11]

- Further to this evidence in a survey by Roy Morgan, over the past seven years financial planning groups associated with the 'Big Six' fund managers (ANZ/ING/OnePath, AMP and AXA (now merged), CBA/Colonial First State, NAB/MLC, and Westpac/BT) have been consistently increasing the allocation of their sales to their own super products from 71 per cent in 2006FY to 77 per cent in 2013FY. The annual allocations have been 71 per cent in2006, 73 per cent in 2007, 74 per cent in 2008, 73 per cent in 2009, 72 per cent in 2010, 77 per cent in 2011, 75 per cent in 2012, and 77 per cent in 2013.[12]

[7] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 11

[8] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 7

[9] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 12

[10] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 12

[11] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 12

[12] Roy Morgan Wealth Management Reports, 2007 to 2013. The most recent data is published in Roy Morgan (2013) *Superannuation and Wealth Management in Australia*, Report 15, Dec 2013, p 48. Note: 2010 data is for the calendar year

3. Consumers do not drive efficiency in the superannuation industry

Competition law traditionally focusses on concentration and market power, primarily the supply side, as in market structures known as monopoly or oligopoly, and to a lesser extent on the demand side, such as in market structures known as monopsony.

This form of competition policy is more important than ever in the Australian context, where most consumer markets (and many business to business markets) are extremely concentrated, with only a handful of suppliers or customers exerting significant market power. Notable examples are the banking sector, in which the major banks have 80-90 per cent market share, and grocery retail, in which two supermarket chains are dominant.

The approach to competition policy based predominantly on concentration analysis is supported by a number of assumptions associated with neoclassical economics, in particular, that information is costless and consumers are hyper-rational. Under these assumptions, adequate competition between suppliers will more or less guarantee efficient outcomes for consumers.

However, these assumptions are now known to be false, with profound implications. Many economists involved in challenging these assumptions are now leaders of the profession. For example, Joseph Stiglitz, George Akerlof, Daniel Kahneman and Vernon Smith have all been awarded the Nobel memorial prize in Economics for related advances.

The key implication is that it cannot be assumed that consumers will drive competition based on price and quality/performance even in markets with many suppliers. This is particularly true for markets with complex pricing structures, such as telecommunications, and with complex and varied products *and pricing*, typical of many financial products, and particularly investment products. Markets are especially prone to inefficient mispricing if they are unfamiliar to consumers (i.e. consumers' activity in that market is infrequent).

Another potential source of inefficiency is evident if costs and benefits are delayed as consumers tend to demonstrate hyperbolic discounting (i.e. they are heavily focussed on immediate costs and benefits). This tendency is reflected in apathy, inertia and disengagement in relation to products which may have a great impact, but only in the medium to longer term. Delayed costs and benefits are fundamental to retirement saving.

These advances in theory, supported by decades of empirical research, imply that in certain markets there is greater scope for Government in competition policy than was previously envisaged. This role certainly would include ensuring that information on products and pricing in key markets with complex, unfamiliar products, is consistent and comparable, to reduce the significant information costs that consumers face.

This role also plausibly extends to the regulation and selection of default products, or implementation of price caps as is being considered in the workplace default retirement savings markets in the UK.

Approximately 75 per cent of consumers of superannuation products do not exercise their right to choose their own superannuation fund, even though the exercise of informed choice could result in future payment differentials of tens, if not hundreds of thousands of dollars at retirement.

3.1 Stronger Super reforms

Policy makers have reacted to the lack of consumer activism with the introduction of a substantial series of legislative and regulatory changes that form part of the Stronger Super reforms. These reforms saw a separation of legislative oversight between choice funds (those said to have been actively chosen by fund members) and default fund members (those fund members who have not actively chosen and have been placed into the default via the default fund arrangements).

The legislative schema has introduced more protections for all fund members via greater levels of transparency; limitations on fees and charges, including commissions; the imposition of higher duties on trustees and product providers. For non-choice fund members the protections are further enhanced and are overlaid by new arrangements for the selection of default funds within Modern Awards.

4. Employer conflicts

Since 1 January 2014 the only product that an employer can use as a default fund is a MySuper authorised product. Consequently Modern Awards have been amended to only include MySuper authorised products.

As part of the award modernisation process the Fair Work Commission is required to undertake a two stage process that in the first instance applies a statutory quality filter to applicant funds followed by a decision of the Full Bench of the FWC to finalise the superannuation provisions in Modern Awards including the naming of default funds.

The representatives of the retail funds and their owners, 'the banks and AMP', have been demanding a change to the existing process which will enable an employer to choose their default fund from any authorised MySuper product. The government appears to be predisposed to this proposition.

Where employers have a number of competing default fund options; either a limited number of named funds within an award or an unlimited choice of funds, there is a potential for conflicts to arise. The business environment raises these potential conflicts as employers negotiate banking and superannuation arrangements.

4.1 Inducements only partially prohibited

Section 68A of the SIS Act prohibits the offering of inducements from a superannuation provider to an employer regarding the employer's choice of default fund. The Act prohibits conduct by fund trustees that amounts to offering goods and services to employers as an inducement to their employees becoming members of the fund, or refusing to supply goods and services, such as banking services, because employees have not agreed to become members.

