20 July 2018

Deputy Chair
Productivity Commission
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SUPERANNUATION: ASSESSING EFFICIENCY AND COMPETITIVENESS

The Financial Services Council (FSC) welcomes the opportunity to make a submission in response to the Productivity Commission's *Superannuation: Assessing Efficiency and Competitiveness* Draft Report (the Draft Report).

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

We agree with the Productivity Commission's assessment that the superannuation system is working well for most Australians, but that the current default system fails too many members.

The Commission has made a range of ambitious proposals for addressing the flaws in the current system, and we believe these should be carefully considered to ensure superannuation continues to provide the best possible retirement outcomes for Australians.

Please contact me with any questions in relation to this submission on (02) 9299 3022.

Yours sincerely,

Allan Hansell
Director of Policy

TABLE OF CONTENTS

INTRODUCTION

The FSC welcomes the Productivity Commission's significant contribution to the ongoing conversation on the future of Australia's superannuation system.

We congratulate the Commission on the scope and detail of the analysis undertaken to inform this report, and its commitment to proposing evidence-based reforms.

We agree with the Productivity Commission's assessment that the superannuation system is working well for most Australians, but that the current default system fails to protect too many members from poor retirement outcomes.

More can be done to ensure all Australians are well served by the default superannuation system and the FSC strongly supports the evolution of the system. The Commission's ambitious proposals for system reform should be carefully considered.

The FSC gives its support to the majority of the Commission's draft recommendations.

In particular, the FSC has long advocated for decoupling the default system from the industrial relations system to give consumers control. Raising the bar for APRA MySuper authorisation through additional carefully designed criteria will also be key to improving default outcomes for those people that the current system is failing.

FSC members also support greater transparency, better disclosure and strong governance in all aspects of superannuation, and we agree with the Commission that high quality, comparable and meaningful data should be available to consumers.

We also welcome the proposal to prevent consumers ending up with multiple accounts by providing a "default once" mechanism. This would work alongside recently introduced government legislation to clean up multiple accounts through consolidation of inactive accounts and those with low balances via an ATO sweep.

While we understand the intent of the proposed "best in show" shortlist approach, our members feel that further consideration is required to fully understand the potential impacts of a fundamental redesign of the system. Given the complexity of this issue and the Commission's request for detailed research, the FSC will make a supplementary submission on this topic.

There will need to be significant work done to understand how the proposed default system would operate and how it will impact consumer outcomes over the long term. The FSC looks forward to being actively involved in this work.

This submission is primarily focused on areas where the FSC can offer additional information and evidence to assist the Commission in developing its final report.

SUMMARY OF FSC RECOMMENDATIONS

FSC Recommendation 1
Any criteria for being selected as a default fund under a "default once" model should include governance requirements, including a requirement that the fund's trustee board have a majority of independent directors and an independent chair.

FSC Recommendation 2
The data working group recommended by the Commission (Recommendation 22) should be expanded to include industry representation.

FSC Recommendation 3
Pending development of improved data relating to superannuation performance and fees, the Commission be more cautious about its findings on these issues.

FSC recommendation 4
Pending development of improved internationally comparable data relating to superannuation performance and fees, the Commission be more cautious about its findings about how Australia's system compares internationally.

FSC Recommendation 5
The Commission does not use data on asset level performance at the level of selected investment options to infer the performance of the remainder of the relevant fund, to conduct comparisons of funds or to conduct international comparisons.

FSC Recommendation 6
The Commission should not interpret the inability of some funds to provide performance data at an asset class level as an indication of misstatements in governance survey responses.

FSC Recommendation 7
Lifecycle products should continue to be eligible for MySuper default status, and not be confined solely to the choice segment, particularly given their ability to improve the risk/return trade-off over the whole accumulation period. The Commission should acknowledge lifecycle products could be improved over time, particularly through tailoring to cater to a broader range of member characteristics.

FSC Recommendation 8
The Commission expand its analysis of the National Default Fund (NDF) proposal (also known as the Future Fund Default proposal) to include analysis of actual or perceived government guarantees in other jurisdictions; whether other large Australian funds have a perceived government guarantee; the possible investment strategies of the NDF; potential political interference in the NDF; the potential economies of scale of the NDF; the adjusted historical return of the Future Fund if it had been the NDF; the lack of competitive pressures on the NDF; the impact of the NDF on supplier markets; and how retirement would work for the NDF.

The FSC also recommends the Commission undertake an indicative analysis of the long-term impact of an NDF with cautious investment strategy on financial markets, investment allocations (including in venture capital), retirement incomes and the Budget.

FSC Recommendation 9
The Commission provide a more in-depth analysis of the proposal involving a government-sponsored fund competing for listing on the top 10 best in show list, building on the analysis FSC recommends of the monopoly NDF model and any previous research by the Commission showing government ownership in a market has not been conducive to good outcomes.

FSC Recommendation 10

The Commission extend its previous analysis of the last resort default model, building on the analysis FSC recommends of the primary NDF model.

FSC Recommendation 11
Trustees should not cancel death and TPD insurance for inactive accounts unless the balance is below $6,000.

FSC Recommendation 12
Combine the Trustee Code and the FSC Life Insurance Code of Practice into a single binding Code with independent oversight.

FSC Recommendation 13
Extend the oversight of the independent Life Code Compliance Committee to monitor the adoption, compliance and guidance of the Trustee Code.

FSC Recommendation 14
An independent review of insurance in superannuation should only be conducted once current reforms have been embedded into the system.

FSC RESPONSE TO DRAFT REPORT RECOMMENDATIONS

Draft Recommendation 1: Defaulting only once for new workforce entrants

In principle, the FSC supports the development of a 'default once' mechanism for new entrants to the workforce.

See section 1.2 below

Draft Recommendation 2: 'Best in show' shortlist for new members

The FSC would like to see the implications of this recommendation, for both consumers and the market, more thoroughly examined.

See section 5.1 below and FSC supplementary submission

Draft Recommendation 3: Independent expert panel for 'best in show' selection

The FSC supports the removal of fund selection from the industrial relations system, but has concerns about the potential for politicisation of the selection criteria and panel.

Draft Recommendation 4: MySuper authorisation

The FSC supports strengthening the MySuper authorisation process and decoupling of defaults from the industrial relations system, and believes that this strengthening of authorisation for MySuper would benefit default members.

See section 5.2 below

Draft Recommendation 5: Regulation of trustee board directors

The FSC supports this recommendation. In fact, we believe that governance standards for trustee boards could be further strengthened to mandate a majority of independent directors.

See section 2.1 below

Draft Recommendation 6: Reporting on merger activity

The FSC supports this recommendation, and considers reporting of mergers that succeed should also be considered.

Draft Recommendation 7: Capital gains tax relief for mergers

The FSC supports this recommendation.

Draft Recommendation 8: Cleaning up lost accounts

The FSC supports the bulk of this recommendation, noting that there is legislation currently before the Senate which will achieve the goal of consolidating inactive accounts.

Draft Recommendation 9: A member-friendly dashboard for all products

The FSC supports this recommendation in principle, although we remain concerned that product dashboards must provide meaningful information to consumers.

See section 1.3 below

Draft Recommendation 10: Delivering dashboards to members

The FSC supports this recommendation, subject to our concerns about meaningful disclosure for choice products.

Draft Recommendation 11: Guidance for pre-retirees

The FSC supports this recommendation. Over and above guidance, the FSC supports the provision of quality retirement-focused advice.

Draft Recommendation 12: Exit fees at cost-recovery levels

The FSC supports the removal of exit fees as per the legislation currently before the Senate.

Draft Recommendation 13: Disclosure of trailing commissions

The FSC supports this recommendation.

Draft Recommendation 14: Opt-in insurance for members under 25

The FSC supports the intent of ensuring that member balances are not unduly eroded by insurance premiums. We note this recommendation has largely been overtaken by legislation currently before Parliament.

Draft Recommendation 15: Cease insurance on accounts without contributions

The FSC supports the intent of ensuring that member balances are not unduly eroded by insurance premiums, but believes trustees should not cancel death and TPD cover for inactive accounts unless the balance is below $6,000.

See section 6.1 below

Draft Recommendation 16: Insurance balance erosion trade-offs

The FSC supports the intent of this recommendation, noting it has largely been overtaken by legislation currently before Parliament.

See section 6.2 below

Draft Recommendation 17: Insurance code to be a MySuper condition

The FSC supports measures to encourage industry participants to adopt industry standards, and this is one way to do so. This could be strengthened by combining the Trustee Code and the FSC Life Insurance Code of Practice into a single binding Code with independent oversight.

See section 6.3 below

Draft Recommendation 18: Insurance code taskforce

The FSC supports the intent of this recommendation, however recommends extending the oversight of the independent Life Code Compliance Committee to monitor the adoption, compliance and guidance of the Trustee Code.

See section 6.4 below.

Draft Recommendation 19: Independent review of insurance in super

The FSC supports an independent review of the role of insurance in superannuation. However, this should be delayed until current reforms are embedded in order to allow for review of their effectiveness.

See section 6.5 below.

Draft Recommendation 20: Australian Prudential Regulation Authority

The FSC supports this recommendation. However, a stronger product rationalisation mandate would also assist this process.

Draft Recommendation 21: Australian Securities and Investments Commission

The FSC supports this recommendation.

Draft Recommendation 22: Superannuation data working group

The FSC supports this recommendation, however we believe industry should also be represented on the data working group. See section 2.2 below.

1. MEMBER OUTCOMES

1.1 Ending account proliferation

The FSC agrees with the Commission that the creation of multiple accounts results in poor member outcomes, particularly through balance erosion.

In principle, the FSC supports the introduction of a ‘default once’ mechanism that allows an individual to choose a fund at the time they enter the workforce, or be placed in a default fund if they fail to exercise choice, and carry that fund with them between employers unless they actively choose otherwise.

Untying default superannuation from the employment relationship through a ‘default once’ system would prevent the account proliferation that is an inherent part of the current industrial relations system.

A mechanism with a strong safety net, such as choice from a list of elevated MySuper products (see section 5.1 below), would ensure that members who do not make an active choice will not be worse off.

It would then be incumbent on funds and employers to engage members ensure any changes in circumstances are disclosed to the insurer to protect against possible loss of future benefits, and where appropriate to choose a different option that may better meet their specific needs (for example providing additional insurance for individuals in high risk occupations).

The FSC also supports the policy intent of other measures aimed at reducing the number of duplicate, inactive and low-balance accounts already in the system, including the *Protecting Your Super* measures in the 2018 Federal Budget which closely reflect the Commissions draft recommendations 8 and 12.

These reforms would work in tandem to reduce account duplication. The budget measures will do the heavy lifting to reduce account proliferation for existing members, while a ‘default once’ mechanism will prevent the ongoing creation of new duplicate accounts.

Further discussion of alternative default models can be found in section 3.

We note mandatory transfer of inactive accounts to the ATO raises issues when the fund member does not have any other active account — the funds will remain with the ATO, earning low returns, until the fund member starts another active account or takes other actions that allow the money to return to the super system. In this situation, there is an argument that the super money should remain in the super system even if the fund member takes no action.

1.2 Choice of product

We note the Commission’s concerns regarding the high number of investment options available at a system level.

The Commission’s use of 40,000 to quantify the proliferation of superannuation products is a simplistic use of APRA’s raw data. The report itself agrees in Box 4.1 that there is some disagreement about how many products there actually are. The Matryoshka dolls analogy is also only partially correct.

To use the APRA statistic of 40,000 at face value assumes that counting an investment option many times over is an acceptable approach. It assumes that counting steps in a “decision tree” of product and investment options represents the sum total of all products, rather than what it really is: the sum total of all “decisions” available to <u>all</u> members in the system, in aggregate. Such a system wide, top down, representation of member choices exaggerates the wrong issues as being “woolly”, while also failing to address the areas which could warrant improvement.

In breaking down what is actually available to a member, we should begin by assessing how many entry points there are into superannuation- the actual main fund offering. Because of these nuances, the number of decisions available to an individual varies greatly depending on what super funds they have access to:

- In particular – those under the awards system have no first tier decision of fund available to them, as the decision has been made for them.
- Of the vast majority of “public offer” funds, very few of these are truly available to the wider public without at least some conditions. Most of these are offered via selected distribution channels. As such:
  - Those who have the ability to choose another fund which is not their employer’s default will only have access to funds which are advertised and offered explicitly direct to consumer and without financial advice.
  - The vast majority of super funds are only available via a specific employer – for example Qantas or Telstra, or a financial adviser.
  - Conversely, once an individual has selected a financial adviser, only a few super funds will be available to them based on the individuals expressed preferences and the application of the existing best interest duty.

Once a super fund has been selected, either for the member through the default process or by the member actively choosing an alternative fund, the individual may have to make a second tier decision on what underlying investment options to select.

- There are two types of investment options available- those that are intrinsically part of the management of the fund, or those that are themselves standalone products available either within or outside of the superannuation environment. This is dependent on the sort of fund being selected- independent investment products are usually available in master trust or wrap style super funds.
- A single “investment option” can be offered in several funds. A single index fund may be available via 10 different super funds. This does not represent 10 different products, nor does a single individual generally have access to all 10 avenues to invest in this managed fund. By extension, references to Rainmaker’s numbers in Box 4.1, such as the existence of 1,100 cash products, does not mean that these are all distinct products. In reality, a much smaller range of products are offered through many different funds.
- The accumulation and retirement/pension version of the same super fund are often counted as two separate “products” when the underlying structure of the fund is the same, and is a question of tax environment and accessibility to monies rather than it being a separate fund. Thus one managed fund option that is offered in both environments is counted twice, for the purposes of APRA statistics.
- Many options are no longer open to new contributions.
- There are some funds in both the MySuper and Choice environments which do not require a second decision to be made on investment options- choosing the fund is to also choose its singular investment option. This is particularly true in the MySuper funds.
- At the other end of the spectrum, funds that are available through financial advice typically will have hundreds of investment options available for further decision making, however a financial adviser will help select from these as part of the financial planning process, and the individual is not required to face these decisions alone.
- As mentioned, the majority of funds across all parts of the industry (and not just in industry funds) have tailored their investment options menu to less than 10, which match a self-assessment of an individual’s risk profile e.g.: Conservative, Balanced, Growth and High Growth. Doing so is the most acceptable method of investing as per financial advice and product provision practices in Australia and globally.

What all these nuances demonstrate is that an individual does not have access to 40,000 super funds, nor are there actually 40,000 distinct investment options available in the superannuation environment. There is not even a choice of 40,000 total fund and investment decisions to be made by a single member. In its supermarket analogy, the Commission mentions between 20,000 and 25,000 different products available at a single supermarket, however using the APRA figure of 40,000 is akin to suggesting that combined, 10 supermarkets offer up to 250 thousand products in aggregate.

The Commission has taken the view that, regardless of the number, evidence from behavioural economics suggests excessive choice can be detrimental to consumers. We recommend the Commission should indicate what constitutes excessive, when:

- many members do not face more than two decision points (i.e. fund and underlying investment option), and
- the investment option choice is narrowed down naturally by risk preferences and, in the case of full service offerings, the assistance of a financial adviser.

We agree with the Commission's remarks that it is over-simplistic to assume that investment options outside the default market are supply driven. Members of the FSC undertake extensive consumer research and provide product offerings in line with what their customers want. A large array of investment options on some full service platforms only exists because of the demand shown.

The FSC believes that adequate choice of fund in the market is paramount to ensure healthy competition and meet the needs of those individuals who are looking for wider variety of investment options. The default MySuper environment is designed to ensure good outcomes for members who may be disengaged, those with poor financial literacy, or those who simply wish to cede their decisions to the trustee. This is an important role, however changing the super industry generally to remove a free market of products does those individuals with a higher level of engagement, access to advice and financial literacy a great disservice.

In terms of product features available on superannuation products, we do not accept that these offer "dubious" value and we would ask the Commission to provide further clarity here. It is the experience of many FSC members that product features go a long way to enhancing the member experience and members' financial literacy.

While we are supporters of maintaining broad choice for engaged consumers in the market, FSC members are committed to facilitating easier decision-making for members and intermediaries and reducing the number of products in the market through rationalisation mechanisms where appropriate.

1.3 Improving product comparison and dashboards

The FSC agrees that it is vital for members to be able to reasonably compare superannuation products.

We support ongoing work to improve existing MySuper dashboards to ensure they provide information that is useful and meaningful to consumers. Part of this will involve ensuring that data that informs these dashboards is calculated in a consistent manner so customers know they are comparing like with like.

However, the Commission appears to have underestimated the difficulty of providing meaningful dashboards for choice products. Dashboards are assisted in MySuper by the fact MySuper is a standardised offer (same and limited fee types, similar investment profile, etc). This standardisation does not apply to choice options.

For choice dashboards to be effective they need to be developed in a way that compares like with like and is useful to consumers. Even if a workable dashboard can be developed, the information for many products types (including legacy, wrap and platforms) would likely be difficult to develop and of limited use to members.