However the following are goods and services that are exempt from the inducement prohibition and therefore can be provided to any person by the trustees of superannuation funds or related entities:

- supply of a business loan on a commercial arm's length basis;
- supply of a clearing house service for the forwarding of contributions and information to other funds or RSAs on behalf of the person in relation to employees of the person who have chosen those funds;
- supply of advice or of an administration service to a person or the employees of the person where the supply relates to the payment of contributions to the fund; and
- supply or offer to supply goods or services to a person only if the supply or offer is available to the employees of the person who are members of the fund, and the terms of the supply or offer are not less than the terms supplied or offered to the person.

Of particular concern are the potential for third line forcing type arrangements surrounding the interplay between businesses and banks regarding contractual arrangements regarding loans and separate contractual arrangements regarding the provision of superannuation services offered by a related party to the bank.

With the restriction falling on superannuation trustees, it is important to note that the SIS Act does not expressly prohibit the offering of goods or services to employers as an inducement in the form of discounts or price bundling by banks. This is discussed further below.

4.1.1 Self-interest has driven decision making

Survey work undertaken by the Australian Taxation Office has found that employers are largely disengaged with superannuation obligations, primarily make decisions based on self-interest and to an unacceptably high degree, are prepared to receive a direct or indirect benefit from a superannuation provider.

The Colmar Brunton survey found that 13% of employers surveyed admitted to receiving a direct or indirect benefit from a superannuation provider.[13] This revelation is not surprising as many employers appear to be unaware that the SIS Act prohibits the receipt of inducements. What is surprising is that such a large number of employers have admitted to the practice, including some large employers.

The Colmar Brunton qualitative survey found that:

> "Employers would be more inclined to consider changing their default superannuation fund if it was clear that membership of one fund would provide financial or resource benefit to the company."[14]

The evidence is that the inducements offered included financial discounts to business and individuals offered by the banks.

It is suggested that most employers do not accept or seek inducements when considering a choice of default fund. However, there appears to be sufficient evidence to warrant additional attention to this area.

5. Relationship between banks and employers

As seen earlier 75 per cent of Australia's financial planners are associated with or employed within the banking industry or related parties within the wealth management arms of the four major banks.

5.1 Banks are targeting employers

The banks have identified profits from superannuation savings as a source of revenue growth and have targeted business customers to leverage their banking relationships to the advantage of third party related entities offering superannuation services. This new aggressive stance is reflected in the recent comments

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[13] Colmar Brunton Social Research prepared for the Australian Taxation Office. *Investigating Superannuation: Quantitative Investigation with Employers*, 20 January 2010. Pages 55-57. http://archive.treasury.gov.au/documents/1885/PDF/Report_ATO_Super_Qualitative_Employer_Report.pdf

[14] Colmar Brunton Social Research prepared for the Australian Taxation Office*. Understanding Superannuation: Preliminary Report: Qualitative Investigation with Employers, Consumers and Industry*, 25 March 2010. Page 28. http://archive.treasury.gov.au/documents/1885/PDF/Report_ATO_Super_Qualitative.pdf

by Ms Vicki Doyle, the Head of corporate and retail super of Westpac Banking Corporation's wholly owned entity BT Financial Services.[15]

Ms Doyle indicated that it was the intention of the bank owned subsidiary to continue its existing targeting of business bank customers. Ms Doyle expressed the banks preference for a 'free enterprise approach' to the selection of default funds which would then enable the bank to "..go and target all our Westpac Group business banking clients with our superannuation offer."

A perusal of the banks submissions to the Fair Work Commission where they are seeking to have related entity products named in modern awards[16] informs the Commission that the banks intend to negotiate special arrangements in the form of fee discounts to employers.

It is not a breach of s68A of the SIS Act for banks to offer 'special arrangements', including fee discounts, to employers who have an existing relationship with a related superannuation entity. There is a growing concern that the banks intend to leverage their existing commercial relationships with employers to encourage employers to change existing superannuation arrangements by entering into contractual relationships with related parties offering superannuation products.

It is suggested that employers are and will continue to face pressure from banks as they 'bundle' their offerings. It should also be recognized that the SIS Act allows for inducements to be offered provided they are made available to the employee and employer and where a loan is offered at arms-length. The Survey work undertaken by Colmar Brunton Social Research for the ATO showed that significant numbers of employers had admitted to accepting an inducement to change or select their employee's superannuation product.

Employers have expressed their concern that banks will pressure them to change to a bank offered superannuation fund and that this may not be in the best interests of their employees. Many employers have also bitterly opposed the notion that they should bear the cost and moral, if not legal responsibility for choosing an appropriate superannuation fund for their employees.[17]

5.2 Third line forcing

The dominant role of the four large banks within the finance industry raises the prospect of their market power influencing product choice in the superannuation industry. This could occur when a bank only agrees to enter into a contract with an employer on the condition that the employer enters into a contract with a superannuation entity associated with the bank.

Or, conversely, the superannuation provider will only enter into a contract or offer discount rates with an employer where the employer agrees to enter into business banking arrangements or enter into another acceptable contract with an associated bank.