However, the FSC and our members are happy to continue working with the government and regulators to develop workable product comparison tools for consumers.

1.4 Retirement

The draft report does not adequately address the retirement phase of superannuation. It focuses on accumulation issues but does not address the efficiency or competitiveness of how funds pay this money back to members in retirement. At June 2017, there was $760 billion already in the retirement phase. Australian superannuation savings are expected to double in size from $2.6 trillion to around $5 trillion by 2030[1]and around $1.3 trillion will move into retirement phase over the same period.[2]

Currently account based pensions (ABPs) are the predominant product available in retirement. Many superannuation funds now manage assets for their retired members that run into tens of billions of dollars. These savings are in ABPs, which are invested little differently from the assets of those still working, even though retirees face very different risks. Specifically, many ABPs provide similar levels of equity exposure in retirement as in accumulation. There is little recognition in the market or the Commission's draft report that retirees are largely 'defaulted' into ABPs. In this context we see the government's comprehensive income product for retirement (CIPR) proposal as going some way to introducing a wider choice of products into the market for those in retirement.

Whilst the FSC is strongly supportive of quality financial advice for members in and approaching retirement, we suggest that the industry placing a greater focus on retirement is also important. For this reason, we do not fully support draft finding 4.4 suggesting that improving the quality of financial advice given to members is the most important task remaining.

Delivering income in retirement is a different paradigm to accumulating savings. Factors that should be addressed in any retirement income strategy include the importance of looking at retirement income over and above end account balances at the point of retirement, management of longevity, market and inflation risks and understanding member needs and wants during retirement.

We note that a 'default once' system would also need to address the retirement income needs of members. Retirement income is an important component of fund choice that members will need to consider in a 'default once' system. The government's proposed retirement income covenant will require funds to develop a retirement income strategy for members and provide guidance to help members understand and make choices about the retirement income products offered by the fund.[3] The covenant is proposed to be legislated by 1 July 2019 with delayed commencement until 1 July 2020. If the covenant does not proceed within these timeframes will be necessary for the 'default once' system to have another mechanism for ensure the retirement income needs of fund members are met.

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[1] Rice Warner Superannuation Market Projections Report 2017
[2]Ibid, sum of flows June 2018 to June 2030 (in 2017 dollars)
[3] The Treasury, *Retirement Income Covenant Position Paper*, May 2018 principles 1 & 2

2. GOVERNANCE

2.1 Fund Governance

The FSC believes strong governance at a fund and system level is crucial to maintain stability and trust in the superannuation system, and agrees that governance is strongly linked to performance. The issue of governance for superannuation trustee boards, in particular, has received considerable attention over the last decade.

Independent directors

The FSC believes that, to ensure high quality governance, a superannuation fund board should include a majority of independent directors and an independent chair.

As noted by the Commission, this view is reflected in FSC Standard No. 20 *Superannuation Governance Policy* (Standard 20) which was introduced with the intention of creating a rigorous standard for fund governance across the FSC membership. It is designed to strengthen fund governance as well as manage potential conflicts which may impact member outcomes.

Standard 20 applies to the trustee board of an RSE licensee and specifies the criteria a director must satisfy in order to be listed as an independent director. It also sets out requirements for conduct of the board and requirements in relation to maintaining appropriate policies and disclosures.

These requirements were designed to align with good practice in the industry, and were consistent with the ASX Corporate Governance Principles. The FSC is not aware of any other superannuation association with a governance standard that is binding on its member companies and which requires the appointment of independent directors and an independent chair.

In addition to Standard 20, the FSC is a member of the ASX Corporate Governance Council and an active supporter of the Corporate Governance Principles.

We note that the Corporate Governance Principles are currently under review, with proposed amendments including updates to Recommendation 2.3, which requires entities to disclose circumstances that may compromise the independence of directors. In addition to requirements around disclosure of potential conflicts, the consultation draft includes new commentary which creates a presumption that, where a director falls into a category which may raise concerns about their independence, they should be ruled not to be an independent director unless the conflict is shown to be immaterial to their judgement.[4]

The FSC has also been supportive of legislative requirements for independent directors on superannuation boards. We believe the industry and fund members would be well served by the passage of the *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017*.

The FSC believes that any fund competing to be a default fund under a "default once" model should be subject to minimum governance requirements. This should include having a majority of independent directors, and an independent chair, on the fund's trustee board.

We also note that APRA is currently undertaking a post-implementation review of the 2013 changes to the prudential framework for superannuation. The FSC and its members will be providing specific comments on the prudential framework in response to this review.

FSC Recommendation 1

Any criteria for being selected as a default fund under a "default once" model should include governance requirements, including a requirement that the fund's trustee board have a majority of independent directors and an independent chair.

[4] *ASX Corporate Governance Principles and Recommendations*, 4th ed. Consultation Draft, 2018

Fund mergers

The FSC agrees that subscale and underperforming funds should merge with better performers.

In this context, we support the Commission's recommendation that mergers be further incentivised by providing permanent capital gains tax relief for funds in the event of mergers and transfers. We consider there are arguments for extending this CGT rollover relief to sub-funds or options that merge (this would enable the merger of corporate funds, which can operate as sub-funds of a larger master fund).

There may also be benefits to simplifying the current 'equivalent benefits test' to create a more flexible, principles-based test that may facilitate additional mergers.

We also support a requirement for trustee boards to disclose to APRA when they enter a memorandum of understanding with another fund in relation to a merger attempt, and disclose reasons where a merger does not proceed. There may also be a case for funds to report on mergers that do succeed, indicating why they were in members' best interest.

Mergers will affect the ability to collect and publish consistent and comparable data on fund returns over time (and other related fund data such as asset allocation). The FSC therefore considers there would be value in the Government (or APRA) developing guidelines as to how fund data is reported and analysed when funds merge. This will be particularly important if historical returns form a significant part of the criteria for the Commission's top 10 best in show model.

2.2 System Governance

The FSC broadly agrees with the Commission's comments in relation to the generally high level of system-level governance and lack of evidence of material risks in the system.

The FSC also agrees with the Commission's finding that most major systemic reforms have been beneficial to members.

In particular, we support the Commission's Draft Finding 10.1 that there would be significant member benefits to be gained through the passage of the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017* currently before the Senate.

Data and disclosure

The FSC agrees with the Commission that consistent, meaningful data collection across the sector is required in order to assess performance and ensure appropriate information is available to members and regulators.

While reforms over the last several years have significantly increased the amount of data being published by funds and collected by regulators, FSC members are willing to work with regulators to facilitate the collection of any additional data that is necessary to effectively monitor and govern the superannuation system.

However, it is important that any information is collected in a standardised manner according to consistent definitions. This is particularly important if it is to be used for sector or fund level comparisons.

We support the creation of a cross-agency working group to ensure data collection and reporting is standardised as far as possible. However, the FSC believes any such working group should involve industry representatives to ensure solutions are developed in a way that is workable for funds.

Additional discussion of performance data can be found above in section 1, and discussion of disclosure to members in section 2.

FSC Recommendation 2
The data working group recommended by the Commission (Recommendation 22) should be expanded to include industry representation.

3. MARKETS AND COMPETITION

3.1 Competition

The FSC is strongly of the view that competition in the default segment is inappropriately constrained by the current industrial relations system which locks individuals into poor performing funds.

The current Fair Work Commission process is designed specifically to stifle competition within the default sector. This system creates a virtual monopoly on default fund provision, since the vast majority of superannuation funds specified in awards and industrial agreements as the default fund providers are industry funds.

As noted by the Commission, the removal of choice for approximately 800,000 consumers who are locked into superannuation funds through enterprise agreements is also evidence of the anti-competitive nature of the default system. This also creates poor outcomes for members, particularly where they are locked into subscale, low performing funds.

Reforms to the default superannuation system to enhance competition are vital to ensure no customer is locked into a fund that doesn't meet their needs.

3.2 Outsourcing and related party transactions

The Commission is correct to be cautious in relying on existing disclosures regarding outsourced service provider arrangements.

Outsourcing

As the Commission notes, a common feature of most superannuation funds is the outsourcing model, where a trustee with primary responsibility for the management of retirement savings oversees a network of outsourced functions. These functions generally include funds management, insurance, financial advice, custodian services, administration and other matters. Outsourcing occurs to both related and non-related parties.

A recent trend towards insourcing, however, has expanded the responsibility of trustee boards. The insourcing a range of funds management activities at superannuation funds, for example has resulted in boards becoming directly responsible for the management of specialist fund managers.

Outsourcing to related parties

The study by Liu and Ooi[5] quoted by the Commission on p300 indicates that retail funds outsource to related parties more often than industry funds, and contends that vertical integration leads only to poor outcomes for members (for example through payment of higher fees to related parties).

However, the report selectively includes some outsourced functions; namely administration, asset consulting, custodian services, insurance services and auditing; but not others; such as investment management, marketing, research, lobbying, government relations and insurance broking provided by industry fund affiliated parties.

Ultimately this report suffers from the same lack of consistent definitions and reporting as APRA's data, and is unable to provide a complete and balanced picture of the use of outsourcing and related parties across the industry.

The FSC's Standard 20 seeks to provide a robust and workable framework to deal with and manage these issues at the RSE Board level, with the goal of ensuring that all outcomes are in the best interests of members.

[5] sponsored by Industry Super Australia

The definition of “affiliated” in the Liu and Ooi paper also appears to be quite broad – it seems to encompass any director who is also on a related party board, regardless of whether one entity provides a service to the other. However, this contention misses the point that such a director may sensibly be treated as an independent director if there is no direct service relationship.

Under Standard 20, provided the "no conflicts" rule is satisfied, an independent director of say a sibling entity may be characterised as an independent director of an RSE licensee. We suspect this is why the report contends that a high proportion of directors in the retail sector are affiliated.

The FSC also supports the intent of APRA’s proposed reforms to improve expense reporting, and has committed to working with APRA to develop a workable methodology for consistent reporting across the industry.

3.3 Economies of scale

We are unsurprised that the Commission has found that significant economies of scale in the system have been realised through mergers of smaller sub scale funds. The FSC has long advocated for policies that encourage smaller funds to consolidate or exit the market, as noted in section 2.1.

However, as the Commission notes, it is more complex to determine whether benefits from economies of scale are being passed through to customers in larger funds. Economies of scale do exist, however it is not always clear if these economies are benefiting members.

The Commission has identified several factors that may offset the cost reductions expected if economies of scale are being realised in the system. We are pleased the Commission has noted the significant investments in technology and system upgrades that have taken place over recent years, including the transition to SuperStream.

While these reforms will undoubtedly provide significant benefits to members and improve the operation and governance of the superannuation system, FSC members report implementation costs in the tens of millions of dollars to embed new systems and processes.

Other investments made by funds that ultimately benefit members should also be considered by the commission, particularly where high upfront costs can be attributed to changes that will ultimately benefit members over the long term.

The FSC looks forward to the Commission’s further analysis in this area.

4. PERFORMANCE AND FEES

The Commission has collected a wide range of data to assess the performance of the superannuation industry as a whole, as well as various segments of the industry (largely contained in Chapters 2 and 3 of the draft report and Technical Supplement 4 (or TS4)). An important part of this analysis is the comparison of performance of the relevant part of the industry against benchmarks that are tailored to the asset allocation of the relevant industry segment. This tailored benchmark is an innovative and admirable approach that should address concerns that performance differences between segments are affected by asset allocations and should enable better analysis of member outcomes.

However, the FSC has concerns about the Commission's data that limit the ability for this analysis to succeed in practice. These concerns about benchmarking and data consistency are particularly important if data on performance and fees are used to determine the funds to be listed in a super default (such as the Commission's proposed top 10 best in show model – see Section 5.1 below and FSC's supplementary submission).

The Commission has requested feedback on how to address concerns with the data and conclusions reached (see information request 2.1 and various requests in Technical Supplements). However, in general terms, the FSC is not aware of alternative data sources or approaches that will address many of the problems raised; as a result the FSC considers the Commission should be more cautious in its findings. Nevertheless, if the problems can be addressed, the Commission may wish to consider expanding the benchmarking approach to cover other segmentations from a consumer perspective, such as analysis by account balance, gender and age (and multiple segmentations simultaneously).

4.1 Data concerns

The FSC's concerns with the data relating to performance and fees include the following:

- The SuperRatings data on performance/returns are calculated net of investment fees, tax and implicit asset-based administration fees. Explicit fees such as fixed dollar administration fees, exit fees, contribution fees and switching fees are excluded (see TS4 at page 11). This means the SuperRatings performance data does not provide a genuine measure of net return. In addition, this makes it difficult to compare the performance data from SuperRatings, APRA and the Commission's own survey.
- The regulatory environment for super has changed substantially over the longer periods used in the Commission's draft report (10 years or 12 years). This changing environment has had numerous interacting effects, at times increasing costs, and at times reducing them, meaning analysing returns over longer timeframes necessarily involves a degree of approximation which reduces the degree of confidence that can be placed in the numbers.
- For some analysis, the Commission has 'spliced together' data from the MySuper era with data from before MySuper. This approach is problematic when this analysis includes non-investment fees; in many cases funds had substantially higher non-investment fees (and lower net returns) before MySuper.
    - This is a particular issue with lifecycle products; there are very few lifecycle products that have 10 year returns, so it is quite likely that the 10 year returns reported by the Commission use the returns of product from before MySuper that are quite unrepresentative of the MySuper lifecycle products (for example having higher fees).
- In relation to benchmarking, the Commission makes assumptions about currency hedging ratios based upon surveys of super funds (see TS4 at page 19); these assumptions have substantial effect on the benchmarks and so any uncertainty in the assumptions causes similar uncertainty about the results. The Commission also made imputations about investments in infrastructure (TS4 at page 24) that affect the results.
- Some of the Commission's analysis includes legacy products (APRA data and some product level data). While a standalone analysis of legacy products is appropriate, these products should not be

included with current retail products as this makes the analysis misleading. In particular, it does not represent the performance outcomes for new members to the relevant fund or to the super system as a whole.

- The products with the highest level of member choice are wraps which are more in the nature of an administration and tax service for self-directed individuals, and master trusts (which offer a range of choice options). It is not valid to compare these choice products with MySuper products as they are at nearly opposite ends of the super option spectrum. Instead these products are most similar to SMSFs, and so comparisons should be made between these choice products and SMSFs.
  - The investments of MySuper products are largely determined by the fund while the investments of wraps are largely determined by the fund member. It is not particularly valid to compare the investment performance of a CIO at a large super fund with the investment performance of a fund member in a wrap.
- Similarly, it may be valid to compare the simplest, or vanilla, choice products (that are composite or diversified portfolios) to MySuper products, but these choice products have little in common with wraps and the Commission should (generally) refrain from comparing vanilla choice and wraps.
- It is unclear whether the Commission has excluded Eligible Rollover Funds (ERFs) from all analysis relating to choice or retail funds.6 Including ERFs with choice or retail funds in any analysis is not appropriate as ERFs are a distinct group of funds with totally different goals than non ERFs. Other funds operate to boost retirement incomes (subject to risk profiles), while ERFs operate to reunite super funds with lost members. The fee structure of ERFs is different, the asset allocation is different (noting the Commission's attempts to correct for asset allocation), and the returns are different.

Asset allocation

The data on asset allocation is critical to the Commission's analysis of the performance of the whole industry, segments of the industry, or individual funds, because the Commission often compares the performance of the industry, segments or funds against benchmarks tailored to the asset allocations for the relevant part of the industry.[7] However, there are a number of concerns about this data:

- The Commission has an admirable goal of comparing funds against a benchmark that corrects for asset allocation. However, the APRA data does not have asset allocation data at a fund level before 2014 so the analysis based on APRA data uses an estimate based on asset allocations of default options. This estimate (broadly) requires the mix of growth vs defensive assets to be similar before and after 2014, but we understand this assumption does not hold for some funds, and the difference is significant.
- We understand the Commission's analysis generally uses the definitions of 'growth' or 'defensive' assets as supplied by super funds; however there are differing views on whether particular assets are growth or defensive, with no standard definition used across the industry (see page 104), meaning the terms are very likely used inconsistently.[8]

[6] For example, ERFs are clearly excluded in Figure 2.3 but it is not clear if they have been excluded in Figure 2.4.
[7] For example, the performance of growth, balanced and stable options are compared against benchmarks that are tailored to the asset allocations of each of these options, see Figure 2.4. The performance of individual funds is compared against a tailored benchmark, see Figure 2.9.
[8] As examples of the classification of risky assets as being (partly) defensive, HostPlus Balanced states it allocates 24% of assets to defensive, which includes 9% property, 4% infrastructure, as well as alternatives and credit. Property has returned low double digit returns over the past 3 years while traditional fixed income low single digit returns. Source: https://pds.hostplus.com.au/5-how-we-invest-your-money#a38cce86-7cbc-44f4-b220-b8f6bfd29656

- In one part of the report (TS4, footnote 8) the Commission has defined defensive assets as cash and fixed interest, while all other asset classes are considered to be growth. This is a broad definition of growth (and narrow definition of defensive) that does not accord with common usage.