It is suggested that it is far from uncommon for the financial sales forces of the banks to establish preconditions to the provision of certain services, including the purchase of other financial services provided by the bank prior to entering into a contract for the provision of services on acceptable terms.

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[15] Financial Standard online: 'BT reveals post-awards strategy', 20 February 2014, http://www.financialstandard.com.au/news/view/38086655

[16] See: https://www.fwc.gov.au/awards-and-agreements/modern-award-reviews/superannuation-fund-reviews/applications

[17] See: Statements from the Council of Small Business of Australia http://www.cosboa.org.au/Page/COSBOA-Policy and the submissions of employer Peter Doyle (one of many) to the Productivity Commission inquiry into the process of selection of default funds in Modern Awards indicating that his business does not have the time to actively choose a default superannuation fund http://pc.gov.au/__data/assets/pdf_file/0011/115976/sub002-default-super.pdf

Recent changes to the types of superannuation products authorised by APRA have increased the ability of banks to 'integrate' their service offerings to employers. As of 1 January 2014 all superannuation products used by employers where their employees do not exercise choice must be a MySuper authorised product. MySuper default funds have greater protections surrounding them and have limits on the fees and charges that can be passed on to fund members.

As part of the MySuper reforms there can only be a single MySuper product offering from each Registrable Superannuation Entity (RSE) with the same pricing structure. This is intended to allow for transparency to enable product comparability. After significant lobbying from the banks, a new product was also introduced. Superannuation entities were also entitled to offer 'Tailored MySuper' products which can be negotiated with individual employers. These products allow for administrative fee discounting on the grounds that there may be certain administrative efficiencies that can be achieved with some employers.

A fee discount can be offered or not offered by a bank for any reason that the bank deems commercially acceptable. Except for any potential breaches of competition law, it is possible within the superannuation regulatory environment for a superannuation entity associated with a bank to only offer fee discounts to existing customers of the banking entity.

5.3 Anti-competitive boycott type behaviour

As was previously noted the majority of Australia's financial planners are either employed by a bank or an entity associated with a bank. Despite an obligation to act in the best interests of clients[18], financial planners associated with banks have rarely if ever recommended products not associated with the employing bank. The approved product lists used by the financial planners have not included industry super funds despite the fact that they have consistently been the best performing funds.

The acquisition of dealer groups and the implementation of limited product lists are clearly designed to reduce competition and choice available to consumers. We submit such arrangements result in consumers paying higher prices and act to shield approved products from competition and ultimately result in reduced product innovation.

5.4 Re-introduction of superannuation sales incentives

The proposals to remove protections associated with the Future of Financial Advice (FoFA) reforms which will allow banking employees to receive financial incentives associated with the sale of superannuation products will introduce further pressures within the system that will inevitably result in the best interests of fund beneficiaries not being a primary consideration of those selling and buying superannuation products.

6. Removal of conflicts from the system

Given the market dominance by banks in the superannuation industry a potential conflict arises when a bank seeks to both enter into a contractual arrangement involving a commercial loan and also seeks to offer superannuation services.

[18] The Federal Governments proposes to remove or reduce the existing best interest obligations

The evidence from the Colmar Brunton work and the banks own statements indicate that there is a high likelihood that an employer will be offered a 'bundled' arrangement involving separate but interlinked contracts regarding superannuation and commercial banking.

It is a standard business arrangement within the financial services sector for products and services to be bundled and discounts applied to loans or services where a consumer purchases multiple offerings. An analogous commercial relationship to the interplay between banking and superannuation offerings is the common practice of offering discounts on insurance products offered by a bank related entity where the consumer has an existing relationship with the relevant bank.

The superannuation context is unique as an employer is empowered to purchase a product on behalf of their employees who do not exercise choice. The vast majority of employees are not engaged consumers of superannuation products and do not exercise choice. The evidence from the Colmar Brunton survey work is that the majority of employers are primarily concerned about the direct and indirect costs and benefits that apply to them and do not believe it is their role or that they have the expertise to select a default superannuation fund that will maximise the retirement benefits of their employees.

6.1 Further investigation and reform required

ISA is of the view that the inquiry consider a focussed investigation into inducements offered by Banks to the benefit of employers in exchange for securing exclusive rights to default super contributions of employees in a workplace.

Further the inquiry should consider regulatory reforms to prevent a 'bundled' range of financial services, including default superannuation, when the benefit is obtained by one party and the cost of an inappropriate decision is borne by another.

6.2 New approach to remove conflicts

With the significant concentration in banking and vertically integrated financial advice businesses it is suggested that there are significant risks built into the default fund selection process that justify a new approach being taken to the obligations upon superannuation providers. To avoid third line forcing type issues it is suggested that a bank or related entity should be prohibited from providing default super fund services to employees where the bank is the main banking provider to the employer.

It is also suggested that where conflicted business relationships are entered into they should be capable of being set aside without recourse to compensation.

This proposal is intended to remove conflicts from the system, avoid third-line forcing type pressures and thereby improve competition within the industry unencumbered by conflicts. Such measures will protect the interests of employees and employers alike.

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