- At a broader level, no asset allocation adjustment can completely address the broadly-distributed nature of the fund-level allocations and returns. In a simulation, the Commission argues that asset allocation has a minor effect on returns – an increase in allocation to growth assets from zero to 100% would boost average/expected returns by only 59 basis points (see Figure 4.7 of TS4). However, the implication of this result – allocation to growth assets does not boost returns by much – is not consistent with other parts of the draft report, for example:[9]
  - The Commission argues lifecycle funds would obtain much higher returns from greater exposure to growth assets (Section 4.3 of the draft report).
  - The difference in actual returns between secure and high growth funds over the period 2005 to 2016 looks to be about 200 basis points (Figure 2.4 of the draft report).
  - Over a shorter timeframe, 2012 to 2016, the difference in actual returns between secure and high growth funds appears to be much larger – around 500 basis points (Figure 4.9 of TS4).

We also note the Commission does not compare MySuper performance against a benchmark tailored to the relevant MySuper product (see p118). This means the MySuper comparisons face all the problems that the benchmarks were meant to correct for – including differences in asset allocation and different risk profiles.

Fees

In relation to fees, the Commission argues (page 151) the data quality is 'poor', which makes analysis of this data on fees 'heavily compromised', at least for comparisons across segments and across time (which are many of the comparisons made by the Commission). The FSC considers this to be a reasonable conclusion, but queries whether these concerns mean it is appropriate for the Commission to reach firm conclusions, let alone tentative conclusions, in relation to fees (including any analysis of the relationship between fees and net performance). The draft report's weighty, and legitimate, criticism of the fee data stands in contrast to the remainder of the report's commentary on fees which is frequently definitive, failing to state levels of uncertainty.

In addition to this overall concern about the Commission's findings on fees, the FSC notes several other concerns:

- The advertised fees, and potentially the fees included in commercial data, do not always reflect the actual fees charged to fund members. This particularly affects retail funds, with many FSC members providing fee discounts off the 'rack rate'. The Commission discusses this issue in TS5 on pages 8-9, arguing that advertised rates are still useful because they "provide a consistent basis on which to assess fee trends". This conclusion is debatable, as the discounts can change over time.
- The fee data can also include trailing commissions which do not apply to new members or new products.

Also Cbus classifies infrastructure and property as 50/50 defensive/growth within their MySuper Cbus Growth product. Source: https://www.cbussuper.com.au/super/my-investment-options#investop
Note that Morningstar classifies both of these products as higher growth than SuperRatings (i.e. Morningstar appears to reclassify some of the supposedly defensive assets as growth/risky assets).

[9] The argument that asset allocation does not make much of a difference is also contrary to research including Gary Brinson, Randolph Hood & Gilbert Beebower (1986) "Determinants of Portfolio Performance" *Financial Analysts Journal*, pp39–44; and Roger Ibbotson and Paul Kaplan (2000) "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?" *Financial Analysts Journal*, pp 26–33.

- As the Commission notes, there are significant gaps in the reporting of fund level fees; this issue may be addressed with the implementation of RG97 which requires funds to report on all fees and costs on a look-through basis (see Box 3.2). The comparability of fee data before this issue is addressed is questionable.
- We understand other submissions to the Commission will argue against the conclusion reached in the draft report that higher fees are associated with lower net returns. Given this, the FSC considers the Commission should be cautious about maintaining this conclusion.

While noting these gaps and anomalies in the data, we share the Commission's underlying goal to have consistent metrics that permit genuine comparisons between funds and provide sound guidance to consumers. Development of such metrics will be critical to the success of key structural reforms being proposed by the Commission, including a "default once" model and elevated MySuper standards. The FSC is committed to playing a constructive role in this process and working with industry to improve data standards where required.

FSC recommendation 3

Pending development of improved data relating to superannuation performance and fees, the Commission be more cautious about its findings on these issues.

4.2 International comparisons of fees

The Commission's draft report compares the superannuation fees in Australia with the fees in comparable systems overseas using OECD data (Figure 3.1). However, this comparison is misleading. First, as indicated in Section 4.1 above, the Commission acknowledges Australian fee data is of poor quality. The OECD acknowledges the same problem as they rely on data provided by respective governments which, in turn, rely on the inconsistent data collected from the pension industry in each country. If the Commission considers the OECD data is of higher quality than Australian data, then we consider the Commission should explain this conclusion. Given there are significant problems with the data, then it is questionable whether international comparisons are appropriate.

Second, the comparison of fees is largely irrelevant if net returns (after fees) are high. If fees are somewhat higher than in other countries, but net returns are also higher, then this should be seen as a good result. However, an international comparison of fees alone would incorrectly reach the opposite conclusion. In fact, the net returns after fees for Australia compare well in the OECD data — for the five and 10 year periods to 2017, net returns after inflation were in the top third of the countries covered.[10]

Third, fees are affected by a broad range of factors which vary significantly across jurisdictions, including:

- benefit design (defined benefit vs defined contribution);
- investment strategy, and in some jurisdictions investment restrictions;
- the regulatory environment; and
- whether products and services such as life insurance and financial planning are embedded.

Fourth, the Financial System Inquiry (FSI) stated the following [emphasis added]:[11]

> *Submissions challenge the observation that operating costs and fees appear high by international standards. They argue that the different features and structures of pension systems globally make comparisons difficult. A Deloitte Access Economics report, commissioned by the Financial Services Council, argues "… fees can be driven by a number of factors, and may not be directly comparable across jurisdictions". **The Inquiry accepts many of these arguments***

[10] Table 1 of Excel sheets for OECD Pension Markets in Focus No.14, 2017. However, this data may be affected by some of the issues facing the OECD fees data.

[11] http://fsi.gov.au/publications/final-report/chapter-2/improving-efficiency/

> *and acknowledges that some unique features of the Australian system contribute to elevated costs and therefore higher fees.*

Given this, the FSC considers the Commission should provide further argument as to why international comparisons are valid given the FSI's acceptance that these comparisons are problematic.

Fifth, various reforms are in train that are may result in substantial declines in fees, including the cap on low balance fees and the ban on exit fees. International comparisons of historical fees are potentially misleading in this context.

FSC recommendation 4

Pending development of improved internationally comparable data relating to superannuation performance and fees, the Commission be more cautious about its findings about how Australia's system compares internationally.

4.3 Data collection relating to performance and fees

The FSC commends the Commission's ambitious approach to the collection and analysis of data to inform performance benchmarking. Since the release of the draft report, the FSC and our members appreciate the Commission's willingness to work with industry to improve the quality of the collected data. This discussion has particularly focused on data on fund performance by asset class at the super fund level.

While FSC members generally do have data on performance of investment options, and overall fund performance, many larger funds do not have data on performance *at an asset class level* across an entire fund. Some FSC members provide a large number of investment options, with numerous different contractual arrangements with fund managers for the different options (see discussion on fund choice/options in section 1.2). Some fund structures such as wraps provide extensive choice to investors, similar to an SMSF, and the fund may not have visibility of the performance of each asset class held by investors through the wrap products. It would take considerable time to change systems to collect and report this data – something that could be considered by the Commission's proposed superannuation data working group (draft recommendation 22).

In addition, some FSC members have had major systems and design changes over the past decade, including the transfer of fund members from a previous fund or system to new or merged arrangements. The data from the old system is difficult to retrieve.

We thank the Commission for meeting with FSC members after the release of the draft report to arrive at a common understanding of what is possible for funds to provide while being useful for the Commission's purposes. Several funds have agreed to provide the Commission with asset level performance figures for agreed investment products/options, which may include the default investment option.

We note that this data for the agreed option(s) is unlikely to be representative of the performance of the relevant funds as a whole. Therefore the FSC considers this data while it may act as a base for future development, will be unlikely to provide a strong basis for conducting fund-level comparisons or international comparisons (noting the concerns with fund and international comparisons raised earlier in this submission).

FSC recommendation 5

The Commission does not use data on asset level performance at the level of selected investment options to infer the performance of the remainder of the relevant fund, to conduct comparisons of funds or to conduct international comparisons.

Comparison with response to governance survey

The Commission's governance survey asked the following question: "My Board regularly assesses and fully understands the attribution of our investment performance outcomes, including by asset class" (question 20Ai). In response, 85% of fund CEOs answered agree or strongly agree (representing 90% of assets and 92% of member accounts).

The FSC considers this response is not inconsistent with the inability of funds to provide performance data at an asset class level across an entire fund (see discussion in previous section). The FSC's members indicate they analyse investment performance outcomes of individual options, including by asset class, and this is how they responded to the governance survey. The survey did not explicitly ask about performance by asset class at a fund level, and FSC members (broadly) did not interpret the question this way.

In addition, as discussed in Section 1.1 above, there are several products such as wrap products that provide fund members with a great deal of choice over investments. FSC members did not interpret the governance question referring to analysis at asset class level to apply to wraps.

FSC Recommendation 6

The Commission should not interpret the inability of some funds to provide performance data at an asset class level as an indication of misstatements in governance survey responses.

4.4 Lifecycle products

The draft report suggests that life-cycle funds are better suited to the choice environment rather than to the default environment (in particular draft finding 4.3).

However, we strongly believe life-cycle funds possess features that are well suited for the default environment. Trustees have a fiduciary duty to act in the 'best interests' of fund members. They are well positioned to exercise discretion relating to the default investment option for the benefits of members.

Specifically, the automatic de-risking feature within a life-cycle fund represents a 'whole-of-adult life' investment approach that seeks to maximise retirement balances by automatically managing sequencing and retirement risks within a default framework. This should align with a trustee's fiduciary duty.

It is also our strong view that lifecycle products align with the stated purpose of superannuation: to provide income in retirement to substitute or supplement the Age Pension.

We acknowledge that the Commission's draft report has raised several important issues regarding life-cycle funds. The reasons provided by the Commission for its suggested findings include (see Section 4.3 of the draft report):

1. There is the possibility of foregone returns due to excessive de-risking in lifecycle options;
2. They are harder to regulate and compare; and
3. They do not sufficiently reflect member circumstances — that is, they are not smart enough.

Potential for Foregone Returns

The Commission proposes the finding that the inclusion in MySuper of life-cycle funds is questionable given the foregone returns they pose to many members' balances (draft finding 4.3).

Life-cycle options generally seek to generate higher returns early in the accumulation phase by taking more risk than balanced funds and gradually adopt a more conservative stance closer to retirement by taking less risk and increasingly prioritising capital preservation. The objective of life cycle options is geared towards addressing short term market volatility for older members, and taking full advantage of long term growth prospects for younger ones.

However, the performance shortfall for life-cycle funds identified by the Commission can be easily addressed by some simple adjustments to the portfolio construction parameters: for example, changing the shape of the de-risking glidepath, increasing the proportion of growth assets in earlier years, delaying the de-risking, or changing the composition of the asset class mix. The 'whole of adult life' approach of life-cycle funds permits easier calibration of the portfolio construction parameters to achieve improved outcomes.

The Commission models the performance of a lifecycle product that holds balanced growth allocations until 5 years before retirement, when it immediately de-risks to 100% low risk portfolio (see technical supplement 6 in section 6.3). Unsurprisingly, this hypothetical product performs poorly — but this is a product that is completely unrepresentative of the lifecycle products that are actually in use (let alone products that are likely to be in use in the future with ongoing product improvements). The Commission is modelling and criticising a lifecycle policy that does not reflect products in use.

Sequencing risks

The draft report considers "as members are enrolled by default into life-cycle options by default, the extent to which their preferred risk/return trade-off is met is a lottery dependent on the MySuper life-cycle product their employer chooses for them. The consequences of those employer decisions are fundamental to their employees' retirement balances and sequencing risks." (page 193).

In fact, all default products (whether lifecycle or not) entail a 'lottery' as to whether the product meets the risk/return trade off preferred by the fund member. Risk and return trade-offs, whether for static options or for life-cycle options, are dependent on the product that the fund provides and the employer chooses (the default system is considered in section 5). So this criticism could equally apply to all default products; and it is unclear why the Commission has singled out lifecycle products in this section.

Life-cycle funds are characterised by an automatic de-risking feature embedded in their product design. This reflects academic evidence and accepted investment practice that members risk appetite diminishes as their age increases. [12]

Although a young dis-engaged default member may be considered to have an ambivalent attitude toward risk, this attitude can reasonably be expected to change over time as the accumulated retirement balance increases in value. Life-cycle funds capture these changing risk preferences over time by automatically moving their members into different cohorts over time, thus providing the 'whole of adult life' perspective to calculate representative member balances at retirement. This is an important governance benefit to trustees because it facilitates measurement of how well a default option is meeting the needs of members.

We consider the benefits that life-cycle funds provide by managing sequencing risk for members have not been adequately addressed by the draft report. The draft report presents the view that since the probability that a member's retirement balance is severely impacted by market events close to

[12] ***Yao, R., Sharpe, D.L., & Wang, F. (2011). Decomposing the age effect on risk tolerance. Journal of Socio-Economics, 40(6), 879-887.*** *Results of this study discussed how increasing age is correlated to a reduction in the willingness to take financial risks.*

[12] ***Holt, J., Morningstar Target-Date Fund Landscape. 2017. p.22.*** *Studies by Morningstar reveal that simplistic performance comparisons can be misleading. While the average static fund outperforms the average target-date fund based on performance league table surveys, once money-weighted investor cash-flows are incorporated in the calculation, target-date funds outperformed static funds. This suggests that investor 'greed and fear' behaviour can corrupt financial outcomes in a static fund environment.*

[12] ***Ryack, K.N., Kraten, M., Sheikh, A. 2016. Incorporating Financial Risk Tolerance Research into the Financial Planning Process. Journal of Financial Planning 29 (10): 54–61.*** *https://www.onefpa.org/journal/Pages/OCT16-Incorporating-Financial-Risk-Tolerance-Research-into-the-Financial-Planning-Process.aspx. This US financial planning article attests to academic and practitioner acceptance that financial risk tolerance should decrease with age.*

retirement is low a better return outcome could be attained maintaining a static 70/30 growth allocation relative to a life-cycle's de-risking. Two issues arise from this singular interpretation:

First, while probabilities may be low, because the severity of the risk event can be extreme this should be risk managed.

Second, the appropriate perspective to a default member is not a comparison between a static fund and a life-cycle fund but the financial impact to that member before and after the risk event. Hence, if a member was unfortunate in encountering market events a year after the GFC, for a representative 70/30 portfolio they would have experienced a return of around -21%[13] for the 12 months ended 31 Dec 2008. Assuming the member's retirement balance was $500k before the GFC, it would have cost the member $105k, an amount that could provide for an additional 2.5 years of retirement income (assuming $42k p.a.). A capital preservation bias to the portfolio would have minimised the detrimental impact of this market risk event.

Minimising sequencing risk is the key differentiator for Lifecycle products - and critical for disengaged members nearing retirement. Over the past nine years, equity market returns have been solid and investment strategies with a preference to growth assets have performed well. If there was certainty this market performance will continue, we would advocate a high growth asset strategy for all members, but the reality is, that markets go through cycles. It is widely accepted that markets go up and go down across the economic cycle.

The low probability high financial risk impact of market risk events are automatically catered for within life-cycle funds. A member invested in a representative life-cycle default that de-risked to life-cycle option invested 40% in growth assets with a capital preservation bias would only have experienced an indicative return somewhere in the vicinity of -3%, costing $15k, a much lower decline than the portfolio that did not de-risk. So irrespective of the probability of extreme market calamities, the severity of the financial impact to each of these members is significantly different.

We understand other submissions on the Commission's draft report provide more detailed calculations and simulations showing how well designed lifecycle funds provide important improvements in risk/return trade offs.

Regulation and comparison of lifecycle products

We recognise that life cycle options can present some challenges to regulators and consumers when making direct product comparisons. For example, for life-cycle funds there is significant variation in the shape of the de-risking glidepath and the number of decade/yearly options available to members.

We acknowledge the aim of the MySuper legislation is to provide a list of complying default funds that are easily comparable, relatively simple to understand, and focus on net costs and returns. [14] A MySuper default fund is one which complies with a regulated set of features:

- Single investment option.
- Minimum level of insurance cover.
- Easily comparable fee structure with a prescribed list of allowable fee types.
- Restrictions on how advice is paid and provided.
- Clear and transparent fund governance.

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[13] Chant West survey of MySuper Growth Funds with "Growth" defined as a diversified fund between 60 and 80% growth assets

[14] The ***Treasury Department's (19 March 2013),*** ***"Stronger Super"*** *R*etrieved 26 June 2018, opening statement describes this as, "MySuper is a new, simple and cost-effective superannuation product…"

Life cycle investment options comply with these aims and features. However, the defining characteristics regulating MySuper default funds fail to mention performance or member objectives that would facilitate comparability.

The rules governing fund governance and transparency currently do not measure and report on the likelihood of achieving members' retirement goals.

Therefore, we support further consultation on a regulatory reporting framework to identify the most appropriate member objective to facilitate fund comparison across different MySuper product types such as static and life-cycle funds.

Factors taken into consideration by lifecycle options

Age based life-cycle options are a significant innovation despite the fact that most do not take into account the broadest number of member circumstances. Life-cycle options could become more sophisticated as better member data is collected. If funds made more use of data to increase tailoring of lifecycle products, this would be consistent with funds addressing the Commission's finding 4.5: "Superannuation funds make insufficient use of their own (or imputed) data to develop and price products".

Academic studies examining risk tolerances have introduced a multitude of member circumstances that have a bearing on risk profiling. Aside from the main determinant of age, such factors as: gender, household income/balance, marital status, education, occupational grouping and race are also relevant.[15]

There are good arguments for funds to incorporate any and all available information in determining the glidepath. This will incur some administration costs, but these costs will likely decline with increasing fund scale and as setup costs are amortised. Funds may need to undertake further research into the relevance of factors for the breadth of their membership demographic.

Given the above discussion, the FSC considers life cycle funds should remain a permitted MySuper default product, if trustees believe the products provide appropriate outcomes for their members. A well-constructed life-cycle product is consistent with a 'whole-of-adult working life' approach to maximising retirement balances. The design benefits of automatic de-risking provide a transparent and administratively simple way for members to manage, accumulate, and drawdown retirement savings. Importantly, members are relieved of the burden of optimising the trade-off between risk and return where these decisions can often be swayed by shorter-term shifts in market sentiment or investor behaviour.

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[15] ***Grable, J.E., Mcgill, S., Britt, S. (2009). Risk tolerance estimation bias: The age effect. Journal of Business and Economics Research, Vol.7, No.7, 1-12.*** *This study analysed these factors as subsets to age with age being the implied dominant risk factor. The findings suggests relying solely on member based surveys may result in survey bias because risk tolerance was over-estimated amongst the young, the more highly educated, in men compared to women, in certain racial groups, the more financially well-off and amongst self-employed, while the married, and those older tended to under-estimate their risk tolerance.*

[15] ***Ryack, K.N., Kraten, M., Sheikh, A. 2016. Incorporating Financial Risk Tolerance Research into the Financial Planning Process. Journal of Financial Planning 29 (10): 54–61.*** *https://www.onefpa.org/journal/Pages/OCT16-Incorporating-Financial-Risk-Tolerance-Research-into-the-Financial-Planning-Process.aspx. This US financial planning article discusses the positive relationship between increasing risk tolerance and increasing wealth and income. This result contrasts with the opposite approach taken in Australia by one MySuper participant, which uses a member-based survey approach to group life-cycle members with larger balances into more conservative risk profiles. The pivotal factor may well be how narrow the surveyed default member demographic is. It also introduces the problem of how the aggregate member circumstances may change over time which would have unintended consequences.*

FSC recommendation 7

Lifecycle products should continue to be eligible for MySuper default status, and not be confined solely to the choice segment, particularly given their ability to improve the risk/return trade-off over the whole accumulation period. The Commission should acknowledge lifecycle products could be improved over time, particularly through tailoring products to cater to a broader range of member characteristics.

5. ALTERNATIVE DEFAULT MODELS

5.1 Top 10 'Best in Show' proposal

The FSC commends the work done by the commission to propose a new default model for superannuation.

The "best in show" proposal is a revolutionary departure from the current system, and if implemented it would have significant impacts on the industry which we are still working to fully understand.

While we support the removal of superannuation from the industrial relations system and a 'default once' mechanism, we believe more work is required to understand the potential practical impacts of the introduction of a top 10 list of funds.

In particular, we believe the Commission should further consider issues including:

- the potential long-term impact of concentrating a large proportion of contributions in up to 10 funds;
- the impact on member engagement for those outside the top 10 list;
- how best to undertake system-level reforms to minimise poor outcomes relating to potentially major disruption.

The FSC has commissioned additional analysis on the "best in show" proposal and will provide a supplementary submission to discuss the Commission's proposal to replace the current superannuation default scheme with a top 10 'best in show' model.

5.2 Elevating the MySuper authorisation process

The FSC agrees with the Commission that elevating the threshold for MySuper authorisation should be central to reforming the default system.

Raising the bar for MySuper through an improved member outcomes test would ensure that the quality of all MySuper products in the market would increase over time. This would ensure disengaged consumers in a "default once" environment are protected because all default products in the market should provide a high quality outcome.

It would also complement APRA's prudential role and priorities, as a more stringent MySuper authorisation process could drive industry consolidation through the merger of underperforming funds.

Reducing the number of MySuper products, while increasing the baseline for their quality, could effectively create a "best in show" list of high performing default funds without the need for an additional selection panel process.

5.3 National Default Fund (Future Fund Default)

In Box 12.7 of the draft report, the Commission provides a useful critique of proposals for a National Default Fund (or NDF), which would be a government sponsored monopoly fund for all default super contributions. The NDF proposal is often taken to mean the expansion of the Future Fund to take on role as the NDF, rather than the establishment of a new government body to take on the NDF role. There are variants on this proposal which are discussed in Sections 5.4 and 5.5 of this submission below.

While the Commission argues a monopoly NDF is strictly outside its terms of reference, the FSC recommends the Commission expand on the analysis in its draft report, given the ongoing interest in the NDF proposal and persistence of arguments in favour of the NDF. We recommend the Commission provide further analysis of the following issues:

- The Commission credibly argues that the NDF may have a perceived government guarantee (see Box 12.7).16 The FSC recommends the Commission extend its analysis of guarantees (perceived and actual) for similar government funds in other jurisdictions,17 and also analyse why this argument doesn't apply to other Australian super funds (that is, address the argument that all large Australian super funds have a perceived government guarantee at the moment, and the NDF would be no different).18
- The possible investment strategies of the NDF. If the NDF has a perceived government guarantee, this suggests the NDF will be particularly cautious and conservative, resulting in lower long-term returns. As the NDF would also likely be fairly large, a cautious investment strategy will affect financial markets, possibly reducing demand for unlisted assets, equities (including venture capital) and property, while boosting demand for bonds. A cautious investment approach for the NDF would also mean lower retirement balances and higher reliance on the Age Pension.
- Potential political interference in the NDF, including through directing its investments. The Commission could usefully build on the analysis in the draft report in Box 12.7.
- Whether the economies of scale achieved by the NDF would be materially greater than the economies achieved by the larger funds in the current system, particularly as the system matures and smaller funds exit.
- The potential net returns of the NDF if it had been run by the Future Fund. Some argue the strong returns of the Future Fund means that the NDF, if it were run by the Future Fund, would similarly produce strong returns, possibly well above the return on most super funds. However, this argument is likely incorrect, as the NDF would have added costs of dealing with members, additional taxes, additional regulatory costs, and reduced certainty about cashflow compared to the Future Fund (meaning the NDF would have to invest in more liquid assets with lower returns). The investment strategy of the NDF is also likely be much more conservative than the Future Fund (given the implicit guarantee point above).
    - There would be substantial value in the Commission publishing an estimate of what the historical returns of the Future Fund would have been if it had been the NDF, after all the adjustments listed above.
- The absence of competitive pressure on the NDF to be efficient or maximise net returns. Various other models, including the Commission's top 10 best in show model, do provide this competitive pressure. The FSC's detailed comments on the top 10 best in show model will be provided in a second submission.
- The potential impact of the NDF on supplier markets — if the NDF becomes very large, its decisions will make or break suppliers, particularly life insurers (assuming the NDF provides insurance).
- It is unclear what the NDF would do for members who reach retirement.
    - If the NDF provided retirement products, there could easily be substantial political interference in the design and management of these products. There could be particular difficulty in the NDF designing CIPRs. The NDF retirement products may be poorly designed for individual circumstances and the NDF would have to become involved in financial advice which it may not do well.

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[16] Various commentators have argued the NDF should have a guarantee; this heightens the *perception* of a guarantee even if one is not explicit. See for example: http://www.afr.com/opinion/columnists/peter-costellos-future-fund-could-revolutionise-super-20171102-gzdyo1

[17] This would expand on previous analysis of other jurisdictions in the Productivity Commission's Draft report on Alternative Default Models at p64.

[18] As far as we are aware, the government faced no pressure for any sort of capital guarantee of superannuation during previous market downturns such as the GFC. This could easily be different under an NDF.

- If the NDF does not provide retirement products, will there be mandatory rollover into another provider? If the member refuses to rollover, will the funds remain at the NDF with no ability to withdraw?

FSC recommendation 8

The Commission expand its analysis of the National Default Fund proposal (also known as the Future Fund Default proposal) to include analysis of actual or perceived government guarantees in other jurisdictions; whether other large Australian funds have a perceived government guarantee; the possible investment strategies of the NDF; potential political interference in the NDF; the potential economies of scale of the NDF; the adjusted historical return of the Future Fund if it had been the NDF; the lack of competitive pressures on the NDF; the impact of the NDF on supplier markets; and how retirement would work for the NDF.

The FSC also recommends the Commission undertake an indicative analysis of the long-term impact of an NDF with cautious investment strategy on financial markets, investment allocations (including in venture capital), retirement incomes and the Budget.

The FSC has for some time advocated for the removal of superannuation defaults from the industrial relations system and the Fair Work Commission process. The NDF would achieve this outcome, but the FSC considers there are better ways of achieving this result, see section 5.2. While the removal of defaults from the industrial relations system will initially depoliticise the superannuation system, there are risks that the NDF itself will become politicised over time (as discussed above).

5.4 A government sponsored fund competing to be on the top 10 best in show list

In Section 12.6 of the draft report, the Commission discusses a model involving a government sponsored fund being established as a super fund that is permitted to compete to be on the top 10 'best in show' list. As the relevant fund would not be a monopoly under this proposal, it is not ruled out by the Commission's terms of reference.

Under this model, the government sponsored fund would have to compete on a level playing field, being subject to the same taxes and regulations as other funds, otherwise it would breach competitive neutrality principles.

While the Commission has included this model for completeness, it would raise many of the issues relating to an NDF that is the automatic default, and the analysis proposed in Section 5.3 above would apply (noting that the government sponsored fund under this model would likely be smaller scale than the monopoly default). In addition we note the following:

- It is unclear why it would or should be necessary to have a government sponsored body competing in a private sector market.
- If existing businesses are not operating efficiently in a particular market, then the addition of a government-sponsored competitor will not have a clear impact on this efficiency and could be detrimental. In many other markets, privatisation of government-owned businesses combined with increased competition have resulted in industries becoming more efficient. For Australia, a clear case is Telstra, where deregulation and privatisation together delivered a more efficient telecommunications market. The Commission would usefully identify other cases where government ownership in a market has not been conducive to good market outcomes.
- In almost all situations, the government has privatised businesses operating in markets with private sector participants, even when the markets are quite concentrated. This includes the privatisation of Qantas, Commonwealth Bank, and more recently Medibank Private. This proposal would run counter to this trend.
    - Similarly, it would be likely that the government sponsored fund under this proposal would be privatised at some stage, which raises the question of why introduce it in the first place?

FSC recommendation 9

The Commission provide a more in-depth analysis of the proposal involving a government sponsored fund competing for listing on the top 10 best in show list, building the analysis FSC recommends of the monopoly NDF model and any previous research by the Commission showing government ownership in a market has not been conducive to good outcomes.

5.5 The National Default Fund (NDF) as a last resort default

This variant would only apply the NDF to any new employees who fail to make a choice of fund, even with assistance offered by other interventions. The FSC recommends the Commission also provide analysis on this variant on the NDF proposal. This analysis would usefully build on the analysis on the main NDF proposal, as recommended earlier.

A similar variant of the NDF was discussed in the Productivity Commission's 2017 draft report into Alternative Default models (see p130ff), but that report focused on a last resort default that would actively encourage members to move to another fund. The Commission noted the impact of a last resort default on competition would be limited because it would only capture a small proportion of people who fail to make any choice (p135).

We also question the need to establish a last resort NDF if recommendations to elevate MySuper authorisation are implemented.

FSC recommendation 10

The Commission extend its previous analysis of the last resort default model, building on the analysis FSC recommends of the primary NDF model.

5.6 Employer-linked rollover

We are also aware of a proposal that would see default members and their balances move to a new super fund each time they change jobs or employers.

The FSC does not support the "employer-linked rollover" proposal, which in our view seems designed to entrench the employer centric nature of the superannuation system.

The FSC cannot identify a clear benefit for consumers in this model. While it does prevent the duplication of accounts, the Commission's "default once" proposal presents a far more efficient way of achieving the same outcome, without the potential poor consequences including potential crystallisation of losses at rollover.

The proposal would further fuel member disengagement by what could be a constant chopping and changing of the member into different funds based on their employment patterns. It is also not clear how this model would adapt to the changing nature of work, and the increasing likelihood that individuals have multiple employers or are operating in the gig economy.

More detailed commentary on this proposal will be included in the FSC's supplementary submission.

6. LIFE INSURANCE

6.1 Cancelling insurance for inactive accounts

The Commission has recommended the cancellation of insurance for all inactive superannuation accounts.

This recommendation is reflected in the Government's "Protecting Your Super" package currently before the parliament.

The proposal to cancel insurance for inactive accounts needs to strike a balance between the erosion of superannuation balances and the value provided by an active insurance policy. The FSC believes this balance could be better reached by cancelling Income Protection (IP) insurance for all accounts classified as inactive, but only cancelling death and TPD insurance for inactive accounts where the balance is below $6,000, as set out in the Insurance in Superannuation Voluntary Code of Practice (Trustee Code).

Despite best endeavours by trustees, communications might not reach the affected members, for example, if someone changes their contact details or is not reachable due to parental leave, career breaks or working/travelling overseas.

Some accounts become inactive due to deteriorating health, where members either cease employment or go on extended sick leave. A person with a long-term illness may not yet be eligible to make a Total and Permanent Disability (TPD) or death claim when their account becomes inactive. However, they are unlikely to be eligible to take out individually underwritten insurance for the very reason that they are more likely to make a claim.

If eligible, a person on long term sick leave would have made an IP claim by the time an account becomes inactive (that is within 13 months). However the time between being unable to work and being eligible to make a TPD or death claim could be much longer than 13 months. IP premiums are also generally higher than for death cover and TPD, so cancelling this IP will materially reduce account erosion.

We therefore recommend that Trustees should not cancel death and TPD insurance for inactive accounts unless the balance is below $6,000.

FSC Recommendation 11
Trustees should not cancel death and TPD insurance for inactive accounts unless the balance is below $6,000.

6.2 Insurance Balance Erosion Trade-Offs

There have been some concerns raised by the Commission in relation to the perceived balance erosion due to insurance premiums. The industry is of the view that these concerns are being sufficiently addressed through "Protecting Your Super" package which is being proposed by the Government and the increased industry obligations the Trustee Code has introduced.
The Trustee Code has introduced the requirement for Trustees to articulate their benefit design decisions and how members' best interests are being met in their Insurance Strategy.

6.3 Insurance Code to be a MySuper Condition

The FSC supports measures to encourage industry participants to adopt industry standards, and this is one way to do so. This could be strengthened by combining the Trustee Code and the FSC Life Insurance Code of Practice into a single binding Code with independent oversight.

FSC Recommendation 12

Combine the Trustee Code and the FSC Life Insurance Code of Practice into a single binding Code with independent oversight.

6.4 Insurance Code taskforce

The FSC Life Insurance Code of Practice is currently overseen by an independent Life Code Compliance Committee (LCCC), which is administered by FOS (soon to be AFCA). The LCCC is already tasked to monitor code adoption, compliance and provide guidance of further code development. As part of ongoing Code development, ASIC and APRA will continue to be consulted as key stakeholders on a regular basis.

Every three years, the FSC Life Insurance Code of Practice requires an independent reviewer to undertake an evaluation of the effectiveness of the Code and provide recommendations for improvements.

The FSC recommends extending the oversight of the independent LCCC to monitor the adoption, compliance and guidance of the Trustee Code. This would be done by combining the Trustee Code and the FSC Life Insurance Code of Practice into a single binding Code. The independent LCCC would then fulfil the role of the proposed Insurance Code taskforce, so a new separate body would not be needed.

FSC Recommendation 13

Extend the oversight of the independent Life Code Compliance Committee to monitor the adoption, compliance and guidance of the Trustee Code.

6.5 Independent review of insurance in superannuation

As the Commission notes, the life insurance industry is currently going through unprecedented change. These changes should be given time to become embedded, before an independent review is initiated.

Some of the recent and ongoing inquiries, initiatives and reviews are listed below:

- The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.
- Parliamentary Joint Committee Inquiry into the life insurance industry
- The proposed “Protecting Your Super” package – that is, opt-in for under 25s, cancellation of cover after 13 months and for low balance accounts.
- Introduction of the Trustee Code of Practice
- The FSC Life Insurance Code of Practice with independent oversight administered by FOS (to become AFCA)

FSC Recommendation 14

An independent review of insurance in superannuation should only be conducted once current reforms have been embedded into the system.